

# COMPETITION COMMITTEE



## Competition and Corporate Governance

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Competition Policy

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**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS  
COMPETITION COMMITTEE**

**COMPETITION AND CORPORATE GOVERNANCE**

*This document compiles documentation related to a hearing on Competition and Corporate Governance held in the Competition Committee meeting on 17 February 2010. It is circulated FOR INFORMATION.*

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## **COMPETITION AND CORPORATE GOVERNANCE**

The Competition Committee decided to hold occasional “hearings” on selected topics which might call for further input from Competition delegates to improve the dialogue in such areas where competition can be meaningful.

Experts on the selected topic are invited to present their views on what they believe are the important issues in this area, and particularly what issues might involve a significant competition element and would therefore deserve further consideration by the Committee.

The Competition Committee held a hearing on Competition and Corporate Governance on 17 February 2010 with the following experts:

Mr. Marcello Bianchi, chair of the OECD Steering Group on Corporate Governance;  
Professor Hugo Caneo, University of Chile;  
Professor Allan Fels, the Australian and New Zealand School of Government;  
Professor Daniel Sokol, University of Florida (US);  
Professor Spencer Weber Waller, Loyola University (US);  
Professor Yishay Yafeh, the Hebrew University.

This document compiles the documentation related to this Hearing.

## **LA CONCURRENCE ET LE GOUVERNANCE D'ENTREPRISE**

Le Comité de la Concurrence a décidé d'organiser des auditions (« hearings ») occasionnelles sur des sujets, susceptibles de générer des contributions ultérieures des délégués du Comité. L'objectif est d'améliorer le dialogue entre responsables publics dans des domaines où la concurrence peut être déterminante.

Des experts sont invités à présenter leurs points de vue sur les questions qu'ils jugent importantes dans le domaine traité, en particulier dans la mesure où elles comportent une dimension de concurrence significative, et, à ce titre, justifier une attention particulière du Comité à l'avenir.

Le Comité de la Concurrence a tenu une audition sur la Concurrence et le Gouvernement d'Entreprise le 17 février 2010 avec la participation des experts suivants :

Marcello Bianchi, Président du Groupe de direction de l'OCDE sur le gouvernement d'entreprise;  
Professeur Hugo Caneo, Université du Chili ;  
Professeur Allan Fels, École de Gouvernement d'Australie et de Nouvelle Zélande (ANZSOG) ;  
Professeur Daniel Sokol, Université de Floride (États-Unis) ;  
Professeur Spencer Weber Waller, Université Loyola (États-Unis) ;  
Professeur Yishay Yafeh, Université Hébraïque.

Ce document rassemble la documentation relative à cette audition.

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## SUMMARY OF DISCUSSION

*By the Secretariat*

The Chairman, Mr. Jenny, explained the purpose of the hearing discussion on the relationship between competition and corporate governance was to explore how corporate governance affects competition and firms incentives, to get a sense of the range of issues at stake and identify possible competition concerns which may call for further Committee work. This is an issue which has come up in many jurisdictions in relation to compliance programmes. It is also relevant in the context of the economic crisis, as a failure can be triggered in the market if incentives are not aligned for the long term and instead focus on short term goals.

The Chairman introduced the panellists who had been invited to contribute to the discussion: Marcello Bianchi, chair of the OECD Steering Group on Corporate Governance and Head of the Italian Regulation Impact Analysis Office, Economic Regulation Division (CONSOB); Prof. Hugo Caneo, University of Chile; Prof. Allan Fels, Dean of the ANZSOG (Australia); Prof. Daniel Sokol, University of Florida; Prof. Spencer Weber Waller, Loyola University Chicago (US); Prof. Yishay Yafeh, the Hebrew University.

At Mr. Jenny's invitation, Professor Spencer Weber Waller started the discussion with a presentation on the new learning on corporate governance and competition policy. In 1933 the publication of *The Modern Corporation and Private Property* by *Berle and Means* introduced the concept of division of ownership and control, as well as what modern commentators would call 'Agency Costs', in addition to arguing for more voting rights, disclosures and other controls for the benefit of owners, and advocating a broader social role for corporations.

During the Great Depression of the 1930's antitrust policy was not particularly robust, but by the 1950's the law shifted towards per se rules, presumptions against monopolisation and prohibition of significant mergers of any kind. The antitrust limitations during this era were far more significant than the corporate governance restraints of the same period<sup>1</sup>. However, during the 1960's and 1970's influential writers also emerged from the corporate governance side<sup>2</sup>, who urged the removal of restraints on takeovers to promote efficiency, prevent rent seeking and increase shareholder value. This coincided with the weakening of merger control and even calls within the Reagan administration for the abolition of Section 7 of the Clayton Act.

The historical rise and fall of antitrust and corporate governance concerns at different times have led to very rare interaction. Competition policy primarily concerns the relationship between corporations and other market actors regarding horizontal and vertical relationships and mergers and acquisitions. In contrast corporate governance primarily concerns the relationship between officers, directors and shareholders. The result is two relatively separate bodies of law, with at times competition policy strong

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<sup>1</sup> In his collection of essays *'The Corporation in Modern Society'* Edward Mason provides a snapshot of the concerns of its era (1960) including primarily the oligopoly status of key US corporations and economic and political corporate power more generally, with pure corporate governance concerns secondary.

<sup>2</sup> Henry Manne (*The Market for Corporate Control*) and influential later writings of Frank Easterbrook, Daniel Fischel.

and corporate governance weaker and vice versa. The US Clayton Act provisions on interlocking directors are the most directly relevant but least important link between the two disciplines. Corporate compliance is perhaps a more important link but another under-explored area.

At the beginning of the 21<sup>st</sup> century a growing body of both empirical and theoretical literature emerged questioning premises and results of the market for corporate control. This new learning on corporate governance encompassed behavioural law and economics, specifically (i) incentives and rewards for corporate decision makers, (ii) continued agency costs, (iii) CEO autonomy and hubris and (iv) biases towards mergers even when not value enhancing. In addition there is now a consideration of the need for continued antitrust presence in even pure markets for corporate control in order to deter collusive bidding and termination of auctions, and to limit antitrust immunities and over deference to securities regulators. There is also a growing body of literature indicating that not all mergers are created equally, with corporate finance literature suggesting many types of mergers destroy shareholder value. Mega-mergers (particularly stock for stock deals between relatively equal sized parties) are particularly suspect for value destroying tendencies, as are mergers dependent on poorly articulated synergies. There may also be different results for industrial versus financial or banking mergers with additional behavioural research showing when entry occurs and when it is effective.

There are, however, some opportunities for deeper interaction. On the corporate governance side this could be via (i) enhanced board duties in mega-mergers between equals, (ii) enhanced securities disclosure in the same categories, and (iii) intermediate standard of review in courts. On the competition side improved interaction could come through (i) increased attention to categories of deals which prove value destroying and a consideration of why (ii) better understanding of why synergies are not achieved, (iii) better understanding of why certain deals are value enhancing e.g. efficiencies, market power. The importance of behavioural economics should also be understood as providing insights into M&A activity; board and shareholder responses; post-merger culture combinations and clashes; insights into entry patterns (i.e. entry may be more prevalent but less effective than normally believed, brand positioning as alternative to entry may be virtually impossible). A renewed connection between the fields of corporate governance and competition is therefore possible, according to Prof. Waller, provided there is renewed attention to corporate finance literature and behavioural economics and increased investment in business theory generally to supplement economic expertise. The soft assumption that all mergers are efficient or competitively benign should be rejected and there needs to be a greater questioning of unsupported entry and efficiencies stories.

The chair then gave the floor to Professor Yafeh who discussed the role of Business Groups in the corporate environment. A Business Group (BG) consists of legally independent entities, operating across industries and bound together through formal and informal ties. BGs are often family owned with varying degrees of outside participation, and each BG may have a diverse scope of activity, control structure and level of interaction with government and society. Outside of the US and UK, BGs are ubiquitous and can be seen in Korea, Thailand, Malaysia, Brazil, Argentina, Mexico, India, Italy, Belgium, Sweden etc.

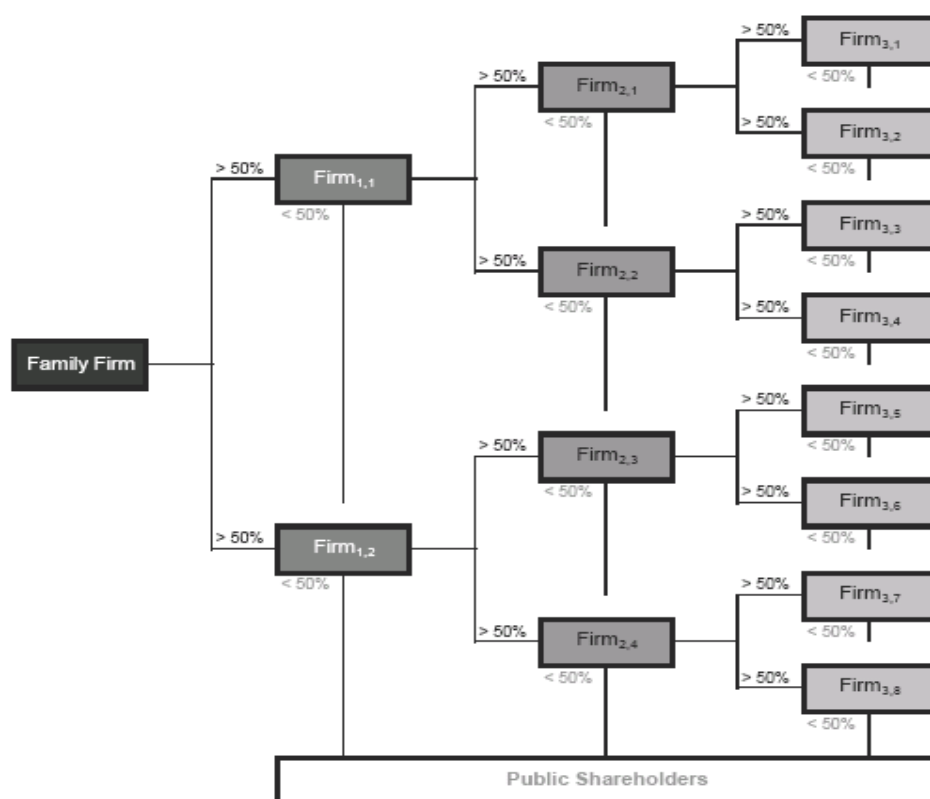
BGs are often vertically controlled pyramids with control rights in excess of cash flow rights in the hands of the controlling family. These pyramids can be used as a mechanism to expropriate minority shareholders, and 'tunnel' the profits to controlling shareholders, thus impairing financial development<sup>3</sup> (see Figure 1).

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<sup>3</sup> There had been a great deal of literature on tunnelling, notably following that of *La Porta, Lopez-de-Silanes, Shleifer and Vishny* (LLSV) in 2002.

**Figure 1. A Stylised Control Pyramid**

A family firm controls a first tier of firms with dominant voting stakes, in this case greater than fifty percent. Each first tier firm controls several second tier firms, each of which controls yet more firms. The overall effect is to extend the family's control to encompass assets worth substantially more than its actual wealth.



Pyramids and family control are frequently observed when investor protection is low<sup>4</sup>. There are a variety of reasons why minority shareholders accept control pyramid structures including (i) limited other options, (ii) the BG may have a reputation for bailouts, or for treating small investors fairly, (iii) in developing economies the tunnelling may constitute a return to a BG asset such as entrepreneurial or lobbying ability.

Performance in family firms in general, including BGs, tends to deteriorate with the transition to the second generation, as the inheritor is chosen because of blood ties and not necessarily because of his capabilities and skills. Larger BGs therefore involve significant risks associated with mismanagement in the second generation.

The origins of BGs are often related to the government, but over time on-going relations between BGs and governments can become more complex and less one sided. This is evidenced in the changing relations between the Japanese government and the zaibatsu groups from the 1880's to 1930's, and with the chaebol in Korea in the 1980s. The governmental links that BGs have mean they may be able to influence policy decisions through their contacts within the regulators. This can have positive effects, for example in

<sup>4</sup> There are a number of very convincing papers on expropriation of minority shareholders by BGs in India (*Bertrand et al*) and Korea (*Bae et al and Joh*), in addition to many others, including some from continental European countries.



Mexico where BGs there used their political influence to support free trade policy, and in India where BGs actively supported liberalisation. However this influence can be used for more nefarious reasons, for example opposition to corporate governance reforms in Korea, which can sometimes result in economic policy measures being taken to favour dominant BGs rather than social welfare. There are also examples of direct BG involvement in politics in Italy, Korea and Thailand and “entrenchment” in general, making it virtually impossible to dissolve established BGs.

The dangers associated with the ‘monopoly power’ of BGs have been highlighted in the theoretical academic literature. Specific concerns include the fact BGs facing each other in multiple industries may be prone to collusion; BGs with ‘deep pockets’ may use their financial clout to deter entry or use predation and BGs operating across industries may bundle or tie products. However empirical evidence on these claims is limited due to data constraints.

The overall welfare effects of BGs are hard to judge as BGs have multiple effects and the counterfactual of what would happen to an economy without BGs is unknown. In general, ‘good’ things that BGs do tend to happen in the early stages of economic development and ‘bad’ things tend to persist long afterwards. In particular, it is claimed that in underdeveloped economies, BGs can make up for missing institutions and therefore have positive effects on social welfare. For example, BGs may provide an internal capital market to allocate capital more effectively than an underdeveloped external financial system. This is partly the explanation for why some of these groups do well in emerging markets. By contrast, the ‘missing institutions’ argument is implausible in the case of economically and institutionally developed countries, where BGs can cause significant damage as outlined above. Policy makers should consider antitrust and other measures to limit this damage.

A delegate from Sweden confirmed that BGs do operate in Sweden, and are behind a number of multinational brands. BGs started in the 1930’s, and continued during WWII, with the most famous example being the Wallenberg family. During the 1950s and 1960s these BGs welded significant influence and are now in their 3<sup>rd</sup> or 4<sup>th</sup> generation and remain very strong. From a competition agency perspective they can become problematic where they lead to high concentration. Minority shareholders with very small holdings can still be very influential. Most Swedish companies are made up of A and B shares, with A shares having more voting rights attached. BGs have A shares, and the BGs lobbied in Brussels on order to keep these shares. Swedish BGs also own banks and private equity houses. Today BGs are not regarded as any more problematic from a competition view point as any other company and can be beneficial for the economy. Competition in the media market has been a problem, but a market investigation is being carried out in which the BGs relevant strength and position are being considered.

A delegate from Korea agreed with Professor Yafeh’s assessment of BGs and noted that the KTFC is trying to overcome a number of practical problems making the implementation of BG policies difficult.

Professor Yafeh agreed with the Swedish delegate that there are situations where family firms are successful through several generations, but eventually the ‘idiot son’ may come to power and it is not clear that minority shareholders and institutional investors would vote against this. He also agreed that BGs may, under certain circumstances, be advantageous for fostering innovation, and that using international trade as a disciplinary mechanism may be a good remedy. In terms of how to incorporate BGs into antitrust, the concept of overall economic concentration is no longer discussed in standard industrial organisation textbooks but when a group company A wishes to acquire company B, there may be additional measures to consider beside an industry-specific measure of concentration such as the Herfindahl index. BG involvement in finance can be particularly problematic and a separate regulatory tool may be required to restrict it.

The Chairman commented that the notion of control may be different, and countries may not necessarily use the same criteria.

A delegate from Israel stated that the competition authorities were interested in BGs and the general issue of concentration, but that foreign groups entering the market may allay any competition related concerns. It may be that ten or twenty companies have power, but if these groups are constantly changing, this is positive as it helps development. In order to prevent collective dominance in the market the Israeli competition authority suggested changes be made to the framework of oligopolies including the provision of instructions to companies in an oligopoly when competition challenges arise. The Israeli market is small, with different and specific markets. If a leading BG were to acquire a meaningful financial institution this could be problematic for competition as there could be issues related to credit issuing.

In response to a question about the definition of BGs, Professor Yafeh responded that BGs are entities where each firm within the group is a separate legal entity. A multi-divisional conglomerate such as General Electric is therefore not a BG., Within a BG such as Tata in India, for example, each firm is separate and shareholders can hold different equity stakes in different group companies, something that would not be possible in a US-style conglomerate. In response to another question, he agreed that the severity of succession problems in family firms (the 'idiot son') is a matter of size, and therefore family control of a large BG may be problematic. In response to a question about the 'optimal' level of concentration in a country like the US, he said that it is difficult to suggest a reasonable quantitative boundary. In the 1930s BGs operating in the US were deemed to be too big and powerful, and taxation was used to enhance the dissolution of pyramidal groups. This was also the case in post war Japan. The threshold for 'excessive concentration' varies across countries, but action must be taken before the BG becomes so large that regulators can no longer control it.

At the invitation of the Chair, Professor Caneo gave an overview of the Chilean market and a recent relevant case in the pharmaceutical industry. In Chile ownership of companies is very concentrated, and held by groups of companies that operate in different markets (finance, property etc) through subsidiaries and affiliates, all of them under one common controller. Therefore the agency problem is not one derived from a conflict of interest between who owns the company and who manages the company, but between the controller(s) of the company and the minority shareholders. Decisions of the board of directors are not usually adopted by the board of directors in a board meeting, but are imposed by the controllers. Some directors participate in more than ten companies' boards and therefore do not really know each organisation they manage or its risks, consequently its monitoring duties could be hardly fulfilled. They therefore accept without question the impositions from the controllers and other interested parties. Some companies that were historically family owned and then took the decision to go public are still managed without deferring to the new shareholders. Most directors focus their functions on short term results instead of a strategic vision of the company and its sustainability. In addition auditing firms opinions may be affected by their interest in obtaining additional incomes from the provision of other services. This became in other markets a real problem in the financial crisis, and it is clear directors should know the risk or likely exposure to failure and this knowledge should be passed onto lower levels of the organisation.

Professor Caneo described the FASA case, a pharmaceutical company founded in 1968. On 9 December 2008 FNE (Fiscalia Nacional Economica) filed a complaint before the TDLC (Tribunal de Defensa de la Libre Competencia) against FASA, Cruz Verde and SalcoBrand on the grounds that they were involved in price fixing. Negotiations took place between the antitrust agency and board of directors of FASA, but were not disclosed to directors or shareholders. In March 2009, under the termination agreement, FASA agreed to pay a fine and compensation to shareholders. As a consequence there was a strong public reaction against the members of the anticompetitive price fixing agreement, but specifically in respect of FASA, and there were numerous manifestations in front of the pharmacies involved in the price fixing. Recriminations were made by directors against FASA's president and FASA's CEO for not informing them about the case and FASA's share price dropped by approximately 10%. On 4 June 2009 a law was proposed in the Chilean Congress (Boletin No6548-07) seeking to re-establish imprisonment for persons involved in fraudulent price fixing cases.

A number of conclusions can be drawn from the FASA case. Material information on monitoring obligations and strategic vision should not be kept confidential from the members of the board of directors, material information must be provided on an equal basis to all members of the board of directors. The sanctions imposed by the Securities Regulator raised doubts about the range of the directors' obligations, as they should be concerned about not just the daily performance of the organisation but also the longer term goals. The board of directors should focus on the risks associated with the organisation, understand them, organise them in order of priority in which they are likely to affect the company and implement mechanisms for preventing or reducing the effects if they occur. Being a director is a full time task, and it is neither an honour nor a right. Therefore a director should be wary of taking up a number of directorship posts in different companies as the position requires the performance of a series of duties and commitment to the company. A correct corporate governance structure would (i) improve the board of directors and officers decision making process, (ii) ensure control of the relevant business environment and (iii) result in a reduction in the firms cost of capital, since investors would perceive less risks in the organisation. There are measures that can be taken to prevent the occurrence of risk, and consequences will be far less onerous if the necessary warning is given. Competition creates the necessary incentives for increased company profitability through the provision of improved services and products, or cost reduction, but without effecting quality. Competition regulation is one of the most serious risks which could affect the future of a company, and the board of directors should therefore be provided with training and aligned incentives to ensure the company is not affected.

A delegate from Chile commented that the FASA case had a significant impact on Chilean corporate law, and in particular on interlocking i.e. the practice of directors serving on corporate boards of multiple corporations. The head of FASA had stated that some information was not passed down to the board of directors as two of the directors also represented a retail firm which had a special agreement with other pharmacies. There was therefore an evident conflict of interest.

The Chairman commented that the case illustrated the issue of directors not being fully informed and asked if the case had been publicised as a self correcting problem and had directors become more aware as a result?

Professor Caneo replied that Chilean directors are now motivated to obtain information not only on legal issues but also on finance issues, and implementing mechanisms to correct the occurrence of infractions to local regulations. The directors in the FASA case should have been informed about the negotiations with the antitrust authority as under director confidentiality rules they are unable to disclose any company information and there was therefore little risk of the directors revealing the secret negotiations. However the directors, according to the Securities Regulator fines, are also to blame for not being sufficiently diligent, and while they should have known that the prices were a result of collusion, they did not.

Finally, he commented in the increasing importance that regulations that may be implemented post-recent financial crisis focus on determining and regulating the incentives that may drive the behaviour of regulated entities and their officers.

Chairman Jenny gave the floor to Professor Fels to present an inquiry carried out into Executive Pay in listed companies in Australia. The study was triggered by concerns that executive pay was too high, and the main conclusions focused on weaknesses in corporate governance. A number of questions related to competition also arose including whether the remuneration market itself is competitive, or distorted. From the 1990s to 2007 there was a huge growth in executive pay, with a rise of 300% in 15 years<sup>5</sup>. Since 2007 it has fallen by 16% a year, which can be largely accounted for by increased use of pay structures linked to company performance. However, instances of large payments despite poor company performance have fuelled community concerns that executive remuneration is out of control.

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<sup>5</sup> Pay for the top 100 CEOs grew 13% real from the mid 1990s to 2000 and then 6% real annually to 2007.

Executive pay varies greatly across Australia's 2000 public companies from \$7.2 million for the top 20 CEOs to \$260,000 for CEOs of the smaller listed companies. The average level of pay rose to around \$7.2 million which is 110 times the average weekly earnings. Australian executives are paid in line with the smaller European countries, but below the UK and USA (the global outlier). Drivers of executive remuneration have included;

- *Globalisation.* The liberalisation of the Australian economy and introduction of global competition means firms are now searching globally for the best to do the job and therefore have to provide remuneration to match.
- *Company size.* A 10% increase in company size equates to a 4% rise in executive pay, and as pay is so closely linked to size this has implications for competition
- *Incentive pay structure.* The shift to incentive pay structures was a concept imported from the US and is designed to deal with the principle-agent problem. Executive incentives were aligned with the goals of the shareholders by linking them to performance, so that incentive pay structures for CEO's equate to around 40% base pay with the remaining made up of short and long term incentives. However, the incentives were introduced without the appropriate hurdles, spurring the dramatic pay rises in the 1990s. They also assume boards are competent and independent of the CEO, and in addition normal cost pressures do not seem to apply.
- *Corporate governance deficiencies.* There has been much public disclosure on pay, and this may have speeded up the spread of the executive 'Lake Woebegone' affect i.e. a tendency to pay above average. The lack of any checks on pay in the US has also been an influential factor. The only real restraint is public outrage, but there remain numerous rewards hidden from public view.
- *Market capitalisation.* There is a strong link between executive pay and market capitalism, and the good luck factor i.e. the stock market upward movement triggers pay rise for 'undeserving' individual executives.

The inquiry concluded that there were periods when the market was out of control (e.g. the 1990s) during which time there were no appropriate hurdles or checks. Bonuses were related to company shares and stock market values rather than business performance, and to how well the business did against other firms in the same industry, which has ramifications for competition. The following recommendations were made to strengthen the corporate governance framework:

- Removing conflicts of interest through:
  - Independent remuneration committees
  - Executives not to sit on remuneration committees
  - Executives and directors not to use their voting shares on remuneration reports
  - Executives and directors prohibited from voting undirected proxies on remuneration reports
  - Require proxy holders to cast all their directed proxies on remuneration reports
- Improve disclosure through:
  - Plain English summary of remuneration policy
  - Report actual remuneration received
  - Companies to disclose executive remuneration advisors and their relationship with company
  - Remuneration advisors to work directly to the board not to management

- Improved ‘Say on Pay’ two strikes recommendation:
  - Where a company’s remuneration report receives a ‘no’ vote of 25% or more, the board be required to explain in a subsequent report how shareholder concerns were addressed, and if not explain why
  - Where subsequent remuneration report receives a ‘no’ vote of 25% or more at the next AGM, a resolution be put that elected directors who signed report stand for re-election

The Chairman commented on the definition of excessive remuneration, and questioned whether if executives were paid on merit, this lead to a collusive oligopoly and therefore a negative impact on competition?

A delegate from Australia commented that the remuneration issue had become a well inflated political football. The Productivity report had not yet received a response from the government, but it was a very populist issue and there were suggestions of an increasingly prescriptive recommendation including compulsory removal. However, this would be a complex procedure and raised three issues (i) why is a specific process to remove directors for reasons of money required given the shareholders can remove them at any time? (ii) if special rights of removal were introduced this could have a floodgate effect and be extended to other special interest areas such as gender bias or climate change, (iii) shareholders should take more of an interest in how their money is being used by directors; it is the shareholders responsibility not that of politicians or talk back radio.

Professor Fels commented that pay can be regarded as a proxy for how well corporate governance works generally, and the situation did deserve some focus on this ‘weak spot’ in the principle/agent relationship. Corporate governance arrangements can limit what shareholders do and the point of the enquiry was to increase their power. Institutions matter and there are issues of administrability and domestic regulatory capture which are powerful interests. The international institutions also have a role to play, although there can be issues associated with understanding that SOEs behave differently in the market, as has been demonstrated at the WTO level. Bilateral investment treaties, free trade agreements (such as that signed between the US and Canada, and which effects the Canadian postal system) and soft law are all used as tools but have weaknesses. So what can be done? The answer lies first and foremost in corporate governance rather than competition, and SOEs should be corporatised rather than treated as separate government departments. However as SOEs have monopoly power by statute, increasing competition in the market is an important way of tackling this situation.

The Chair invited Professor Sokol to give a presentation on competition policy and comparative corporate governance of state owned enterprises (“SOEs”). Following the financial crisis a number of governments are now in control of companies which were previously privately owned, including both financial institutions such as banks and other non-financial institutions such as car manufacturers. However once firms start receiving government support this can lead to different outcomes as compared to private firms, and these differences affect performance. As discussed in the work of *Alchian* and *Demsetz*, SOEs incentives are different from those of private firms. *Steigler’s* work also suggested that corporate governance and competition are substitutes, but there is an overlap between the two and a role for both. Firstly good corporate governance mechanisms for SOEs minimise bad management both ex ante and ex post, and secondly competition policy can reduce distortions of SOEs and state supports. Therefore while from an efficiency standpoint SOEs create problems, improved corporate governance and effective competition policy are substitutes that could lead to more efficient outcomes.

SOEs are different from private firms in that the profit motive in an SOE may not exist, and some SOE functions may be based on non-financial goals. A company under state ownership may be used for political objectives e.g. employment, social goals or capital formation. SOEs may not be about profit maximisation because they are in regulated industries, and the government must therefore balance its role

as regulator with its role as owner of a firm. The lack of an efficiency rationale changes the incentives for an SOE. Since SOEs lack shareholders because they are owned by the government, the ultimate shareholder equivalent in an SOE is the country's citizens. Therefore owners have a restricted right i.e. they do not have direct ownership rights in the SOE and they do not receive the proceeds of the firm. Transferability of shares in private firms means shareholders dissatisfied with managerial decision making can simply sell on their shares. This is an important control mechanism as a lower share price creates a threat to management through the market for corporate control, which SOEs do not face. In addition governments may create an uneven playing field in those markets where an SOE competes with private firms. Governments have an interest that its state owned firms succeed and the government, as regulator, may therefore restrict competition by providing various benefits to SOEs that it does not offer to other firms. Furthermore managers in SOEs are less likely to be fired by the board for making a bad decision and the state is more likely the bail out a mismanaged SOE.

It is clear that SOEs and private firms have different internal and external controls and there has been some empirical work carried out in this area, noting the specific controls for each and how they differ:

- Internal Controls
  - *Managerial ownership and pay*: Some level of corporate ownership by management may increase firm performance. However, SOE managers do not face the types of financial rewards of private firms and SOE managers therefore cannot be rewarded additional compensation based on the increase of the stock price of the SOE.
  - *Board oversight*: The board of a firm serves to monitor managers on behalf of shareholders, protecting them from potentially risky and costly managerial mistakes in strategy. However, without effective monitoring it is easy for managers in SOEs to make bad decisions because of a lack of accountability for the consequences of such decisions which otherwise would entail, and they do not face repercussions such as termination for poor decision making.
- External Controls
  - *Market for corporate control*: If management decision is poor, this will usually be reflected in a depressed stock price for the firm, with the risk of a hostile takeover. These incentives discipline managerial behaviour. However, SOEs do not face the same acquisition threats as they do not operate under 'hard' budget constraints, they operate under 'soft' budget constraints i.e. another institution will pay the shortfall for mismanagement of the SOE.
  - *Equity*: Publicly traded shares of stock provide information on the relative state of a firm. SOEs are not publicly traded so they lack this signal of firm performance that equity markets provide.
  - *Debt*: Firms that are poorly managed and in financial difficulty will have a poor debt rating by credit agencies such as Moody's and Standard & Poor's. However because the government either explicitly or tacitly guarantees SOE debt, they have an advantage over their private competitors and are given preferential debt ratings.
  - *Market for managers*: In private firms reputational consequences may force a manager to better run a firm to preserve his/her reputation going forward. In SOEs managers may be poorly monitored relative to private firms due to the lack of external controls. However, because the firm may not be profit maximising, managers will secure their jobs regardless of firm performance.
  - *Bankruptcy*: The risk of bankruptcy and possible liquidation forces many firms to undertake less risk because of the potential negative consequences of overly risky strategies. In contrast SOEs generally do not go bankrupt, and managers do not therefore face the same constraints as private firms.

<b>Private v SOE: Internal Controls</b>		
<b>Internal Controls</b>	<b>Private</b>	<b>Public (SOE)</b>
Corporate Form	Yes	No, but sometimes a modified yes
Managerial Ownership	Yes	No
Managerial Pay	Yes	Not so well
Board Oversight	Yes (but sometimes problematic)	Yes (but generally problematic)
<b>Private v SOE: External Controls</b>		
<b>External Controls</b>	<b>Private</b>	<b>Public (SOE)</b>
Market for Corporate Control	Yes	No
Equity	Yes	No
Debt	Yes	Sometimes
Market for Managers	Yes	No
Bankruptcy	Yes	No

Incentives are an important factor in the institutional design and corporate governance of SOEs. The more a government treats an SOE like a private firm, the more it behaves like a private firm. Corporatised forms of governance should yield better outcomes, but due to flaws in institutional structure this is not always the case. SOEs behave differently from private firms for the following reasons: (i) SOEs focus on revenue maximisation rather than profit maximisation, (ii) SOEs have incentives to raise rivals costs and (iii) SOEs have incentives to predatory price. The latter is problematic as predation tests are cost based, but it is not clear what the appropriate costs for an SOE should be; marginal, average variable, average avoidable or long run average incremental. There is no separate legal antitrust test for SOEs and they will generally win in predation tests as (i) the benefit of government ownership is not imputed into costs and (ii) the benefits of government regulatory bias is not imputed into costs.

Ideally the institutional design of SOEs should mimic corporations but in practice this is rarely the case. In some countries, for example Sweden and New Zealand, SOEs are required to carry out the same kinds of reporting and efficiency rationale as private companies. However, this is not the case for the majority of SOEs. For example in the US the board of directors of the state owed US postal service is made up of politically appointed lawyers, and looks very different from that of its privately run competitor UPS. This has an important spill over effect as if SOEs are not behaving as profit maximising firms then competitive assumptions cannot work. It is impossible to know the true costs associated with an SOE if everything is subsidised, and SOEs are winning cases they should not be.

Following these amendments it is intended that future recovery periods would not witness such a sudden increase in SOEs. There are questions over whether domestic institutions alone can remedy the SOE problem, but other institutions such as the World Trade Organisation and various Free Trade Agreements are equally problematic. In order to counteract these issues soft law and best practices may be able to help. Additional recommendations to improve competition and corporate governance of SOEs include:

- Improved External Oversight
- Improve Internal Corporate Governance
- Corporatisation of SOEs
- Increase Competition
- Privatisation
- Create an Effective Antitrust test (e.g. built on research carried out by *Sidak & Sappington* (2003) in which is it recognised that cost imputation has potential problems, and a cost test may not be easy to administer given institutional weaknesses of the judiciary and regulators.)

Overall it is important to recognise that one size does not fit all and different solutions based on different sectors and different types of SOE problems are needed.

Mr. Bianchi was invited to give an overview of competition, corporate governance and the crisis from an OECD corporate governance perspective. The financial crisis raised a number of new challenges for policy makers, with the main issues being (i) how to reduce the systemic effects of the crisis, (ii) how to overcome the structural weaknesses which contributed to the emergence of the crisis, and (iii) how to handle the exit strategy. The two strategic areas for policy makers are corporate governance and competition. The market and macroeconomic environment before the crisis put the corporate governance system under stress, with a number of effects. Firstly there were new and unusual profit and growth opportunities. Secondly shareholders were able to exercise stronger pressure for short-term results while neglecting their monitoring functions. Thirdly boards failed to define and manage a ‘sustainable’ growth strategy. In addition the presence of oligopolistic elements contributed to moral hazard and the creation of too-big-to-fail situations.

The OECD decided to focus on corporate governance and competition as two of the main elements in its strategic response to the financial and economic crisis. The corporate governance principles were revised in 2004 and constituted part of the Financial Stability Board (FSB)’s core principles. The OECD is the international standard setter in corporate governance and its principles are one of the FSB’s 12 core standards. A number of other international organisations rely on OECD work, including the World Bank, BIS, IOSCO, ICGN, and IFSE. The OECD principles are frequently referenced in national initiatives even in non member countries such as Brazil and China.

It is still an open issue whether corporate governance and competition are substitutes or complements. In perfect competition, corporate governance can be ineffective, but empirical evidence points to significant complementarities in ‘second best’ situations. The post-crisis economic context (strongly suboptimal) stresses the opportunity to enhance both competition and corporate governance best practices. Specific issues include the increasing state role in the economy through ownership and regulation, public outrage on excessive remunerations, scepticism on market virtues, and a switch from shareholder to stakeholder value. However the ‘new context’ environment will look rather different with the following factors likely to occur:

- Less room for competition and higher rents
- Easier for politicians to interrupt/reverse the process towards privatisation and competitive markets
- Increasing power of the controlling shareholder
- Less competitive markets for corporate control and top managers (loyalty v skill)
- More emphasis on political consideration within corporate strategy
- Less incentives to invest in the market
- Lower role for institutional investors in corporate governance

These factors indicate a return to the more traditional ‘Italian’ corporate governance model. This is typically marked by a strong controlling owner, weak managers, weak minority shareholders and a wide use of control enhancing mechanisms such as pyramids, dual class shares and coalitions. The model runs the risk of shareholders’ expropriation and problems arising from the role of state as owner and rule maker. There is also low emphasis on executive remuneration as an incentive mechanism, insufficiently dispersed ownership and a low degree of stock market development.

How can corporate governance play a role in this? Corporate governance can be seen as a ‘competition booster’. Corporate governance is especially needed when competition is lower as it helps the market for corporate control and the market for top managers ‘survive’. Similarly to competition, contestable ownership structures combined or complemented by robust internal governance mechanisms induce efficiency. The Corporate Governance Committee has issued an action plan, with a set of recommendations in the specific



areas of corporate governance connected to the crisis. The areas addressed with priority in the recommendations were:

- Governance of remuneration
- Implementation of effective risk management
- Quality of board practices
- Exercise of shareholders rights

On each of these areas the Committee identified (i) the key findings of the analysis of corporate governance lessons from the financial crisis and (ii) a number of main messages which have been transposed in actual recommendations. Systematic mechanisms for peer review and peer dialogue will be adopted as instruments for effectively monitoring implementation and the timely identification of new problems. This would be based on (i) the analysis of emerging critical issues across a set of countries (thematic peer review) and (ii) an in-depth analysis of corporate governance systems in selected individual countries (countries peer review) The first thematic peer review is scheduled for Spring 2010 and will consider non-financial companies remuneration in the UK, Japan, Brazil, Portugal and Sweden.

In the current climate policy makers cannot neglect corporate governance and competition. Both have been strongly involved and affected by the crisis, and both are a key aspect of the recovery. The OECD can play a relevant role through (i) guidelines for effective implementation of principles and standards on a global basis (including major non-member countries i.e. BRICs) and (ii) adapting the principles to new circumstances e.g. through addressing the temporary ownership role of governments in banks. It is essential to develop effective monitoring mechanisms and provide a forum for policy dialogue. This involves identifying the emergence of further possible weaknesses in a forward looking approach, and supporting effective rather than excessive regulation. The specific danger lies in transplanting reforms designed to address systemic risks in the financial markets to the corporate sector generally.

A delegate from Portugal commented that while corporate governance and competition issues should be discussed in conjunction, it is doubtful if executive pay and competition issues should be discussed together. Executive pay is a very sensitive issue both politically and publically. The corporate governance issue may lead to excessive remuneration but we should refrain from making the link. Discussing excessive pay could trigger issues related to wage negotiations and competition policy, and the strong trade unions that are associated with protected industries. This is something which should be avoided by competition policy.

Professor Fels responded that while labour questions are not currently dealt with by competition law this may change. Education, health and public services all have significant competition issues related to labour and it will therefore be interesting to see how the landscape looks in ten years time.

A delegate from Egypt commented that there have been complaints as to why companies pay fines for antitrust infringements when it is an individual who carried out the infringement. Governance issues should therefore include increased responsibility regarding company revenues to ensure they are compliant with the laws of the country in which they operate, including for example money laundering regulations.

The Chairman concluded in noting that the hearing had provided the delegates with a better view on the interface between corporate governance and competition and explored the facets of ownership. It also addressed issues of conflict between shareholders and directors, and non functioning boards either because of issues related to interlocking or lack of company knowledge. Improving governance is one of the key tools for improving the current situation. Conglomerate size is another issue, and it should be considered whether the categories currently being used are inadequate, and whether other dimensions should be brought in. The Chairman emphasised the discussion would have to continue, especially on the issue of remuneration as there have been cases of strict antitrust enforcement based on financial incentives offered to employees, resulting in a lack of competition compliance.

## COMPTE RENDU DE LA DISCUSSION

*Par le Secrétariat*

Le Président, M. Jenny, explique que l'objectif de l'audition sur la relation entre concurrence et gouvernance d'entreprise est de déterminer l'influence de ce dernier sur la concurrence et sur les mesures d'incitation mises en œuvre dans les entreprises, de mieux cerner les différents enjeux et de définir les éventuels problèmes de concurrence auxquels le Comité devrait consacrer de plus amples travaux. Il s'agit là d'une question qui se pose dans de nombreux pays en relation avec les programmes de conformité. Elle est aussi pertinente dans le contexte de la crise économique, car une défaillance peut se produire sur le marché si les incitations ne sont pas axées sur le long terme mais centrées sur des objectifs à court terme.

Le Président présente les intervenants invités : M. Marcello Bianchi, président du Groupe de direction de l'OCDE sur la gouvernance d'entreprise et chef du bureau italien d'analyse d'impact de la réglementation, à la division de la réglementation économique (CONSOB) ; M. Hugo Caneo, Université du Chili ; M. Allan Fels, doyen de l'ANZSOG (Australie) ; M. Daniel Sokol, Université de Floride (États-Unis) ; M. Spencer Weber Waller, Université Loyola à Chicago (États-Unis) ; M. Yishay Yafeh, Université Hébraïque.

À l'invitation de M. Jenny, M. Spencer Weber Waller ouvre les débats avec une présentation de l'état des recherches sur la gouvernance d'entreprise et la politique de la concurrence. En 1933, dans leur ouvrage intitulé *The Modern Corporation and Private Property*, Berle et Means introduisaient le concept de séparation entre propriété et contrôle de l'entreprise, ainsi que les "coûts d'agence", comme on dirait aujourd'hui; ils plaidaient aussi en faveur d'un accroissement des droits de vote, de la transparence de l'information et du contrôle au bénéfice des actionnaires, et prônaient en outre l'élargissement du rôle social des entreprises.

Pendant la dépression des années 30, la politique antitrust n'était pas particulièrement sévère, mais dans les années 50 la législation s'est mise à tendre vers des règles *per se*, des préjugés contre les monopoles, et l'interdiction de fusions importantes, quel que soit leur type. Pendant cette période, les mesures antitrust étaient beaucoup plus rigoureuses que les restrictions relatives à la gouvernance d'entreprise<sup>1</sup>. Pendant les années 60 et 70, cependant, des auteurs influents ont commencé à s'exprimer aussi sur la question de la gouvernance d'entreprise<sup>2</sup>, prônant l'élimination des restrictions aux rachats d'entreprises afin de promouvoir l'efficacité, d'empêcher l'exploitation de rentes et de créer davantage de valeur pour les actionnaires. Au même moment, l'hostilité à l'égard des fusions s'affaiblissait et des voix s'élevaient au sein même du gouvernement Reagan en faveur de l'abolition du chapitre 7 de la loi Clayton.

Du fait de l'alternance entre essor et déclin de ces préoccupations au cours du temps, les interactions entre la lutte antitrust et l'intérêt pour la gouvernance d'entreprise n'ont été que très rares. La politique de la concurrence concerne avant tout le rapport entre les grandes entreprises et les autres acteurs du marché dans les relations horizontales et verticales ainsi que dans le cadre des fusions et acquisitions. La

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<sup>1</sup> Dans son recueil d'essais intitulé *The Corporation in Modern Society*, Edward Mason offre un aperçu des sujets qui préoccupaient son époque (1960) dont, avant tout, le statut oligopolistique des grandes entreprises américaines et, plus généralement, le pouvoir économique et politique des entreprises, le thème de la gouvernance d'entreprise restant secondaire.

<sup>2</sup> Henry Manne (*The Market for Corporate Control*) et, plus tard, les écrits influents de Frank Easterbrook et Daniel Fischel.

gouvernance d'entreprise, en revanche, porte sur les relations entre les gestionnaires, les administrateurs et les actionnaires. Il en résulte deux corpus de législation relativement distincts : à certains moments, la politique de la concurrence l'emporte sur la gouvernance d'entreprise, et c'est le contraire à d'autres moments. Aux États-Unis, les dispositions de la loi Clayton sur les directions imbriquées constituent le lien le plus directement pertinent mais le moins important entre ces deux domaines. Le respect des lois par l'entreprise est peut-être un lien plus important, mais il n'est pas suffisamment étudié.

En ce début du XXI<sup>e</sup> siècle, on voit apparaître un volume croissant de travaux empiriques et théoriques qui remettent en question les fondements et les résultats du marché du contrôle des sociétés. Ces nouvelles études sur la gouvernance d'entreprise englobent l'approche comportementale de l'économie et du droit, et en particulier i) les incitations et les récompenses pour les dirigeants d'entreprise, ii) l'existence continue des coûts d'agence, iii) l'autonomie et l'arrogance des PDG, iv) l'attitude favorable aux fusions même lorsqu'elles ne créent pas de valeur. En outre, on admet désormais la nécessité de maintenir une veille antitrust sur les marchés du contrôle des sociétés, même s'ils fonctionnent correctement, afin de décourager les soumissions collusoires et la clôture prématurée des enchères, et de limiter l'immunité antitrust et l'excès de déférence envers les autorités des marchés de valeurs. D'autres travaux, de plus en plus nombreux, indiquent que les fusions ne répondent pas toutes aux mêmes motifs, et les études sur la finance d'entreprise laissent penser que de nombreux types de fusions vont même jusqu'à détruire de la valeur. Les mégafusions (en particulier les échanges d'actions une pour une entre des parties de taille plus ou moins égales) sont particulièrement soupçonnées d'être destructrices de valeur, de même que les fusions justifiées par des synergies mal formulées. Les résultats peuvent aussi être différents selon que la fusion est industrielle ou alors financière ou bancaire, et d'autres recherches sur le terrain comportemental montrent quand une entrée se produit et quand elle est effective.

Il existe toutefois des possibilités d'interactions plus étroites. Du côté de la gouvernance d'entreprise, elles pourraient prendre la forme i) d'un renforcement des obligations du conseil d'administration dans les mégafusions entre parties égales, ii) d'un accroissement des obligations d'information sur les titres détenus, pour cette même catégorie et iii) d'une norme intermédiaire de révision par les tribunaux. Du côté de la concurrence, il pourrait s'agir i) d'une plus grande attention portée aux catégories d'opérations qui s'avèrent destructrices de valeur, ii) d'une meilleure compréhension des raisons de la non réalisation de synergies et iii) de l'exploration des sources de création de valeur dans une fusion, telles que les gains d'efficacité ou le pouvoir de marché. Par ailleurs, l'économie comportementale est importante parce qu'elle offre un éclairage sur : l'activité de fusion-acquisition ; les réactions des conseils d'administration et des actionnaires ; la combinaison réussie ou non des cultures d'entreprise après une fusion ; et les caractéristiques des entrées sur le marché – ainsi, l'entrée peut être plus fréquente mais moins efficace qu'on ne le pense généralement, ou le positionnement de la marque comme solution de rechange à l'entrée peut être pratiquement impossible. Il est donc possible de restaurer les connexions entre les domaines de la gouvernance d'entreprise et de la concurrence, d'après M. Waller, pour peu que l'on s'intéresse de nouveau aux recherches menées sur la finance d'entreprise et l'économie comportementale et que l'on investisse davantage dans la théorie des entreprises en général, en complément de l'expertise purement économique. Il convient de rejeter l'hypothèse diffuse selon laquelle toutes les fusions sont efficaces ou sans danger pour la concurrence, et de remettre davantage en cause les idées préconçues sur l'entrée et les gains d'efficacité.

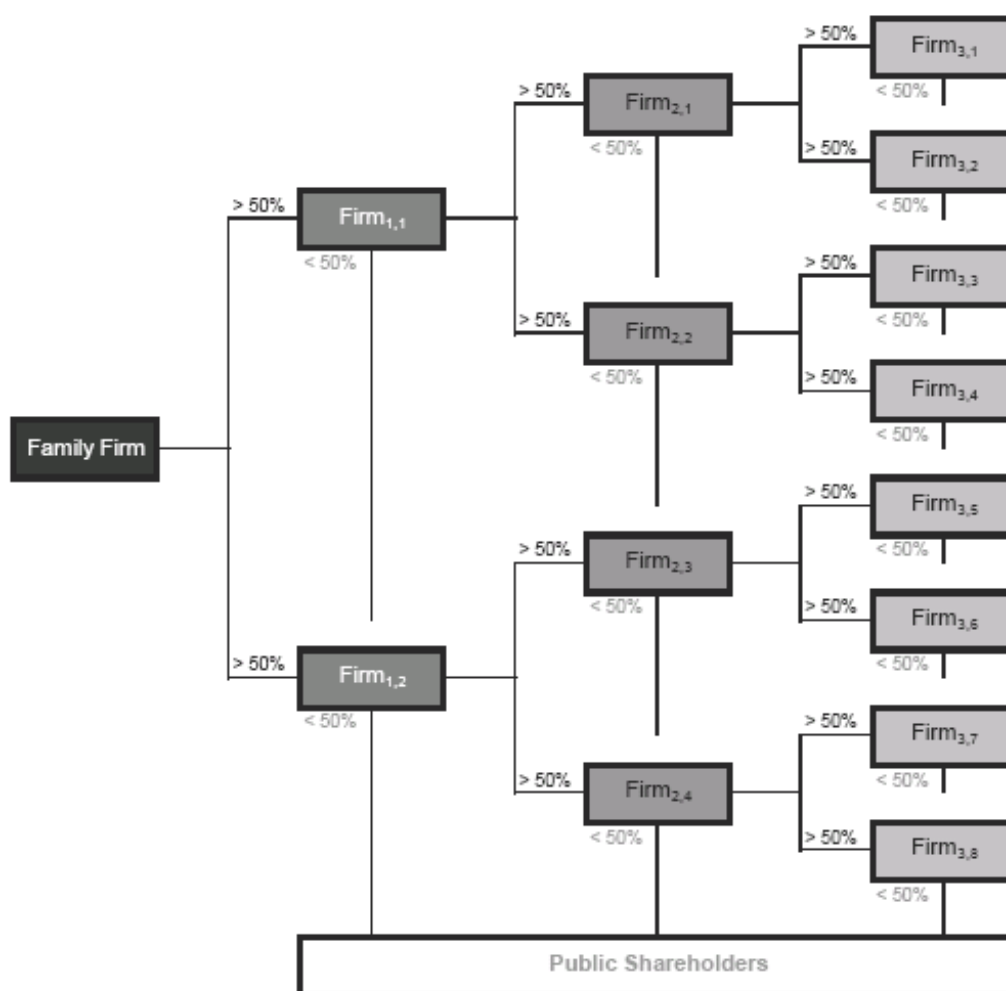
Le Président donne ensuite la parole à M. Yafeh, qui présente le rôle des groupes industriels dans l'environnement des entreprises. Un groupe d'entreprises se compose d'entités juridiquement indépendantes, actives dans plusieurs secteurs et liées par des relations formelles et informelles. Les groupes appartiennent souvent à une famille, avec des degrés variables de participation extérieure, et ils peuvent avoir différents périmètres d'activité, structures de contrôle et niveaux d'interaction avec l'État et la société. En dehors des États-Unis et du Royaume-Uni, les groupes industriels sont omniprésents et

existent aussi bien en Corée qu'en Thaïlande ou en Malaisie, au Brésil qu'en Argentine ou au Mexique, en Inde, en Italie, en Belgique, en Suède, etc.

Les groupes sont souvent des pyramides à contrôle vertical, où la famille propriétaire exerce un contrôle disproportionné par rapport à ses droits sur les recettes. Ces pyramides peuvent être un mécanisme servant à expulser les actionnaires minoritaires et à faire remonter les bénéfices vers les actionnaires majoritaires par un « effet cheminée », ce qui nuit au développement financier<sup>3</sup> (voir Figure 1).

**Figure 1. Pyramide de contrôle simplifiée**

Une entreprise familiale contrôle un premier niveau de sociétés parce qu'elle détient une part dominante des droits de vote, dans ce cas plus de 50 %. Chaque société du premier niveau contrôle plusieurs entreprises du deuxième niveau, dont chacune contrôle d'autres entreprises encore. La pyramide a pour effet global d'étendre le contrôle de la famille sur un volume d'actifs d'une valeur substantiellement plus grande que sa richesse réelle.



*Family firm: société familial; Firm: société; Public shareholders: actionnaires dans le public*

<sup>3</sup> De nombreux ouvrages traitent de l'effet cheminée, notamment suite à celui de La Porta, Lopez-de-Silanes, Shleifer et Vishny (LLSV) en 2002.

C'est souvent lorsque la protection des investisseurs est faible que l'on rencontre des pyramides et des groupes contrôlés par une famille<sup>4</sup>. Les actionnaires minoritaires peuvent accepter une structure de contrôle pyramidale pour toutes sortes de raisons : i) il n'y a guère d'autres options disponibles ; ii) le groupe peut avoir une réputation de sauveteur, ou de traitement équitable des petits investisseurs ; et iii) dans les économies en développement, l'effet « cheminée » peut constituer la rémunération d'un atout que possède le groupe, tel qu'une capacité entrepreneuriale ou de lobbying.

La performance des entreprises familiales en général, y compris des groupes, a tendance à se dégrader lors de la transition vers la deuxième génération, du fait que l'héritier est choisi en raison de liens de sang et pas nécessairement en fonction de ses capacités et compétences. Les grands groupes comportent donc des risques importants de mauvaise gestion à la deuxième génération.

Les origines des groupes industriels sont souvent en rapport avec l'État, mais au fil du temps les relations entre les groupes et les États peuvent devenir plus complexes et moins unidirectionnelles. C'est ce qui s'est passé entre l'État japonais et les zaibatsu entre 1880 et 1930 environ, ainsi qu'avec les chaebol en Corée pendant les années 80. Du fait que les groupes entretiennent des liens avec les gouvernements, ils sont en position d'influer sur les décisions des pouvoirs publics, grâce à leurs contacts au sein des instances de réglementation. Les effets peuvent être positifs, comme au Mexique où les groupes ont usé de leur influence politique pour soutenir la politique de libre-échange, et en Inde, où les groupes ont activement défendu la libéralisation. Mais cette influence peut aussi être utilisée à des fins moins louables, par exemple l'opposition à la réforme de la gouvernance d'entreprise en Corée, ce qui se traduit parfois par l'adoption de mesures de politique économique qui favorisent les groupes dominants plutôt que le bien-être de la population. Il existe aussi des exemples d'implication directe des groupes dans les affaires politiques, notamment en Italie, en Corée et en Thaïlande, et des cas d'« enracinement » de manière plus générale, qui rendent pratiquement impossible la dissolution des groupes établis de longue date.

Les recherches théoriques mettent en lumière les dangers que présente le pouvoir monopolistique des groupes industriels. Des sujets de préoccupation spécifiques sont par exemple le fait que des groupes qui sont en concurrence dans différents secteurs peuvent être tentés par la collusion ; les groupes qui possèdent un « trésor de guerre » peuvent user de leur puissance financière pour décourager l'entrée de nouvelles entreprises sur le marché ou pratiquer l'éviction ; et les groupes qui opèrent dans plusieurs branches d'activité peuvent procéder à des offres groupées ou à des ventes liées. Les preuves concrètes étayant ces allégations font toutefois défaut en raison de la difficulté de recueillir des données.

L'effet global des groupes sur le bien-être collectif est difficile à juger, car les groupes produisent des effets multiples, et on ignore comment se comporterait une économie en l'absence de groupes. De manière générale, les effets positifs des groupes ont tendance à se manifester dans les premiers stades du développement économique, et les effets négatifs ont tendance à persister longtemps après. En particulier, d'aucuns soutiennent que, dans les économies en développement, les groupes peuvent se substituer aux institutions absentes ou défaillantes et donc exercer un effet positif sur le bien-être collectif. Par exemple, les groupes peuvent faire fonction de marché financier interne, qui allouera les capitaux plus efficacement qu'un système financier externe sous-développé. C'est d'ailleurs l'une des raisons pour lesquelles certains de ces groupes réussissent bien sur les marchés émergents. En revanche, l'argument des « institutions de substitution » n'est guère plausible dans le cas de pays économiquement et institutionnellement développés, où les groupes peuvent causer des préjudices considérables, comme décrit ci-dessus. Les responsables politiques devraient envisager des mesures antitrust, entre autres, pour limiter ces dommages.

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<sup>4</sup> Il existe plusieurs études très convaincantes sur l'expropriation des actionnaires minoritaires par les groupes en Inde (Bertrand et al) et en Corée (Bae et al, et Joh), parmi de nombreuses autres, y compris portant sur certains pays d'Europe continentale.

Un délégué de la Suède confirme qu'il existe bien dans son pays des groupes industriels, qui ont lancé plusieurs marques internationales. Leurs origines remontent aux années 30 et ils ont poursuivi leurs activités pendant la Seconde Guerre mondiale, l'exemple le plus célèbre étant la famille Wallenberg. Pendant les années 50 et 60, ces groupes ont exercé une influence considérable ; ils en sont maintenant à la 3<sup>e</sup> ou 4<sup>e</sup> génération et demeurent très puissants. Du point de vue de l'autorité de la concurrence, ils peuvent devenir problématiques lorsqu'ils entraînent une concentration élevée. Mais les actionnaires minoritaires, même s'ils détiennent une très faible participation, peuvent néanmoins être très influents. Dans la plupart des entreprises suédoises, le capital est constitué d'actions A et d'actions B, les actions A ayant plus de droits de vote. Les groupes, qui ont des actions A, ont fait pression sur Bruxelles pour pouvoir conserver ces actions. Les groupes suédois possèdent aussi des banques et des sociétés de capital-investissement. De nos jours, les groupes ne sont pas considérés, du point de vue de la concurrence, comme plus problématiques que d'autres entreprises, et ils peuvent être bénéfiques pour l'économie. La concurrence sur le marché des médias pose un problème, mais une enquête est actuellement menée pour étudier la position des groupes sur ce marché.

Un délégué de la Corée exprime son accord avec le point de vue de M. Yafeh sur les groupes et signale que l'autorité coréenne de la concurrence s'efforce de résoudre un certain nombre de problèmes pratiques qui entravent la mise en œuvre des politiques relatives aux groupes.

M. Yafeh reconnaît avec le délégué suédois qu'il existe des cas où les entreprises familiales sont florissantes pendant plusieurs générations, mais il peut arriver un moment où l'« idiot de la famille » prend les commandes, et il n'est pas sûr que les actionnaires minoritaires et les investisseurs institutionnels voteraient contre. Il convient aussi que les groupes peuvent, dans certaines circonstances, œuvrer en faveur de l'innovation et que le recours aux échanges internationaux en tant que mécanisme de discipline peut être une bonne solution. Sur la question de savoir comment incorporer la question des groupes dans les dispositifs antitrust, il précise que les manuels standard d'organisation industrielle n'évoquent plus le concept de concentration économique globale, mais lorsqu'une société A du groupe souhaite acquérir une société B, il peut être souhaitable de prendre en compte d'autres critères qu'une mesure de concentration spécifique au secteur telle que l'indice de Herfindahl. L'implication des groupes dans la sphère financière peut être particulièrement problématique, et il peut être nécessaire d'utiliser un outil réglementaire distinct pour la restreindre.

Le Président fait observer que la notion de contrôle peut être variable, et que tous les pays n'appliquent pas forcément les mêmes critères.

Un délégué d'Israël explique que les autorités de la concurrence s'intéressent effectivement aux groupes et à la question générale de la concentration, mais que l'entrée de groupes étrangers sur le marché peut remédier à d'éventuels problèmes de concurrence. Sur un marché où dix ou vingt groupes exercent un pouvoir, si ces groupes changent constamment, c'est un phénomène positif parce qu'il contribue au développement. Pour prévenir une domination collective du marché, l'autorité israélienne de la concurrence suggère de modifier le cadre d'exercice des oligopoles, notamment en émettant des instructions à l'intention des entreprises concernées lorsqu'il se pose des problèmes de concurrence. Le marché israélien est petit, et composé de segments différents et spécifiques. L'acquisition d'un établissement financier important par un groupe de premier plan pourrait nuire à la concurrence, notamment en raison de problèmes liés à l'octroi des crédits.

En réponse à une question sur la définition des groupes, M. Yafeh répond que les groupes sont des structures au sein desquelles chaque société est une entité juridique distincte. Un conglomérat multidivisionnel tel que General Electric n'est donc pas un groupe. Au sein d'un groupe tel que Tata, en Inde, par exemple, chaque société est distincte et les actionnaires peuvent détenir des parts différentes dans différentes sociétés du groupe, ce qui n'est pas possible dans un conglomérat de type américain. En

réponse à une autre question, il admet que les problèmes de succession dans les entreprises familiales (« l'idiote de la famille ») sont plus ou moins graves selon la taille du groupe et que le contrôle familial d'un grand groupe peut effectivement poser problème. En réponse à une question sur le niveau « optimal » de concentration dans un pays comme les États-Unis, il juge difficile d'avancer une limite quantitative raisonnable. Pendant les années 30, les groupes qui opéraient aux États-Unis étaient jugés trop grands et trop puissants, et la fiscalité était utilisée pour encourager la dissolution des groupes pyramidaux. C'était aussi le cas dans le Japon de l'après-guerre. Le seuil de concentration « excessive » varie selon les pays, mais il convient d'agir avant que les groupes ne deviennent trop grands pour être contrôlés par les autorités de tutelle.

À l'invitation du Président, M. Caneo présente un aperçu du marché chilien et d'une affaire récente dans le secteur pharmaceutique. Au Chili, la propriété des entreprises est très concentrée et détenue par des groupes d'entreprises qui opèrent sur différents marchés (finances, immobilier, etc.) par le biais de filiales et autres sociétés affiliées, toutes contrôlées par une même entité. Le problème d'agence ne vient donc pas d'un conflit d'intérêts entre les propriétaires et les gestionnaires de l'entreprise, mais entre l'entité qui détient une participation dominante et les actionnaires minoritaires. Les décisions du conseil d'administration ne sont généralement pas adoptées par le conseil lors d'une réunion, mais sont imposées par l'actionnaire dominant. Certains administrateurs siègent au conseil d'administration de plus de dix entreprises : ils ne peuvent donc pas vraiment connaître chaque organisation et ses risques, et assumer leurs obligations de surveillance. Par conséquent, ils acceptent sans discuter les décisions imposées par l'actionnaire dominant et d'autres parties intéressées. Certaines entreprises, qui appartenaient à une famille puis ont décidé de s'introduire en bourse, sont toujours gérées sans en référer aux nouveaux actionnaires. La plupart des administrateurs axent leur fonction sur les résultats à court terme plutôt que sur une vision stratégique de l'entreprise et sa viabilité à long terme. Par ailleurs, l'opinion des cabinets d'audit peut être influencée par leur souci d'obtenir des revenus supplémentaires en fournissant d'autres services. Sur d'autres marchés, cette situation est devenue un réel problème pendant la crise financière, et il est évident que les administrateurs devraient être conscients des risques ou des possibilités de faillite, et que ces connaissances devraient être transmises aux niveaux inférieurs de l'organisation.

M. Caneo décrit ensuite l'affaire FASA, un laboratoire pharmaceutique fondé en 1968. Le 9 décembre 2008, la FNE (*Fiscalia Nacional Economica*) a déposé plainte auprès du TDLC (*Tribunal de Defensa de la Libre Competencia*) contre FASA, Cruz Verde et SalcoBrand au motif que ces entreprises se concertaient sur les prix. Des négociations ont eu lieu entre l'agence antitrust et le conseil d'administration de FASA, dont la teneur n'a été révélée ni aux administrateurs ni aux actionnaires. En mars 2009, aux termes de l'accord de règlement final, FASA a consenti à verser une amende et un dédommagement aux actionnaires. La réaction du public a été vive à l'encontre des participants à ce cartel d'entente illicite sur les prix, et surtout à l'égard de FASA, avec de nombreuses manifestations devant les pharmacies concernées. Les administrateurs ont reproché au président et au directeur général de FASA de ne pas les avoir informés de l'affaire, et le cours des actions de FASA a chuté d'environ 10 %. Le 4 juin 2009, une proposition de loi a été soumise au Congrès chilien (Bulletin No 6548-07) en vue de rétablir des peines d'emprisonnement pour punir les participants à des ententes illicites sur les prix.

On peut tirer plusieurs conclusions de l'affaire FASA. La première est que les informations importantes sur les obligations de suivi et la vision stratégique ne doivent pas être cachées aux administrateurs, mais au contraire communiquées de la même manière à tous les membres du conseil d'administration. Les sanctions imposées par l'autorité de tutelle ont soulevé des doutes quant à la nature des obligations des administrateurs, qui devraient se soucier non pas simplement des résultats de l'organisation au jour le jour mais aussi des buts à plus long terme. Le conseil d'administration devrait se pencher sur les risques que court l'organisation, pour mieux les comprendre, les classer par ordre de priorité en fonction de leur degré de probabilité et mettre en œuvre des dispositifs de prévention ou d'atténuation des effets. La fonction d'administrateur est une tâche à plein temps, ce n'est ni un honneur ni

un droit. Par conséquent, les administrateurs devraient éviter d'occuper cette fonction dans plusieurs sociétés, car elle suppose une série de devoirs et d'engagements envers l'entreprise. Une organisation dotée d'une bonne structure de gouvernance peut i) améliorer le processus de prise de décision du conseil d'administration et des cadres dirigeants ; ii) assurer le suivi de l'environnement des affaires dans la branche concernée ; et iii) abaisser le coût de son capital, car les risques perçus par les investisseurs sont moindres. Il existe des mesures à prendre pour prévenir les risques, et les conséquences sont beaucoup moins graves si les avertissements nécessaires sont lancés à temps. La concurrence crée les incitations appropriées pour accroître la rentabilité de l'entreprise au travers de la fourniture de services et produits améliorés, ou d'une réduction des coûts, mais sans nuire à la qualité. La modification de la réglementation de la concurrence est l'un des risques les plus graves qui puisse peser sur l'avenir d'une entreprise, et le conseil d'administration devrait donc recevoir une formation et des incitations appropriées de façon à ce que l'entreprise n'en souffre pas.

Un délégué du Chili précise que l'affaire FASA a eu un impact considérable sur la législation chilienne applicable aux entreprises et, en particulier, sur l'imbrication, c'est-à-dire la pratique selon laquelle des administrateurs peuvent siéger au conseil d'administration de multiples entreprises. Le président de FASA a déclaré que certaines informations n'avaient pas été transmises au conseil parce que deux des administrateurs représentaient aussi un détaillant qui avait conclu un accord spécial avec d'autres pharmacies. Il y avait donc un conflit d'intérêts évident.

Le Président fait remarquer que cette affaire illustre bien le problème que pose le manque d'information des administrateurs et demande si l'affaire avait été présentée comme un problème qui s'était corrigé de lui-même et si elle avait eu pour résultat de sensibiliser les administrateurs.

M. Caneo répond que les administrateurs des entreprises chiliennes sont désormais plus motivés pour obtenir des informations non seulement sur les questions juridiques mais aussi sur les affaires financières, et mettent en œuvre des mécanismes pour prévenir les infractions à la réglementation locale. Dans l'affaire FASA, les administrateurs auraient dû être informés des négociations avec l'autorité antitrust puisque, aux termes des règles de confidentialité applicables aux administrateurs, ceux-ci sont tenus de ne pas divulguer d'informations sur la société ; il n'y avait donc guère de risques que les administrateurs révèlent la teneur de ces négociations secrètes. Comme l'indique la sentence de l'autorité de tutelle, les administrateurs se sont toutefois rendus coupables d'une diligence insuffisante : ils auraient dû savoir que le niveau des prix résultait d'une entente, mais ce n'était pas le cas.

Enfin, de l'avis de M. Caneo, la récente crise financière a rendu encore plus importante l'application de règles visant à formuler et encadrer des mesures d'incitation susceptibles d'influer sur le comportement des entités réglementées et de leurs responsables.

M. Jenny donne la parole à M. Fels pour qu'il présente une enquête qui a été menée sur la rémunération des cadres dirigeants en Australie. Cette étude a été suscitée par le niveau de salaire des cadres, perçu comme trop élevé, et ses principales conclusions ont porté sur les faiblesses de la gouvernance d'entreprise. Un certain nombre de questions relatives à la concurrence ont également été soulevées, notamment celle de savoir si le marché des rémunérations lui-même est concurrentiel ou faussé par des distorsions. Des années 90 jusqu'en 2007, les salaires des cadres ont connu une croissance colossale, de 300 % sur 15 ans<sup>5</sup>. Depuis 2007, ils diminuent de 16 % par an, ce qui est en grande partie imputable au recours accru à des structures salariales liées à la performance de l'entreprise. Le public, sensibilisé par des cas de salaires astronomiques versés en dépit d'une mauvaise performance de l'entreprise, craint cependant une dérive dans la rémunération des dirigeants d'entreprises.

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<sup>5</sup> Les salaires des 100 premiers directeurs généraux ont augmenté en termes réels de 13 % entre le milieu des années 90 et 2000, puis de 6 % par an jusqu'en 2007.



Les salaires des cadres varient grandement sur l'ensemble des 2 000 sociétés cotées d'Australie, puisqu'ils s'échelonnent de 7,2 millions de dollars pour les directeurs généraux des 20 plus grandes entreprises à 260 000 dollars pour les dirigeants des sociétés plus petites. Le niveau moyen a atteint environ 7,2 millions de dollars, soit 110 fois le salaire hebdomadaire moyen. Les chefs d'entreprise australiens perçoivent approximativement le même niveau de salaire que leurs homologues des petits pays européens, mais moins que ceux du Royaume-Uni et des États-Unis (valeurs extrêmes). Les facteurs qui sous-tendent la rémunération des cadres sont les suivants :

- *Mondialisation.* La libéralisation de l'économie australienne et l'apparition de la concurrence à l'échelle mondiale signifient que les entreprises recherchent désormais les meilleurs professionnels dans le monde entier, et doivent donc offrir une rémunération en conséquence.
- *Taille des entreprises.* Un accroissement de 10 % de la taille de l'entreprise entraîne une augmentation de 4 % du salaire des dirigeants ; le salaire étant étroitement lié à la taille de l'entreprise, cet élément a une incidence sur la concurrence.
- *Structures salariales incitatives.* Les structures salariales comportant des éléments incitatifs sont un concept importé des États-Unis, dont le but est de remédier aux problèmes que pose la relation principal-agent. Les composantes incitatives des rémunérations ont été alignées sur les objectifs des actionnaires par le biais du lien établi avec la performance, de sorte que, pour les cadres dirigeants, la part variable représente environ 40 % de la rémunération de base, le reste étant constitué d'incitations à court et long terme. Cependant, comme l'adoption de ces primes ne s'est pas accompagnée de garde-fous appropriés, les niveaux de rémunération se sont envolés pendant les années 90. En outre, ce système part du principe que les conseils d'administration sont compétents et indépendants des directeurs généraux ; de plus, les contraintes de coût habituelles ne semblent pas s'appliquer.
- *Déficiences de la gouvernance d'entreprise.* La rémunération des cadres a fait l'objet d'une vaste médiatisation, qui a peut-être accéléré la propagation d'une sorte de complexe de supériorité des cadres, se manifestant par une tendance à se rémunérer mieux que la moyenne. L'absence de tout plafond à la rémunération des cadres aux États-Unis a exercé également une nette influence. Le seul frein réel est l'indignation du public, mais de nombreuses primes demeurent inconnues du grand public.
- *Capitalisation boursière.* Il existe une forte corrélation entre le salaire des cadres et la capitalisation boursière, et notamment le facteur chance : les mouvements à la hausse sur le marché des actions déclenchent un relèvement des rémunérations, même pour des dirigeants qui ne le « méritent » pas.

L'étude a conclu que, pendant certaines périodes (les années 90, par exemple), le marché s'était emballé, en l'absence de tout critère limitatif ou dispositif de contrôle. Les primes suivaient la valeur des actions de l'entreprise et des tendances boursières plutôt que les performances de l'entreprise ou ses résultats comparés à d'autres sociétés de la même branche, ce qui a des conséquences pour la concurrence. Les recommandations suivantes ont été formulées, pour renforcer le cadre de la gouvernance des entreprises :

- Éliminer les conflits d'intérêts en veillant à ce que :
  - les comités de rémunération soient indépendants ;
  - les dirigeants ne siègent pas aux comités des rémunérations ;
  - les dirigeants et les administrateurs n'utilisent pas leurs droits de vote au sujet des rapports concernant les rémunérations ;

- les dirigeants et les administrateurs n'utilisent pas de procurations sans consigne de vote au sujet des rapports concernant les rémunérations ;
  - lors des votes sur les rapports concernant les rémunérations, les détenteurs de procurations utilisent tous les pouvoirs qu'ils ont reçus avec consigne de vote.
- Améliorer la transparence :
    - un résumé de la politique de rémunération sera rédigé dans un langage simple ;
    - la rémunération effectivement reçue sera déclarée ;
    - les entreprises divulgueront l'identité des conseillers en matière de rémunération des cadres et leur relation avec l'entreprise ;
    - les conseillers en matière de rémunération dépendront directement du conseil d'administration et non de l'équipe dirigeante.
  - Renforcer le contrôle des actionnaires sur la rémunération (*say on pay*) :
    - lorsqu'un rapport de l'entreprise sur les rémunérations obtient au moins 25 % de voix « contre », le conseil d'administration est tenu de décrire, dans un rapport subséquent, comment il a tenu compte de l'avis des actionnaires et, sinon, d'expliquer pourquoi ;
    - lorsque le rapport subséquent sur les rémunérations obtient au moins 25 % de voix « contre » lors de l'assemblée générale suivante, une résolution impose aux administrateurs élus qui ont signé le rapport de remettre leur siège en jeu.

Le Président commente la définition d'une rémunération « excessive » et se demande si, dans la mesure où les dirigeants sont rémunérés au mérite, cela peut conduire à un oligopole collusif et, partant, avoir une incidence négative sur la concurrence ?

Un délégué de l'Australie fait observer que la question de la rémunération est devenue un enjeu politique considérable. Le gouvernement n'a pas encore émis de commentaires sur le rapport sur la productivité, mais c'est un thème populiste, et des voix s'élèvent pour suggérer des recommandations de plus en plus prescriptives, y compris la démission d'office. Cependant, la procédure serait complexe et soulèverait trois questions : i) pourquoi faudrait-il une procédure spécifique pour démettre un administrateur de ses fonctions pour des questions d'argent alors que les actionnaires peuvent le faire à tout moment ? ii) L'introduction de droits spéciaux de démission d'office pourrait ouvrir des vannes et se propager à d'autres critères tels que l'égalité homme-femme ou le changement climatique ; iii) les actionnaires devraient s'intéresser davantage à l'usage qui est fait de leur argent par les administrateurs ; c'est en effet leur responsabilité, et non celle des hommes politiques ou des commentateurs de la radio.

M. Fels estime qu'on peut considérer le salaire comme un indice du bon fonctionnement de la gouvernance d'entreprise en général, et la situation demande en effet que l'on se penche sur ce maillon faible de la relation « principal-agent ». Les dispositions prises pour la gouvernance d'entreprise peuvent fixer des limites à la liberté d'action des actionnaires, et l'étude a conclu qu'il fallait augmenter leur pouvoir. Les institutions ont leur importance, et il y a des questions d'administrabilité et de détournement de la réglementation qui peuvent mettre en jeu des intérêts puissants. Les institutions internationales ont elles aussi leur rôle à jouer, même s'il peut être difficile de comprendre que les entreprises publiques se comportent différemment sur le marché, comme on l'a vu au niveau de l'OMC. Les traités d'investissement bilatéraux, les accords de libre-échange (comme celui qu'ont signé les États-Unis et le Canada, et qui a des effets sur les services postaux du Canada) et des normes juridiques non contraignantes sont autant d'outils qui sont utilisés mais qui ont leurs inconvénients. Alors que peut-on faire ? Pour trouver la réponse, il faut se tourner avant tout vers la gouvernance d'entreprise plutôt que vers la

concurrence, et traiter les entreprises publiques comme des sociétés plutôt que comme des ministères. Mais comme celles-ci sont statutairement des monopoles, un instrument important pour remédier à cette situation consiste à accroître la concurrence sur le marché.

Le Président invite M. Sokol à présenter son exposé sur la politique de la concurrence et la gouvernance comparée des entreprises publiques. Suite à la crise financière, un certain nombre d'États contrôlent désormais des entreprises qui étaient auparavant dans le secteur privé, qu'il s'agisse d'institutions financières comme des banques ou d'entités non financières telles que des constructeurs automobiles. Mais lorsque ces entreprises commencent à recevoir un soutien de l'État, leurs résultats peuvent être différents de ceux des sociétés privées, et ces différences influent sur la performance. Comme l'expliquent dans leurs travaux Alchian et Demsetz, les incitations à l'œuvre dans les entreprises publiques sont différentes de celles des entreprises privées. Les recherches de Steigler semblent indiquer elles aussi que la gouvernance d'entreprise et la concurrence fonctionnent comme des substituts, mais ces deux domaines se chevauchent et ont chacun leur rôle à jouer. Premièrement, de bons mécanismes de gouvernance des entreprises publiques minimisent les cas de mauvaise gestion à la fois *ex ante* et *ex post*, et deuxièmement, la politique de la concurrence permet de réduire les distorsions induites par les entreprises publiques et les aides d'État. Par conséquent si, du point de vue de l'efficacité, les entreprises publiques créent des problèmes, une meilleure gouvernance et une politique de la concurrence efficace peuvent néanmoins se substituer l'une à l'autre pour aboutir à une situation plus efficace.

Les entreprises publiques sont différentes des sociétés privées dans la mesure où elles n'ont généralement pas de but lucratif et où certaines de leurs fonctions peuvent poursuivre des buts non financiers. Une entreprise qui appartient à l'État peut être utilisée à des fins politiques telles que l'emploi, des buts sociaux ou la formation de capital. Il se peut que les entreprises publiques ne soient pas concernées par la maximisation des profits parce qu'elles opèrent au sein d'un secteur réglementé, et l'État doit alors trouver un équilibre entre son rôle d'instance de réglementation et son rôle de propriétaire de l'entreprise. L'absence de justification par l'efficacité modifie le profil des incitations pour une entreprise publique. Les entreprises publiques, appartenant à l'État, n'ont pas d'actionnaires : les citoyens du pays en sont le plus proche équivalent. Ainsi, les propriétaires ont des droits restreints, c'est-à-dire qu'ils n'ont pas de droits de propriété directs sur l'entreprise et qu'ils ne reçoivent pas le produit de son activité. Grâce à la transférabilité des actions des sociétés privées, les actionnaires qui ne sont pas satisfaits des décisions prises par la direction peuvent simplement vendre leurs actions. Il s'agit là d'un important mécanisme de contrôle, car une baisse du cours de l'action met en péril la direction au travers du marché du contrôle des sociétés, péril auquel les entreprises publiques n'ont pas à faire face. De plus, les pouvoirs publics peuvent créer des règles du jeu inévitables sur un marché où une entreprise publique est en concurrence avec des sociétés privées. Comme la réussite des entreprises publiques est dans l'intérêt de l'État, celui-ci peut, en tant que responsable de la réglementation, restreindre la concurrence en offrant aux entreprises publiques divers avantages qu'il ne concède pas aux autres sociétés. En outre, les dirigeants des entreprises publiques sont moins susceptibles d'être démis de leurs fonctions par le conseil d'administration pour cause de mauvaise gestion, et une entreprise publique mal gérée a plus de chances d'être sauvée par l'État.

Il est clair que, dans les entreprises publiques et les sociétés privées, les contrôles internes et externes sont différents ; des recherches empiriques ont été menées dans ce domaine, répertoriant les contrôles spécifiques qui s'appliquent à chaque type et leurs différences.

- Contrôles internes
  - *Participation au capital et rémunération* : si les dirigeants possèdent une partie du capital de l'entreprise, les performances de celle-ci peuvent s'en trouver améliorées. Or, les dirigeants des entreprises publiques ne bénéficient pas des avantages financiers qu'offrent les sociétés privées, et ils ne touchent pas de primes supplémentaires lorsque le cours de l'action augmente.

- *Surveillance par le conseil d'administration* : le rôle du conseil d'administration est de surveiller l'équipe de direction pour le compte des actionnaires, et de protéger ceux-ci contre de coûteuses erreurs de gestion potentiellement assorties de risques. Dans les entreprises publiques en revanche, en l'absence de surveillance effective, il est facile pour les dirigeants de prendre de mauvaises décisions, parce qu'ils ne sont pas tenus responsables des conséquences de leurs décisions et ne sont pas confrontés à des répercussions telles que la démission d'office pour cause de mauvaise gestion.
- Contrôles externes
  - *Marché du contrôle des sociétés* : si les dirigeants d'une société privée prennent de mauvaises décisions, cela se traduit généralement par un fléchissement du cours de l'action, assorti d'un risque de prise de contrôle hostile. Ce sont là des facteurs incitatifs qui encadrent le comportement des dirigeants. Les entreprises publiques, en revanche, n'ont pas à faire face aux menaces de prise de contrôle puisqu'elles opèrent selon des contraintes budgétaires « souples », ce qui signifie qu'il se trouvera toujours une autre institution pour payer le prix de leurs erreurs de gestion.
  - *Marché boursier* : le cours des actions en bourse fournit des informations sur la situation relative d'une société. Les entreprises publiques, n'étant pas cotées, n'ont pas ce retour d'information qu'offrent les marchés boursiers sur les performances d'une entreprise.
  - *Notation* : les entreprises qui sont mal gérées et dans une situation financière difficile voient leur dette mal notée par les agences de notation telles que Moody's et Standard & Poor's. Or, parce que l'État garantit, de façon implicite ou explicite, la dette des entreprises publiques, celles-ci jouissent d'un avantage par rapport à leurs concurrents privés et obtiennent ainsi des notations privilégiées.
  - *Marché de l'emploi des cadres* : dans une société privée, un dirigeant peut se voir obligé d'assurer une gestion de bonne qualité pour préserver sa réputation et donc ses chances de retrouver un emploi ultérieurement. Dans les entreprises publiques, en revanche, la surveillance exercée sur les dirigeants est souvent faible, par rapport aux sociétés privées, en raison de l'absence de contrôle extérieur. Mais, en l'absence de but lucratif, leurs dirigeants peuvent conserver leur emploi indépendamment des performances de l'entreprise.
  - *Faillite* : le risque de faillite et de liquidation éventuelle oblige de nombreuses entreprises à limiter les risques qu'elles prennent, en raison des conséquences potentiellement négatives de stratégies trop risquées. Les entreprises publiques, quant à elles, sont rarement mises en faillite, et leurs dirigeants ne sont pas soumis aux mêmes contraintes que ceux des sociétés privées.

<b>Entreprises privées et publiques : contrôles internes</b>		
<i>Contrôles internes</i>	<i>Privée</i>	<i>Publique</i>
Structure de l'entreprise	Oui	Non, mais parfois oui (conditions)
Participation au capital	Oui	Non
Rémunération	Oui	Pas vraiment
Surveillance par le conseil d'administration	Oui (mais parfois problématique)	Oui (mais généralement problématique)
<b>Entreprises privées et publiques : contrôles externes</b>		
<i>Contrôles externes</i>	<i>Privée</i>	<i>Publique</i>
Marché du contrôle des sociétés	Oui	Non
Marché boursier	Oui	Non
Notation	Oui	Parfois
Marché de l'emploi des cadres	Oui	Non
Faillite	Oui	Non

Les mesures d'incitation constituent un facteur important dans l'organisation institutionnelle et la gouvernance des entreprises publiques. Plus l'État traite une entreprise publique comme une société privée, plus elle se comporte comme telle. Les formes de gouvernance calquées sur le modèle privé devraient produire de meilleurs résultats mais, en raison des lacunes des structures institutionnelles, ce n'est pas toujours le cas. Les entreprises publiques se comportent différemment des sociétés privées pour les raisons suivantes : i) les entreprises publiques se concentrent sur la maximisation des revenus plutôt que sur celle des bénéfices ; ii) les entreprises publiques sont incitées à faire augmenter les coûts de leurs concurrentes ; et iii) les entreprises publiques sont incitées à pratiquer des prix artificiellement bas. Ce dernier phénomène pose problème, car les critères permettant de déterminer un prix d'éviction sont fondés sur les coûts ; or, il est difficile de décider quel est le coût à prendre en compte pour une entreprise publique : coût marginal, coût variable moyen, coût évitable moyen ou coût marginal moyen à long terme. Il n'existe pas de critère antitrust spécifique pour les entreprises publiques, qui réussissent généralement les tests de prix d'éviction parce que i) les avantages qu'apporte la propriété publique de l'entreprise ne sont pas imputés dans les coûts et ii) le bénéfice du biais réglementaire de l'État n'est pas non plus intégré dans les coûts.

La conception des structures institutionnelles devrait idéalement refléter celle des sociétés privées mais, en pratique, c'est rarement le cas. Dans certains pays, comme la Suède et la Nouvelle-Zélande, les entreprises publiques sont tenues de suivre les mêmes procédures que dans le secteur privé en matière de communication financière et de recherche de l'efficacité. Ce n'est toutefois pas le cas de la majorité des entreprises publiques. Aux États-Unis par exemple, le conseil d'administration de l'entreprise publique de services postaux est composé de juristes nommés selon des critères politiques, ce qui lui donne un tout autre visage que son concurrent privé, UPS. Les répercussions sont importantes parce que, si les entreprises publiques ne cherchent pas à maximiser leurs bénéfices, les hypothèses relatives à la concurrence ne peuvent pas s'appliquer. Il est impossible de connaître les coûts réellement encourus par une entreprise publique si tout est subventionné : les entreprises publiques apparaissent comme des exemples de réussite alors que ce n'est pas le cas.

Si ces modifications étaient adoptées, les futures périodes de reprise ne donneraient pas lieu à une telle multiplication des entreprises publiques. On peut se demander si les institutions nationales peuvent à elles seules remédier au problème des entreprises publiques, mais d'autres institutions, telles que l'Organisation mondiale du commerce et divers accords de libre-échange, posent tout autant de problèmes. L'adoption de mesures juridiques non contraignantes et des meilleures pratiques peut constituer une partie de la solution. Pour améliorer la concurrence et la gouvernance des entreprises publiques, d'autres recommandations incluent :

- l'amélioration de la surveillance externe
- le renforcement de la gouvernance interne des entreprises
- la constitution des entreprises publiques en sociétés privées
- l'intensification de la concurrence
- la privatisation
- l'élaboration de critères antitrust viables (s'appuyant par exemple sur les travaux de Sidak & Sappington (2003), qui reconnaissent que l'imputation des coûts pose des problèmes potentiels et que les critères de coût ne sont pas faciles à appliquer, étant donné les carences institutionnelles du système judiciaire et des autorités de tutelle).

Au total, il importe d'admettre que toutes les entreprises ne peuvent pas rentrer dans le même moule et qu'il convient d'imaginer des solutions différentes en fonction des secteurs et des types de problèmes que posent les entreprises publiques.

M. Bianchi est invité à donner une vue d'ensemble de la concurrence, de la gouvernance d'entreprise et de la crise du point de vue des services de l'OCDE chargés de la gouvernance d'entreprise. La crise financière a placé les décideurs politiques devant un certain nombre de nouveaux défis, dont les principaux sont i) comment réduire les effets systémiques de la crise, ii) comment surmonter les faiblesses structurelles qui ont contribué à l'émergence de la crise et iii) comment mener à bien les stratégies de sortie. Les deux domaines stratégiques pour les responsables politiques sont la gouvernance d'entreprise et la concurrence. L'environnement macroéconomique et de marché prévalant avant la crise a mis le système de gouvernance d'entreprise à rude épreuve, avec différents effets. Premièrement, on a vu apparaître des possibilités nouvelles et inhabituelles de générer des bénéfices et de la croissance. Deuxièmement, les actionnaires ont été en mesure d'exercer des pressions plus fortes en faveur de résultats à court terme, tout en négligeant leurs fonctions de surveillance. Troisièmement, les conseils d'administration n'ont pas su définir et gérer une stratégie de croissance « soutenable ». De plus, la présence d'éléments oligopolistiques a favorisé l'aléa moral et la création d'entités trop grandes pour faire faillite.

L'OCDE a décidé de se concentrer sur la gouvernance d'entreprise et la concurrence, deux des principales composantes de sa réponse stratégique à la crise économique et financière. Les principes de gouvernance d'entreprise ont été révisés en 2004 et constituent une partie des principes de base du Conseil de stabilité financière (CSF). L'OCDE est la référence pour la définition des normes de gouvernance d'entreprise, et ses principes en la matière forment l'une des douze normes de base du CSF. Un certain nombre d'autres organisations internationales s'appuient sur le travail de l'OCDE, notamment la Banque mondiale, la BRI, l'OICV, l'ICGN et l'IFSE. Les principes de l'OCDE servent fréquemment de référence dans des initiatives nationales, même dans des pays non membres comme le Brésil et la Chine.

La gouvernance d'entreprise et la concurrence sont-elles des substituts ou des compléments ? La question n'est toujours pas tranchée. Dans une situation de concurrence parfaite, la gouvernance d'entreprise peut être sans effet, mais des données empiriques semblent indiquer d'importantes complémentarités dans des situations de concurrence quasi-parfaite. Le contexte économique de l'après-crise (largement inférieur à l'optimum) souligne la nécessité d'affiner les meilleures pratiques, tant en matière de concurrence que de gouvernance d'entreprise. Parmi les enjeux spécifiques, on peut citer l'accroissement du rôle de l'État dans l'économie par le biais de la participation au capital et de la réglementation, l'indignation du public à l'égard des rémunérations excessives, le scepticisme quant aux vertus du marché, et le recul de la notion de valeur actionnariale au profit du concept de valeur partenariale. Ce nouveau contexte pourrait toutefois prendre un visage très différent si, comme il est probable, les facteurs suivants entrent en jeu :

- réduction des possibilités d'exercice de la concurrence et accroissement des rentes de situation
- assouplissement, pour les décideurs politiques, des possibilités d'interruption ou d'inversion du processus de privatisation et d'instauration de marchés concurrentiels
- renforcement du pouvoir de l'actionnaire dominant
- relâchement des pressions concurrentielles sur le marché du contrôle des sociétés et sur le marché de l'emploi des cadres dirigeants (loyauté / compétences)
- importance croissante des considérations politiques dans la stratégie des entreprises
- baisse des incitations à investir dans le marché
- diminution du rôle des investisseurs institutionnels dans la gouvernance d'entreprise.

Ces facteurs annoncent le retour à un modèle de gouvernance plus traditionnel, « à l'italienne », dont les caractéristiques sont un actionnaire fortement dominant, des gestionnaires timorés, des actionnaires minoritaires peu dynamiques et un recours fréquent aux mécanismes favorisant le contrôle tels que les

pyramides, les doubles catégories d'actions et les coalitions. Les risques que présente ce modèle sont l'expulsion des actionnaires et les problèmes découlant du double rôle de l'État, actionnaire et responsable de la réglementation. Il est par ailleurs marqué par un moindre usage de la rémunération des dirigeants en tant que mécanisme d'incitation, une dispersion insuffisante du capital et un faible degré de développement du marché des actions.

Quel est alors le rôle de la gouvernance d'entreprise ? Elle peut être considérée comme un « stimulateur de concurrence ». La gouvernance d'entreprise est particulièrement nécessaire lorsque la concurrence s'exerce plus faiblement, parce qu'elle contribue à maintenir en vie le marché du contrôle des sociétés et le marché de l'emploi des cadres dirigeants. Tout comme la concurrence, les structures d'actionnariat contestables, combinées ou complétées par de solides dispositifs internes de gouvernance, induisent l'efficacité. Le Comité sur la gouvernance d'entreprise a élaboré un plan d'action contenant un ensemble de recommandations dans les domaines de la gouvernance d'entreprise qui sont spécifiquement en rapport avec la crise. Les thèmes prioritaires sont les suivants :

- la gouvernance des rémunérations
- la mise en œuvre d'une gestion des risques efficace
- la qualité des pratiques du conseil d'administration
- l'exercice des droits des actionnaires.

Dans chacun de ces domaines, le Comité a mis en évidence i) les principales conclusions de l'analyse des leçons à tirer de la crise financière au regard de la gouvernance d'entreprise et ii) un certain nombre de messages importants qui ont été transposés en recommandations concrètes. Des mécanismes systématiques d'examen par les pairs et de dialogue entre pairs seront adoptés afin de surveiller efficacement la mise en œuvre des recommandations et la détection en temps opportun de nouveaux problèmes. On s'appuiera pour ce faire sur i) l'analyse de questions critiques apparaissant dans un ensemble de pays (examen thématique par les pairs) et ii) une analyse approfondie des systèmes de gouvernance d'entreprise dans une sélection de pays (examen de pays par les pairs). Le premier examen thématique par les pairs est prévu pour le printemps 2010 et portera sur la rémunération dans les sociétés non financières au Royaume-Uni, au Japon, au Brésil, au Portugal et en Suède.

Dans l'environnement actuel, les responsables politiques ne peuvent pas se permettre de négliger les questions de gouvernance et de concurrence. Ces deux domaines ont joué un rôle important et ont subi l'influence de la crise, et ils occupent tous les deux une place capitale dans le mouvement de reprise. L'OCDE peut mener une action pertinente i) en établissant des lignes directrices pour une mise en œuvre effective des principes et des normes à l'échelle mondiale (y compris dans les grands pays non membres, à savoir le groupe BRIC) et ii) en adaptant les principes aux nouvelles circonstances, par exemple en ce qui concerne le rôle temporaire des États en tant que propriétaires de banques. Il est essentiel de mettre au point des mécanismes de surveillance efficaces et de proposer un forum de dialogue sur l'action des pouvoirs publics. Il s'agit notamment de détecter, grâce à une démarche prospective, l'apparition de nouvelles faiblesses éventuelles et de plaider pour une réglementation effective plutôt qu'excessive. L'erreur à éviter serait de transposer à l'ensemble des entreprises des réformes qui ont été conçues pour remédier aux risques systémiques sur les marchés financiers.

Un délégué du Portugal fait observer que, s'il convient certes d'examiner conjointement les questions de gouvernance et de concurrence, on peut se demander si la rémunération des dirigeants et les questions de concurrence devraient faire l'objet d'une analyse commune. La rémunération des dirigeants d'entreprise est un sujet très sensible, tant sur le plan politique que vis-à-vis de l'opinion publique. Certains types de gouvernance d'entreprise peuvent aboutir à une rémunération excessive, mais il faut s'abstenir d'établir un lien de cause à effet. En abordant le problème des rémunérations excessives, on risque de déclencher des

débats sur les négociations salariales et la politique de la concurrence, compte tenu de la puissance des syndicats qui sont présents dans les secteurs protégés. La politique de la concurrence devrait rester à l'écart de ces débats.

M. Fels répond que, si la question des relations entre partenaires sociaux est encore pour le moment hors du champ couvert par le droit de la concurrence, cela pourrait changer. Dans les secteurs de l'éducation, de la santé et des services publics, il se pose d'importants problèmes de concurrence en relation avec la main-d'œuvre, et il sera intéressant de voir comment le paysage évolue au cours des dix prochaines années.

Un délégué de l'Égypte signale que des protestations ont été enregistrées contre le fait que c'est l'entreprise qui paie les amendes pour infraction à la loi antitrust alors que c'est un individu en particulier qui est responsable de cette infraction. Les questions de gouvernance devraient donc inclure un renforcement de la responsabilité concernant les revenus de l'entreprise, pour vérifier qu'ils sont en conformité avec la législation du pays où opère l'entreprise, par exemple en matière de blanchiment de capitaux.

En conclusion, le Président déclare que cette audition a offert aux délégués une meilleure vision de l'interface entre gouvernance d'entreprise et concurrence, et a exploré les différents aspects de la propriété des entreprises. Elle a également abordé la question du conflit d'intérêts entre actionnaires et administrateurs, et celle du mauvais fonctionnement des conseils d'administration, résultant de problèmes d'imbrication ou d'un manque de connaissance de l'entreprise. Le renforcement de la gouvernance est l'un des outils essentiels qui permettront d'améliorer la situation actuelle. La taille des conglomérats est une autre question importante, et il conviendrait de déterminer si la classification actuelle est adéquate et s'il ne faudrait pas ajouter d'autres dimensions. Le Président souligne qu'il faut poursuivre les débats, en particulier sur la question de la rémunération ; on a en effet enregistré des cas d'application stricte de la législation antitrust sur la base des incitations financières offertes aux salariés, entraînant la non-conformité avec le droit de la concurrence.





**CONTRIBUTIONS FROM PANELLISTS**



## COMPETITION, CORPORATE GOVERNANCE AND THE CRISIS

*Presentation by Mr. Marcello Bianchi*



ORGANISATION FOR ECONOMIC  
CO-OPERATION AND DEVELOPMENT



## Competition, Corporate Governance and the Crisis

Marcello Bianchi

Chair, OECD Corporate Governance Committee  
Head, Impact Assessment Unit, CONSOB



## The financial crisis raised new challenges for policy makers

- The main questions are:
  - how to reduce the systemic effects of the crisis
  - how to overcome the structural weaknesses which contributed to the emergence of the crisis
  - how to handle the exit strategy



## Two strategic areas for policy makers: corporate governance and competition

- The market and macroeconomic environment before the crisis put the corporate governance systems under stress:
  - new and unusual profit and growth opportunities emerged in particular in the financial sector
  - shareholders were able to exercise stronger pressure for short-term results while neglected their monitoring functions
  - boards failed to define and manage a “sustainable” strategy with regard to: risk appetite and incentive/remuneration mechanisms
- The presence of oligopolistic elements contributed to moral hazard and to create Too-Big-To-Fail situations



## The role of OECD

- The OECD decided to focus on corporate governance and competition as two of the main elements of its Strategic Response to the Financial and Economic Crisis
- In corporate governance, the OECD is the international standard setter :
  - the Principles are one of the FSB's 12 core standards
  - the World Bank and others (BIS, IOSCO, ICGN, IFSE) rely on OECD work
  - OECD Principles are frequently referenced in national initiatives even in non member countries (Brazil, China)



## Corporate Governance and Competition: substitutes or complements?

- It is still an open issue in the theoretical debate
- Empirical evidences point to significant complementarities in "second best" situations
- The post-crisis economic context (strongly suboptimal) stresses the opportunity to enhance both competition and corporate governance best practices:
  - Increasing State role in the economy (ownership and regulation)
  - Public outrage on excessive remunerations
  - Skepticism on market's virtues
  - Switch from shareholder to stakeholder value



## The new context:

- Less room for competition /higher rents
- Easier for politicians to interrupt/reverse the process towards privatization and competitive markets
- Increasing power of controlling shareholder
- Less competitive markets for corporate control and top managers (loyalty vs skills)
- More emphasis on political consideration within corporate strategy
- Reduced value creation reduce incentives to invest in the market
- Lower role for institutional investors in corporate governance



## Coming back to the traditional “Italian” corporate governance model?

- Strong (controlling) owner, weak managers and weak minority shareholders
- Wide use of control enhancing mechanisms (pyramids, dual class shares, coalitions)
- Risk of shareholders’ expropriation
- Problems arising from the role of the State as owner and rule maker
- Low emphasis on executive remuneration as incentive mechanism
- Insufficiently dispersed ownership and low degree of stock market development



## The role for Corporate Governance

- Corporate Governance as a “Competition booster”
- CG especially needed when competition is lower as it helps the market for corporate control and the market for top managers “surviving”
- Similarly to competition, contestable ownership structures combined /complemented by robust internal governance mechanisms induce efficiency



## The CG Committee action plan

- The issue of a set of recommendations in the specific areas of Corporate Governance more connected to the crisis (a self-standing commentary to the Principles to be published in February)
- The adoption of a systematic mechanisms for peer review and peer dialogue as instruments for effectively monitoring implementation and timely identifying new “problems” based on:
  - the analysis of emerging critical issues across a set of countries (thematic peer review)
  - an in-depth analysis of corporate governance system in selected individual countries (countries peer review)
 (April 2010: first thematic peer review on non-financial companies remuneration in **Uk, Japan, Brazil, Portugal, Sweden**)





## The recommendations for better implementation of the Principles

- the areas that we have addressed with priority are:
  - the **governance of remuneration**,
  - implementation of effective **risk-management**,
  - the quality of **board practices**
  - the exercise of **shareholders rights**
- on each of these areas we identified:
  - the **key findings** of our analysis of corporate governance lessons from the financial crisis  
(mainly focused on financial companies affected by the crisis)
  - a number of **main messages**, which will be transposed in actual recommendations to be published by the end of this year  
(valid for all listed companies)



## Conclusions

- It is not true that in current hard times corporate governance can be neglected
- The OECD role is to ensure the relevance of the Principles as the international standard and favor their effective implementation on a global basis (relevance of major non-member countries, i.e. BRICs)
- Adapt the Principles to new circumstances
  - Address temporary ownership role of Governments in banks



## Conclusions

- Support effective rather than excessive regulation
  - specific danger lies in transplanting corporate governance reforms designed to address systemic risks in the financial markets to the corporate sector generally.
- Develop effective monitoring mechanisms and policy dialogue to improve implementation of standards and good practices

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## COMPETITION AND CORPORATE GOVERNANCE IN CHILE

*Note by Prof. Hugo Caneo*

### 1. Introduction

The Chilean system of protection of competition is regulated by a particular statute the DL N° 211 of 1973, as amended by Laws N° 19.911 (14 November, 2003) ND 20.361 (13 July, 2009), hereinafter the “Law”, as well as by guidelines issued by the *Tribunal de Defensa de la Libre Competencia*, and, particularly, by the *Fiscalía Nacional Económica*, in order to clarify certain matters that may affect those under regulated by the Law, construe obscures parts of the Law, as well as for creating certainty among entities affected by such regulations.

That system rests, mainly, in three institutions: the Corte Suprema, (Chilean Supreme Court), the Tribunal de Defensa de la Libre Competencia (Competition Protection Court or Competition Court, hereinafter the “TDLC”) and the Fiscalía Nacional Económica (Chilean Competition Prosecutor Agency or National Economic Prosecutor’s Office, hereinafter the “FNE”).

The Chilean Supreme Court reviews not just the fulfilment of the rules governing the due process or formalities, but also the merits of the decisions of the TDLC. Its decision is the final one. It has not been infrequent that the Supreme Court changes well justified TDLC holdings.

On the other hand, the TDLC, created by the law No. 19.911, in force from 14 April 2004 onwards, that amended the Law, is a specialised and independent entity with judicial powers, that although is not part of the Chilean Judicial System is under the authority and corrective supervision of the Chilean Supreme Court, and whose purpose is to prevent, correct and punish infractions to competition regulations. TDLC has the authority to resolve or decide legal disputes from claims and non-controversial processed filed, either from the FNE, private or governmental entities and persons. TDLC administers justice in accordance with the rules of the Law and the evidence brought to it by parties of the process. Furthermore, it has remedial powers in case of findings.

The TDLC judges are comprised by a lawyer, who shall be the President of the Tribunal<sup>1</sup>, four experts in competition matters, two of them must be lawyers and the other two must be experts graduated or with post graduate studies in economics and competition issues.

Finally, the FNE is the entity in charge of investigating acts or conducts that may impair the normal development of the competition in Chile; it may file claims against those who such investigations determine as responsible for such acts or conducts conflicting competition regulations in Chile; propose sanctions; provide a “well founded opinion” in order to recommend or not the Chilean State may confer a monopoly on a private party or authorise conducts prohibited by the competition law.

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<sup>1</sup> Appointed by the President of the Chile Republic from a list of five candidates designated by the Supreme Court comprised by those candidates determined prior a public contest. Only candidates with a distinguished professional or academic career in the area of competition, or in commercial or economic law, and with at least 10 years of professional experience, may participate in such contest.

A recent amendment to the Law introduced by Law N° 20.361 (13 July, 2009), incorporated the following matters:

- Immunity/leniency provisions that has been complemented by an “Internal Guideline” issued by the FNE;
- More extensive powers of investigation against cartels. The powers thereby encompass searches, raids, inspections, wiretapping and examination of communication records. These powers are subject to a double judicial revision: first, a TDLC authorisation, and then, a judicial order from a Court of Appeals. Certain provisions applicable to criminal proceeding must be complied with;
- Statute of limitations was extended from two years to five years for collusion cases and to three for any other competition infractions;
- Increase in the maximum amount of fines to be imposed by the TDLC from USD 15 million to USD 22.5 million, approximately. The fines may be imposed upon both, legal entities and individuals, such as board of directors, managers or officers who participated in the collusive agreement, in which case their fines cannot be borne either by the firm itself or by its shareholders.
- The highest sanctions in the Law are fines, there is no sanction consisting of imprisonment. Although there is a law proposal that seeks to re-establish as the highest sanction imprisonment for cases of collusion on prices;
- Changes in the substantive provision addressing cartels, that includes better definitions for hard core cartel conducts (including boycotts and bid rigging), to which the new enforcement tools, namely leniency, raids, inspections and wiretappings, are applicable; regulation of a non-adversarial procedure before the TDLC (which applies to mergers), the FNE will have standing for opening merger consultation procedures. TDLC’s decisions in these procedures can be appealed before the Supreme Court.

## **2. Chilean corporate governance environment**

Corporate Governance could be understood as the group of institutional practices and mechanisms in the process of adopting corporate decisions that facilitate the permanent creation of value in a frame of transparency, ethics and corporate responsibility, by aligning different interests and promoting the respect of the rights of every shareholder and stakeholder that directly or indirectly participates in the company.

The main characteristics of the Chilean Market are:

- The ownership of companies is very concentrated;
- The ownership of companies is held by groups of companies that operate in different markets (financial, brick & mortgage, etc) through subsidiaries and affiliates;
- The agency problem is not one derived from a conflict of interest between who owns the company and who managed the company, but between the controller(s) of the company and the minority shareholders. Actually the latest amendments included in the securities market law had as objective precisely to solve that conflict;

- Decisions of the board of directors are usually adopted neither by the board of directors nor during the board of directors meeting, but they are imposed by the controllers;
- It seems that several boards of directors have not been acting diligently in the fulfilment of its duties, specifically with their role of monitoring the company, resting such work on the labour of managers and officers. For example, several directors participate in boards of directors of more than 10 different companies;
- Some companies that in the past were family owned and took the decision to go public, seem have been seen by their old owners as the same business previous to its opening with disregard of the fact that their ownership is now shared among different investors. For example, not disclosing on timely manner material information about the company or using business opportunities for their own interest instead of permitting its use for the company;
- Most directors focus its function to short term results instead of a strategic vision of the company and its sustainability in the long term;
- Material non disclosed information is still being managed in ways no compatible with its fair and timely provision to the market and shareholders;
- Some directors have probably not been so active in the fulfilment of their duties accepting with no further discussion or analysis impositions from controllers or other interested parties;
- Auditing firms opinions seem having been affected by their interest in obtaining additional incomes coming from the provision of other services, different to only auditing the companies that they have audited, situation that could hamper the requested judgment independence at the moment of performing their revisions, affecting in that way the quality, precision and reliance of their work.

The issues indicated from iv to vii and from ix and x produce a serious and unnecessary exposition to risks to the organisation, since managers or other officers may be tempted to act opportunistically, as they may feel that no effective controls are in place that may permit the detection of their actions, behaviours or non-formal agreements that may affect the business of the organisation or its compliance with applicable regulations.

Regarding iv to ix a recent amendment in the Chilean Securities Law in force from 1 January, 2010 has introduced specific regulations that seek that the board of directors establishes and formalises procedures, practices and manuals that regulates how the organisation provides and control the flowing of information within and out of the organisation. As a logical consequence of such legal request the board of directors must monitor and comply with the regulation issued by it, as well as keep it permanently updated in order to avoid the company, its board of directors, and its managers and officers may incur in responsibility.

Likewise, the amendment looks for facilitating the enforcement of the responsibility of the board of directors through legal suits that could be filed by shareholders and stakeholders. In that sense, the amendment in the Law changed the *onus probandi*, since now are directors those who have to prove the correctness of their actions, as well it made explicit certain minimal actions and obligations that the board of directors has to comply with in order to accredit their diligence.

Finally, as a result of the implementation of the suggestions made by the OECD, in order to the institutional environment of Chile would approach to its principles and standards and, consequently,

permitting Chile being accepted as member, a new law enter into force on 2 December, 2009, that imposes criminal sanctions not only to natural persons, as has been the Chilean legal tradition, but to entities, on the basis that a dependant, officer or controller of the organisation commits any one of the following crimes: money laundering, financing of terrorism, bribery to domestic or foreign public officers.

This new law requests to any organisation (private or governmental) the creation of internal regulations, manuals and procedures that establish clear restrictions and how the employees and organisation have to act in order to prevent that any of the above mentioned crimes are committed either by the organisation, its dependants, or other employees or persons with powers to represent the organisation.

Such preventive mechanisms must exhaust the likelihood that such acts may be committed in such a way that if any employee or officer in fact commits any of those crimes, he would breach the express and written internal regulations on the matter. In consequence, the organisation must be able to accredit that it has implemented all the mechanisms necessary for preventing such conducts.

Other new element to be highlighted regarding that regulation, despite the fact of the burdensome Chilean labour regulations, the new rules referred above are considered as part of the labour agreement and its infraction is deemed by the law as a serious infraction to the labour obligations of any employee or dependant, and consequently it is possible to base firing an employee on that ground.

### **3. A recent case with a high impact in both areas**

The retail pharmacy Chilean market is, according to the opinion of the FNE, provided in its claim filed before the TDLC, a “strongly concentrated one in three retail pharmacy chains (*Farmacias Ahumada – FASA – Cruz Verde* and *SalcoBrand*, hereinafter the “Members of the Agreement”, their sales represent, jointly, more than 90% of that market. Retail pharmacy market is characterised, also, by having high entry barriers that prevent or make harder to compete in that market, unless the challenger company is organised or acts as a chain, among other requirements.

In 2007, the Members of the Agreement faced each other in a strong commercial and advertisement competition that soon become in a price and commercial war among each other, one of the ways of competition included the use of price comparison, which, at its time, provoked that those pharmacy chains ask the intervention of the TDLC on the grounds of unfair competition.

As consequence of such campaign the commercialisation margins of those competitors were reduced, especially regarding those products that were able to guide the preferences of the consumers. Therefore, those products were intensively used during the course of that campaign.

In the opinion of the FNE the effects of that price war concerned the Members of the Agreement, because the consequences regarding several products were becoming increasingly negative, introducing doubts about the convenience of following that campaign, instead of looking for the same benefits, but this time by the way of collaborating each other.

In parallel, *Empresas Juan Yarur S.A.C.*, controller of the *Banco de Crédito e Inversiones* entered into the ownership of the *Salcobrand*, situation that permits *Salcobrand* to strength its financial position as well as improving its market position during most of the 2008 period.

### **4. Conversations among competitors**

In the meanwhile, *Salcobrand* hired executives from *Fasa* and *Cruz Verde*, even more one of the officer responsible for purchases of *Salcobrand* owns stocks of *Fasa*.

Other element used for evidencing the collusion among competitors, was the strategic union of Salcobrand and Socofar S.A., being the latter company the provision supply central of Cruz Verde, for providing pharmaceutical products to Salcobrand.

According to the FNE investigation on November, 2007, the Members of the Agreement agreed to terminate the price war, not only by ending the competition among them, but also by co-ordinating fixing price. Such co-ordination would require that the three chains would agree sharing information about them in order to permit fixing prices, in order to avoid that one chain could get a bigger share of that market, and furthermore that would also permit creating among the public an image of a generalised increasing in of the pharmaceutical products, as well as permitting to extract as much resources as possible based on the inevitability of the consuming by customers.

In order to organise the collusion the Members of the Agreement had to prepare lists of the products elaborated by different pharmaceuticals that presented low profitability as consequence of the war price, in order to evaluate the products that would be include in the agreement as well as programming their increases.

The co-ordination of the increasing of prices was facilitated by the usual publication by Chilean pharmaceuticals companies of the prices of their products suggested for sale at the retail level.

The number of products included in that list was increased as soon as the success of that strategy was proved by the Members of the Agreement.

At the end, the Members of the Agreement used the pharmaceuticals companies to co-ordinate and monitor the fulfilment of the agreement, by the way of being used as mechanism for announcing the subsequent increases in the prices, its amount, the beginning date for the increase of price, in certain cases, the order in which the increases of prices should occur, and even they permitted showing lack of co-ordination.

Such agreement was implemented from December, 2007, by the co-ordinated increasing of 62 products, from which 15 were notorious anticonceptives, most consumed, for instance, the price of the anticonceptive "*Marvelón-20*", was increased in an average of 94%, during the same day, 28 December, 2007. The same day the three pharmacy chains raised at the same time the price of the product called "*Tobe 2.5 Mg*" (sexual hormones), in an average of 61%.

Once the Members of the Agreement verified the fulfilment of the agreement, they decide to raise the number of products that the agreement involved. Later in March, 2008, the Members of the Agreement added new 40 products. For example, on 12 March, 2008 the price of "*Nexium 40 Mg*" was increased in average up to 105%.

The increases of prices between December, 2007 and April, 2008, in the opinion of the FNE were material, uniform and simultaneous, because in each increase the Members of the Agreement augmented materially the group of products, in the same percentages; up to the same price; in the same day or close to the same day, never longer than a few days. During the period the FNE investigated, between December 2007 to April, 2008, the Members of the Agreement co-ordinated a material increase of the prices, in average 48%, producing a total increase of \$27.000 million (US54 million) in their gross income.

Those increases of the prices would have been obtained as the consequence of the agreement in the prices of products called notorious, ethical and frequently used generally chronicle, because they were those which price variations are more perceived by customers and which prices are frequently asked by consumers because they its relevance for them, situation that granted a better market position to the Members of the Agreement.



Furthermore, the Members of the Agreement knew that if one of them breached the agreement that member would be exposed to lose its market share in respect of the other parties of the agreement, but on the opposite the agreement would allow them to obtain increasing profits from the extraction of resources from the customers.

Finally, as evidence of such agreement, the FNE indicated that no one of the Members of the Agreement has based, again, its strategy of competition on the basis of reducing prices, but only on offering better attention or supplement benefits, usually paid by the pharmaceuticals.

In conclusion, for the FNE, the above described acts and conducts had as purpose and effect, agree and obtain a co-ordinate increasing of the prices for sales to the public of pharmaceuticals products hindering, restricting or impeding the competition, in infraction to the article 3° of the *Decreto Ley N° 211* (the “Law”), particularly its letter a). Consequently, the FNE requested to the TDLC the imposition of the highest fines established on the Law.

The pertinent section of article 3° reads as follows: “Among others, the following shall be considered as acts, agreements or conventions that hinder, restrict or impede free competition, or which tend to produce said effects:

Express or tacit agreements between competitors, or concerted practices between them, which confer to them market power and which consist of fixing sale prices, purchase prices, or other commercial terms and conditions, restricting output, allocating territories or market quotas, excluding competitors, or affecting the results of call for tender processes (bid rigging).

Abusive exploitation by an economic agent or a group of economic agents, of a dominant position in the market, fixing sale or purchase prices, tying a sale to the purchase of another product, allocating territories or market quotas or imposing other similar abuses.

Predatory practices, or unfair competition practices, carried out with the purpose of attaining, maintaining or increasing a dominant position.”

As consequence of such claim, Fasa agreed with the FNE the recognition of its participation in the collusion, the payment of a fine and the offer of a compensation program to Fasa’s customers affected by the collusion in exchange for being excluded of the claim being known by the TDLC.

Fasa maintains investments in Chile, Peru and Mexico.

## **5. Relevant dates of the case**

- *9 December, 2008.* FNE filed a claim before the TDLC against Fasa, Cruz Verde and SalcoBrand on the grounds that they agreed each other in order to fix prices (raising prices).
- *10 December, 2008.* Date on which the board of directors of Fasa was informed about the filing of the claim of the FNE against Fasa.
- *13 March, 2009.* Date of signature of the agreement between the FNE and Fasa. That is filed with the TDLC on 23 March, 2009 in order to obtain the approval of the latter.
- *23 March, 2009.* Fasa and FNE filed before the TDLC an agreement terminating the investigation against FASA. Part of the conditions requested by the FNE in order to reach the agreement was the recognition by FASA of its participation in a mechanism to raise prices of certain products (222 products), as well as the payment of a sum of \$593 million (approximate USD 1.2 million).

- *20 April, 2009.* Fasa offered to the customers affected by the collusion a reimbursement equal to the price paid in excess because the collusion in respect of any one of the 222 products involve in the collusion. The reimbursement program was calculated involving a total cost for Fasa of \$2,500 million (approximate USD 5, 02 million).
- *28 April, 2009.* Fasa shareholders held a meeting, in which minority investor (Falabella and Chilean AFPs) accused to the president and controller of Fasa on the grounds that they were neither informed about the negotiations nor about the agreement reached with the FNE in which Fasa declares itself guilty of collusion with its main competitors. Despite the fact of his legal obligation to be informed about a process like the above mentioned. Despite the fact that the Chilean AFPs appointed two directors in Fasa, such directors indicated that they were not informed about the status of the negotiations with the FNE.
- *4 June, 2009.* AFP Capital<sup>2</sup> filed a legal suit against the President of the board of Directors of Fasa<sup>3</sup>, during the period of the FNE investigation on the grounds of breaching the Chilean corporate Law, N° 18.046, and affecting minority shareholders rights, in his position of President of the board of directors and the controller of Fasa.
- *2 July, 2009.* the *Superintendencia de Valores y Seguros* (Chilean Securities and Insurance Regulator, hereinafter the “SVS”) officially reported charges against the President and all the members of the board of directors and the CEO of Fasa on the grounds of no communicating material information to the board of directors, the shareholders and the market, as well as for not acting diligently in the performance of their duties as directors by not inquiring the course and consequences of the negotiation and the status of the businesses and prices policy followed by Fasa during the period in which the collusion was being complied with by the Members of the Agreement.
- *31 August, 2009.* Supreme Court confirms and approves the formal agreement reached by Fasa and FNE. The consequence of such approval is that the trial followed before the TDLC would continue only regarding of Cruz Verde and SalcoBrand.
- *4 November, 2009.* The president of Fasa quits to the presidency of the board of directors, as consequence of serious differences with other members of the Board of Directors of Fasa, profusely informed in the Chilean Media.
- *4 September, 2009,* Fasa paid to the FNE the sum of UTA<sup>4</sup> 1.350 (approximate USD 1.0 million). As point of comparison the highest fine imposed by the TDLC and confirmed by the Supreme Court has been USD 5 million) in order to be excluded from the FNE inquiry.

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<sup>2</sup> AFP Capital is one of the five Chilean Pension Funds Asset Manager Company. They are the main Chilean Institutional Investors and one of the most important private actors pushing for improvements in Corporate Governance external and internal regulations.

<sup>3</sup> President of the board of directors and controller of Fasa.

<sup>4</sup> UTA is a unit of account that varies monthly adjusted by inflation.

- *31 December, 2009.* The SVS made public its sanctions:
  - Sanction for UF<sup>5</sup> 1500 (approximate USD 63,200) to the president of Fasa, on the grounds of:
    - Not providing sufficient information about the negotiations with the FNE being held by Fasa's CEO and by its President, through, and advised by, economic and law experts in the field; and,
    - Not monitoring the business performed by FASA during the period in which the collusion was in place by the Members of the Agreement by not controlling the price policy of the company.
  - Sanction for UF 2,000 (approximate USD 84,300.-) to FASA's CEO for not providing to the board of directors the information about the participation of FASA in the collusion alleged by the FNE as well as regarding the course of the negotiations being held with the FNE, and the new scenario that the knowledge about the involvement in the collusion claimed by the FNE.
  - Sanction for UF300 (approximate USD12,650) to the members of the board of directors of Fasa by not monitoring the businesses performed by FASA during the period in which the collusion was in place by the Members of the Agreement, since they should have taken care regarding the policy of prices followed by FASA.

Several opinions have been raised indicating that the grounds on which the SVS based its fines would not permit them, since the SVS could imposed fines or other kind of punishment on infractions to the Securities Law or those cases in which the law has expressly indicated that administrative penalties can be imposed. Otherwise, the SVS would be allowed to do it.

- It is expected that the decision from the TDLC would be informed on May or June, 2010.

## **6. Consequences of the case**

In addition to the sanctions above indicated and the quasi leniency agreement<sup>6</sup>, several other non desired effects occurred:

- There was a strong reaction of the public against the Members of the Agreement, but specifically in respect of Fasa, because it is the only member that accepted its participation in the collusion;
- The 5 Chilean AFPs (currently they are six) that jointly owns 10% of Fasa held a meeting in order to request an extraordinary shareholders meeting with the objective of being informed and discuss the reality and other elements related to the collusion recognised by Fasa and being investigated by the FNE;
- President of Fasa quitted to its position as president of the board of directors, after being questioned by the same directors that as controller of Fasa he appointed;
- FASA's stocks drop off approximate a 10% once it was known its acknowledgment regarding the case followed by the FNE;

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<sup>5</sup> UF is a unit of account that varies daily as the Chilean Peso is adjusted by inflation.

<sup>6</sup> At the moment of the agreement no regulations permitting such kind of agreement between the FNE and investigated entity was in force.

- The SVS notified charges against the all the members of the board of directors, the CEO and the General Counsel of Fasa on the grounds of no communicating material information to the board of directors, the shareholders and the market, as well as for not acting diligently in the performance of their duties as directors by not inquiring the course and consequences of the negotiation and the status of the businesses and prices policy followed by Fasa during the period in which the collusion was being complied with by the Members of the Agreement.
- All of them were fined, except the General Counsel. Some of those fines have been claimed by the affected before Chilean Courts;
- The *Servicio Nacional del Consumidor* (Consumer Protection Service “SERNAC”) filed a law suit against Fasa for not complying with the reimbursement program to consumers;
- At least 2 collective legal actions seeking to obtain being indemnified for the damages produced by the collusion were filed by groups of consumers against Fasa. Furthermore, criminal actions were also filed against Fasa;
- The reaction from the Chilean political world came in the form of a proposal of law (*Boletín* N° 6548-07) filed in the Chilean Congress on 4 June, 2009 that seeks to re-establish, this time in the Chilean Criminal Code, the sanction of imprisonment for those persons involved in cases in which the prices are fixed by fraudulent means (there is no special definition of what can be comprehended by fraudulent mean. Therefore, it has to be understood that common rules are applicable).

Furthermore, for those cases in which the fixing price is made on necessity goods, the proposal provides the following two joint sanctions: the requisition of those goods affected by the fixing prices; and, a fine equal to three times the amount of the excess over the price that had to be actually charged.

## 7. Conclusions

This case provides a good example of how things should not be made.

- Material information should not be kept as confidential to the members of the board of directors (monitoring obligations and strategic vision of the board of directors). Chilean Corporate Law provides that the directors should keep as confidential all information of the organisation that has not made public in the way that the organisation has determined.  
In Fasa’s case the President of Fasa informed as part of his defence that he was uncertain about the conduct of certain directors that kept relationships with certain pharmaceuticals and with Cruz Verde. In the latter case, the defence indicated that those directors kept positions as director of the non banking credit card company, and executive vice-president of an affiliate company of the latter, in one case, and as corporate general manager of the holding company of the non banking credit card company referred above, that has provided the use of a non-banking credit card to Cruz Verde’s customers, company that was simultaneously being investigated by the FNE. In his opinion revealing to those directors the negotiations with the FNE would have meant the possible failure of them, as well as would have warned to the other pharmacy chains under investigation about the course of action of FASA.
- In the case, the reason why the president of Fasa kept the information about the negotiations with the FNE away from the board of directors was that the president would have had serious doubts that such information could be revealed by certain directors of Fasa but related to the other pharmacy chains involved in the FNE investigation.

- The sanctions imposed by the SVS raised natural doubts about the range of the director's obligations, since it would seem that the directors should care about the short term goals of the organisation as well as of the daily performance of the organisation.
- The board of directors has to focus on the risks that threaten the organisation, knows them, organise them in the order of their likelihood to impact the organisation, and according to their seriousness, materiality and likelihood to happen, and appoint committees that should be responsible for making the following and monitoring of the development of any risk.
- Being director is a full time task. Therefore, a director should carefully assess the possibility to be part of number of board of directors that may affect his performance.
- Being director is not a right, it is an honour, but more important it is a position that requires the performance of a series of duties.
- Competition regulations is one of the most serious risks that may compromise the future of an organisation, especially because the increasing competitiveness of the current conditions of markets. Therefore, it has to be considered as highly probable that the organisation could infringe competition regulations not only in the domestic markets (where the company is incorporated), but in international ones.<sup>7</sup>

Fasa's case shows that such probability it is still higher regarding employees of medium levels of an organisation who, in order to show their effectiveness, may be tempted to consent illegal agreements with competitors or providers in order to accomplish the request targets, as soon as possible.

The risk that may mean for the organisation the exposition to different level, kind and magnitude of sanctions depending on the jurisdiction, should be taken as a serious one that may result in the imposition of serious sanctions, even the dissolution or forced division of the organisation, depending on the jurisdiction.

- The board of directors has a relevant role in preventing the occurrence of such risks, not only by being informed about charges communicated by the authorities or legal suits filed against the organisation, but specifically in adopting as many policies, means, procedures and manuals that permit the entire organisation, with inclusion of all its different levels, may be permeated in the knowledge of the importance to not infringe that regulation, even indirectly, but on the opposite to act in a way that keeps far away any risk of any infraction.
- Likewise, it is relevant for the board of directors to get knowledge as complete and real about the organisation as possible, for permitting it to understand what levels or officers may be more likely exposed to behave in a way that may represent for the organisation receiving charges or accusations for infraction to the competition regulations. Affecting, by that way, not only the legal liability of the organisation, its shareholders and directors and officers, but also its reputation, since consumers and regulators may perceived it as a risky one or a company that is not reliable.
- A correct structure of corporate governance should permit an improvement of the board of directors and officer in the decision-making processes. Regarding the risks it would permit obtain a better control of the relevant and pertinent environments, and a reduction in firms' cost of capital, since the providers of financing would perceive that organisation as a less risky one.

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<sup>7</sup> In fact at least in Peru several voices required that the subsidiary of Fasa in that country were investigated on the basis of its recognition to the charges of the FNE.

For instance, in Fasa's case the board of directors should have measure its risks, and regarding those more probably to occur they should have structure committees in charge to permanently monitor and being reported about the behaviour of the organisation and its officers and employees.

- Accordingly, the board of directors should take positive actions in order the organisation provides training about avoiding practices or agreements that may affect fair and free competition; implement mechanisms (we think specifically of the kind of "check and balance") that permit to keep a permanent surveillance of the actions followed by the organisation and its personnel.
- Further, it has to be deeply considered the fact that corporate governance principles, guidelines and regulations as well as those that seek to protect competition in domestic and international markets seeks to provide an economic environment of more efficiency, effectiveness and opportunities to as many actors and new actors as possible.
- Therefore, corporate governance principles should be used in order to an organisation permanently acts in a fair and competitive manner, incorporating such principles in its organisational culture. Furthermore, a strong and correctly implemented corporate governance ideas and internal regulations should become in impenetrable firewall that impedes the organisation or its personnel may act against competition regulations, whatever such regulations may consist.  
Consequently, the internal regulations applied and implemented in the organisation should be those that create and align incentives in a manner that no benefit can be obtained of executing acts against competition, even for a short period of time, but on the opposite those conducts may be investigated, detected, sanctioned and/or reported to the competent authorities.
- In any case, at the moment to implement solutions the main rule to be followed is that no strict and unique mechanisms can be provided, but the success of any regulation, internal or external to any organisation, would depend of how the solution fits and adjust to the reality of the entity target of it.
- Competition is the only real tool that would permit the existence of growing and organisations that may sustain on the long term. Therefore, board of directors that seeks such goal for the organisation they manage and monitor should not only be looking for a correct compliance with regulations, but most important should be looking for the permanency and sustainability of the organisation that permit the long term benefit of the shareholders and relevant stakeholders.
- Competition creates the necessary incentives for companies look for profitability by the way of providing better services and products, or reducing its costs, but not affecting quality. Competition would exist for as long as organisations perceive that they cannot obtain profits by other means different that competing each other.  
That perception would move organisations to obtain profits and benefits by reducing costs (not affecting quality), by improving products, gaining the loyalty of customers, elements all of them that permit a better use of resources and benefiting to clients.



## COMPETITION AND CORPORATE GOVERNANCE IN CHILE

*Presentation by Prof. Hugo Caneo*

### Chilean Market

- i.- Ownership of companies is very concentrated;
- ii.- Ownership of companies is held by groups of companies that operates in different markets (financial, brick & mortgage, etc) through subsidiaries and affiliates, all of them under with a common controller.
- iii.- Agency problem is not one derived from a conflict of interest between who owns the company and who managed the company, but between the controller(s) of the company and the minority shareholders.
- iv.- Decisions of the board of directors are usually adopted neither by the board of directors nor during the board of directors meeting, but they are imposed by the controllers.



## Chilean Market

- v.- Directors participating in more than 10 different companies' boards of directors.
- vi.- Some directors do not really know the organization or its risks, accepting with no further discussion or analysis impositions from controllers or other interested parties, etc.
- vii.- Some companies that in the past were family owned and took the decision to go public, seem been managed regardless of the new shareholders.
- viii.- Disclosing on a timely manner material information about the company or using business opportunities for their own interest instead of permitting its use for the company.

## Chilean Market

- ix.- Most directors focus its function in short term results instead of a strategic vision of the company and its sustainability
- x.- Material non disclosed information is still being managed in ways no compatible with its fair and timely provision to the market and shareholders.
- xi.- Auditing firms opinions may be affected by their interest in obtaining additional incomes coming from the provision of other services, different to only auditing.

## FASA CASE

- 1968 FASA is founded by Mr. José Codner Chijner.
- 1996 Beginning of operations in Peru.
- 1997 Farmacias Ahumada becomes a public corporation
- 2000 FASA and AIG Capital acquire 77% of Drogamed, Brazil.
- 2002, FASA takes control of Far-Ben S.A. de C.V. (Farmacias Benavides), Mexico.
- 2006 FASA left the Brazilian market

## FASA CASE

- 2006 FASA and Laboratoriu Volta incorporate Pharma Genexx S.A. for marketing generic medicines and medical and hospital supplies
- 2007 Alliance with the Euroamerica Group to create a real estate company for building commercial centres, strip centres and stores.
- 2008 Administradora FASA S.A. is created in order to improve payments to FASA providers, and provide them liquidity regarding its payables.

## FASA CASE

- 9 December, 2008. FNE filed a claim before the TDLC against FASA, Cruz Verde and SalcoBrand on the grounds that they agreed each other in order to fix prices (raising prices).
- 10 December, 2008. Date on which the board of directors of FASA was informed about the filing of the claim of the FNE against FASA.
- 13 March, 2009. FASA and FNE agreed the termination of the investigation against FASA.
- 23 March, 2009. FASA and FNE filed before the TDLC an agreement terminating the investigation against FASA.

- 13 July 2009. Publication of the new law introducing Immunity/leniency programs. (In force from October 2009).
- 30 September 2009, FASA owned 1.236 pharmacy stores in Latin America (710 in México, 350 in Chile and 176 in Peru). Becoming number one pharmacy chain in Latin America.
- Price of the stock at the time of the disclosure of the agreement between FASA and the FNE was approximate CLP\$760. At 5 February, 2010 the highest price has been CLP\$1,340, and the lowest has been CLP 1,119.

## Consequences of FASA case

- 1° Strong reaction of the public against the Members of the Agreement, but specifically in respect of FASA.
- 2° 5 Chilean AFPs that jointly hold 10% of FASA meet in order to request an extraordinary shareholders meeting for being informed about the case.
- 3° Crossed recriminations were made by directors against FASA's president and its CEO for not being informed about the case.
- 4° Fasa's stocks drop off approximate a 10% once it was known its acknowledgment.

## Consequences of FASA case

- 5° *Servicio Nacional del Consumidor* (Consumer Protection Service "SERNAC") filed a law suit against FASA.
- 6° At least 2 collective legal actions were filed by consumers against FASA. Further, criminal actions were also filed against FASA.
- 7° Securities Regulator notify about charges against board of directors, the CEO and the General Counsel of FASA. All of them except the General Counsel were fined. Some of the fines were claimed in Chilean Courts.
- 8° A proposal of law (*Boletín N° 6548-07*) was filed in the Chilean Congress on 4 June, 2009 seeking to reestablish imprisonment for those persons involved in cases in which the prices are fixed by fraudulent means.

## Causes of FASA case are basically related to governance issues

- Incentives of managerial officers
- Monitoring from board of directors (board included independent directors appointed by Institutional Investors).
- Understanding of the business and risks
- Knowledge of the organization and its risks

## Causes of FASA case are basically related to governance issues

- Communication between managerial level and board of directors
- Communication among members of board of directors
- Change from a family owned company to a public corporation

## Conclusions

- Material information should not be kept as confidential to the members of the board of directors (monitoring obligations and strategic vision of the board of directors).
- The sanctions imposed by the SVS raised natural doubts about the range of the director's obligations, since it would seem that the directors should care about the short term goals of the organization as well as of the daily performance of the organization.
- The board of directors has to focus on the risks that threaten the organization, knows them, organize them in the order of its likelihood to impact the organization.
- Being director is a full time task. Therefore, a director should carefully assess the possibility to be part of number of board of directors that may affect his performance.

## Conclusions

- Being director is not a right, it is an honour, but more important it is a position that requires the performance of a series of duties.
- Correct structure of corporate governance would improve the board of directors and officers decision-making process. Further it would permit obtain a better control of the relevant and pertinent environments, and a reduction in firms' cost of capital, since the investors would perceive less risks in that organization.
- Competition creates the necessary incentives for companies look for profitability by the way of providing better services and products, or reducing its costs, but not affecting quality.
- Competition would exist for as long as organizations perceive that they cannot obtain profits by other means different that competing each other.
- Competition regulations is one of the most serious risks that may compromise the future of an organization, especially because the increasing competitiveness of the current conditions of markets.



## EXECUTIVE REMUNERATION IN AUSTRALIA

*Note by Prof. Allan Fels<sup>1</sup>*

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### Introduction

This paper is largely based on the recent Australian Productivity Commission Inquiry Report into Executive Remuneration in Australia. This presenter was a co-author. This paper largely reproduces the overview of the Report.

The Report focussed on executive pay in general. It did not focus on financial services remuneration in particular. The Australian Prudential Regulatory Authority has been dealing with that matter. In addition, the report did not deal with general taxation issues, eg whether executives or other persons on high incomes should be subjected to higher rates of tax. A general review of the Australian taxation system is being conducted separately at present and the Productivity Commission report only dealt with tax issues that were very specific to executive pay. These were of a relatively technical nature concerning the timing of some tax imposts.

The recommendations of the report are under consideration by the Australian Government at the present time.

This paper for the OECD

- Summarises key points
- Provides an overview of the report and
- Lists the 17 recommendation and two findings

The 476 page report is available for downloading from the Productivity Commission website at [www.pc.gov.au/](http://www.pc.gov.au/)

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<sup>1</sup> Professor Allan Fels, Dean, Australian and New Zealand School of Government; Associate Commissioner, Productivity Commission (for Inquiry into Executive Remuneration in Australia).



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## Key Points

- Strong growth in executive remuneration from the 1990s to 2007, and instances of large payments despite poor company performance, have fuelled community concerns that executive remuneration is out of control.
- Pay for CEOs of the top 100 companies appears to have grown most strongly, at 13 per cent real a year, from the mid-90s to 2000, and then increased by around 6 per cent annually in real terms to 2007. Since 2007 average remuneration has fallen by around 16 per cent a year, returning it to 2004-05 levels.
  - The rise and decline in executive pay over the 2000s largely reflects increased use of pay structures link to company performance
- Executive pay varies greatly across Australia's 2000 public companies.
  - For the top 20 CEOs, in 2008-09 it averaged \$7.2 million (110 x Average Weekly Earnings) compared to around \$260,000 for CEOs of the smallest listed companies (4 x Average Weekly Earnings).
  - Generally speaking, Australian executives appear to be paid in line with smaller European countries, but below the UK and USA (the global outlier).
- Liberalisation of the Australian economy and global competition, increased company size, and the shift to incentive pay structures, have been major drivers of executive remuneration - companies compete to hire the best person for the job, and try to structure pay to maximise the executive's contribution to company performance.
- Nonetheless, some past trend and specific pay outcomes appear inconsistent with an efficient executive labour market, and possible weakened company performance.
  - Incentive pay 'imported' from the United States and introduced without appropriate hurdles spurred pay rises in the 1990s partly for 'good luck'. More recently, complex incentive pay may have delivered unanticipated 'upside'.
  - Some termination payments look excessive and could indicate compliant boards.
- Instances of 'excessive' payments and perceived inappropriate behaviour could also reduce investor and community trust in the corporate sector more broadly with adverse ramifications for equity markets.

- But the way forward is not to by-pass the central role of boards. Capping pay or introducing a binding shareholder vote on it would be impractical and costly.
- Instead, the corporate governance framework should be strengthened by:
  - Removing conflicts of interest, through independent remuneration committees and improved processes for use of remuneration consultants;
  - Promoting board accountability and shareholder engagement, through enhanced pay disclosure and strengthening the consequences for those boards that are unresponsive to shareholders' 'say on pay'.
- These reforms would significantly reduce the likelihood in future of inappropriate remuneration outcomes, or those that shareholders would find objectionable.

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## Overview

A catalyst for this inquiry was concern that executive pay had got out of hand. This perception was fuelled by practices in financial institutions abroad that were seen as a key contributor to the global financial crisis (GFC). Further, while local shareholder value plummeted in 2008 as a result of that imported crisis — with some companies and sectors being propped up by taxpayers — executive pay seemed to emerge unscathed, crystallising a view that executives were being rewarded for failure (after having been rewarded for success).

This has come on top of longstanding community discomfort about the widening gap between the remuneration of executives and other employees, as well as some large termination payments with perceived lack of justification. Public opinion polling over the years consistently shows that most respondents believe executives to be overpaid. But polls also reveal limited awareness of the drivers of executive pay and wealth creation.

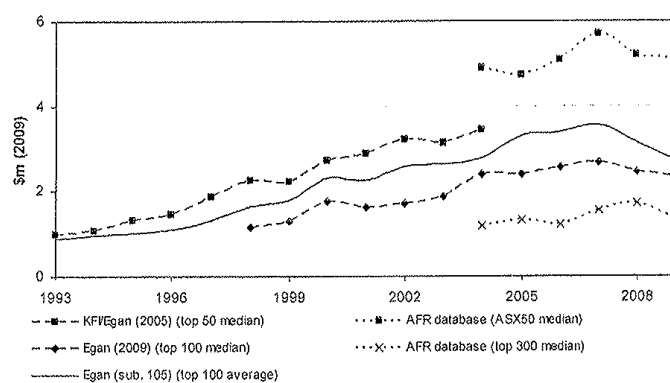
Accordingly, this inquiry was tasked with ascertaining what has actually happened to executive pay in Australia's publicly-listed companies, as well as identifying what can and should be done about it. The appropriate test for any policy intervention is that it promotes community wellbeing; hence the Commission has explored the likely drivers of executive pay and the economic implications of current pay levels and structures. Ultimately, judgment must be exercised, particularly in relation to the magnitude of identified problems and the case for intervention, taking into account both the potential costs and benefits.

### **Some 'facts' about executive pay**

Notwithstanding a lack of consistent data over the longer term, on any measure remuneration for executives of larger companies has grown strongly overall since the early 1990s (figure 1). Depending on the sample used, CEO remuneration at the 50–100 largest Australian listed companies increased between 1993 and 2007 by as much as 300 per cent in real terms. Since 2007, this trend has been reversed to some degree, with pay returning to levels recorded in 2004–05. (The story for non-CEO executives is similar, but with slightly lower growth rates and much lower levels.

Pay for non-executive directors (NEDs) — which is paid as a fixed amount in cash or shares — grew by around 9 per cent per year from 1993 to 2007.)

Figure 1 Trend executive pay growth in large companies



In 2008-09, estimated total remuneration for CEOs of the top 20 companies averaged approximately \$7.2 million, or 110 times average wages (figures 2 and 3). CEOs of the next 20 biggest companies had remuneration packages valued about one third less (approximately \$4.7 million). Multi-million dollar packages all but disappear for companies ranked 150–200, while for the smallest of Australia's almost 2000 publicly-listed companies, CEO remuneration averaged around \$260 000 (or approximately four times average wages).

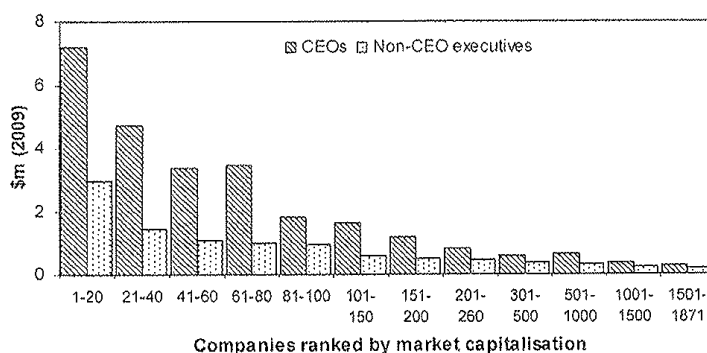
Remuneration levels also vary significantly across industries, being highest in the finance, telecommunications and consumer sectors, and lowest for the CEOs of information technology and utility companies.

While there are no consistent long-run time series for executive pay (because of evolving disclosure rules), the different series available suggest:

- CEO pay grew most strongly from the mid 1990s to 2000 — at around 13 per cent a year in real terms for the top 100 companies and 16 per cent for the ASX50
- from 2000 to 2007, annual real growth moderated to 6 per cent for the top 100 companies, but still led to a 50 per cent increase overall

- between 2006-07 and 2008-09, real total CEO pay fell across ASX300 companies, especially for the top 100 (which have proportionately more pay linked to company performance). The decline in average total remuneration for CEOs of ASX100 companies over the two-year period was approximately 16 per cent per year, in real terms.

Figure 2 **Executive pay rises with market capitalisation**  
2007-08



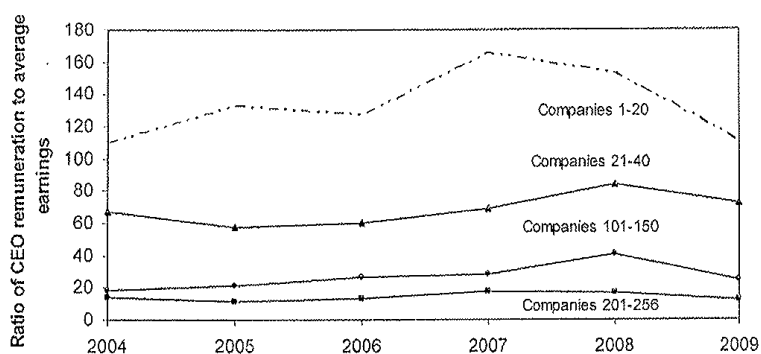
With growth rates for executive remuneration exceeding growth in average weekly earnings for nearly two decades, the gap between them widened, especially for the largest companies (figure 3). However, since 2006-07 the gap has narrowed somewhat, returning to levels observed between 2004 and 2006.

Nearly all of the growth in reported CEO pay for the top 300 companies in the years preceding the GFC was attributable to increases in incentive pay (as valued for accounting purposes), especially 'long-term' incentives, which tripled between 2004 and 2007. The extent to which there was any initial trade-off with base pay (cash-in-hand) or other unreported rewards such as fringe benefits is unclear, though average base pay has declined somewhat in real terms in more recent years. Since 2007, long-term incentives (LTIs) have fallen by around 25 per cent and the decline in short-term incentives (STIs) ('bonuses') has been even greater.

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Figure 3 Earnings multiples vary with company size

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### Why has executive pay grown so strongly?

There have been a number of drivers of executive pay in Australia over the past 20 years, some of which relate to demand and supply pressures and developments, while others revolve around corporate governance and the implementation of incentive pay structures intended to address principal-agent issues.

#### *Globalisation, increased company size and competition for top talent*

Liberalisation of Australia's product and financial markets together with the introduction of competition in many formerly government-controlled sectors in the 1980s and 1990s, drove substantial domestic structural change, including corporate consolidation and the emergence of internationally-competitive companies with global operations. Today, for example, BHP Billiton (Australia's largest listed company) has a market capitalisation of some \$200 billion, compared to \$16 billion in 1989 at the end of the high protection era. Wesfarmers' capitalisation increased from \$800 million to around \$26 billion over the same period.

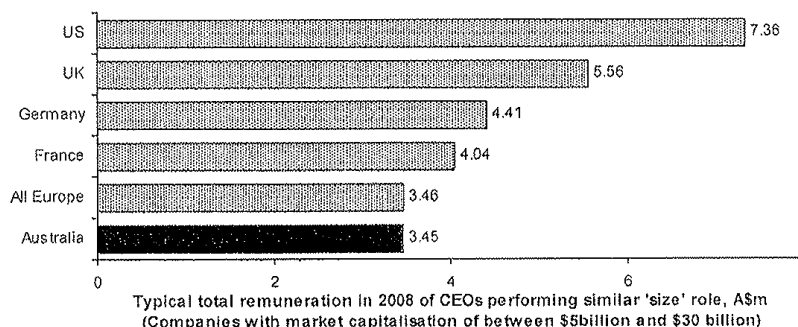
The pay-offs for these and other large companies operating in competitive markets from having a highly-talented CEO and senior executives (and the losses from having inferior ones) are potentially commensurately large. In line with their global focus, many companies now demand candidates with international experience. At the same time, Australian (and other) executives have become more mobile across companies and internationally.

While Australian data constrain the scope for long-term time series analysis, the results of a simple regression analysis of the effect of changes in company size on changes in Australian CEO pay for the 2000s accord with overseas and local research — a 10 per cent increase in company size seems to be associated with around a 4 per cent increase in CEO pay. This same relationship (with opposite sign) can be observed during the recent decline in market capitalisation. While the relationship is not present precisely for every company, broadly speaking, bigger companies seem to be prepared to pay more — both to compensate for increased job importance and complexity and to attract the most talented people. In sum, company size seems to explain 25–50 per cent of observed increases in executive pay.

The increased mobility of executives, coupled with the very high levels of executive pay in the United States (which is the outlier globally), has also had flow-on effects to Australia — for example, through the ‘importation’ of a few high profile US executives to key CEO positions in the early 1990s. These appointments essentially introduced US-style incentive-based remuneration structures to Australia, although such a trend was probably inevitable.

Since then, a number of CEOs have been recruited abroad (for example, 5 of 28 new CEOs for the top 50 companies between 2003 and 2007). That said, Australian executive remuneration levels generally remain below those in the United States and the United Kingdom, being more in line with smaller European economies (figure 4).

Figure 4 **CEO remuneration is closer to the European average**



This could reflect non-pecuniary benefits or lower costs of living in Australia, or for US CEOs, the much higher share of at-risk pay (which commands a risk premium).

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It could also indicate that US pay has become distorted, and that Australian companies simply do not consider candidates who command such rates.

There is some evidence that remuneration of CEOs in the Australian finance sector is closer to US pay levels (for similar sized banks), possibly reflecting higher mobility and global integration in that sector and the dominance of New York and London.

*Did enhanced disclosure trigger pay ratcheting?*

Since 1998, individual disclosure of the remuneration of the top executive earners in all listed companies has been required. (Before then, executive pay was reported by pay 'band'.) Some participants argued that public disclosure of individuals' pay triggered a pay spiral, as companies and executives sought to 'position' themselves in the market, with no one wishing to be seen as hiring or being a 'below average' executive. This is sometimes characterised as the 'Lake Wobegon' effect — a mythical place from US public radio where '... all the children are above average'.

But there is no clear evidence of an acceleration in the growth of executive remuneration in aggregate following introduction of the new disclosure rules. Indeed, the rate of increase in pay slowed in the 2000s compared to the late 1990s. The reversal in executive remuneration since 2007 also indicates that not all companies are locked into providing above average remuneration.

Nonetheless, by improving access to market comparator information for both executives and boards, public disclosure is likely to have led to more rapid flow-on effects where, for example, one company in an industry disturbs relativities by paying an overseas appointee a significantly higher level of remuneration.

*More pay for improved performance, or just more pay?*

Since the 1990s, the composition of remuneration for senior executives in Australia has changed fundamentally, with a greater focus being placed by boards (and shareholders) on equity-based remuneration, such as options and ordinary company shares (LTIs), and other performance-based forms of remuneration, such as short-term bonuses (STIs) (table 1).

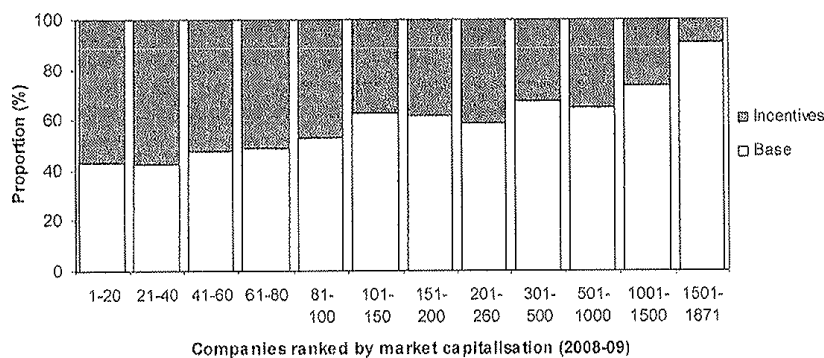


Table 1 The increasing share of incentive pay in total pay (%)

ASX300	CEOs			Non-CEO executives		
	Base	STI	LTI	Base	STI	LTI
2003-04	59	30	11	67	23	10
2006-07	40	34	26	45	32	23
2007-08	43	29	28	45	29	27
2008-09	50	25	25	57	21	22

Granting performance-based pay can make sense for companies, because it has the potential to reduce the ‘agency costs’ that would result from executives being paid fixed cash amounts regardless. Agency costs include the costs of executives putting their efforts into decisions that promote their own interests and agendas, but are not in the best interests of the company, as well as the costs incurred monitoring them to make sure this does not happen. As these costs tend to be higher for larger companies (because of more dispersed ownership and the potentially greater influence of executives over company assets), they might be expected to rely more heavily on incentive pay, and the data lend broad support to this (figure 5).

Figure 5 Incentive pay is proportionately bigger for bigger companies



Incentive pay will generally involve greater monetary cost for companies than fixed pay, because of the additional risks for the executive (box 1). In principle, boards will be prepared to pay executives a risk premium *if* they consider that the associated incentives (at least) improve company performance commensurately over time. In this sense, incentive pay can be a positive sum game, with rewards accruing to both the executive and shareholders.

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However, while greater use of incentive pay has almost certainly led to higher reported pay over time, in practice, it might not have translated to improved company performance. Compliant boards, or the difficulties posed for them by very complex incentive pay arrangements, could allow executives to mould performance measures and hurdles in their favour, so that 'at risk' pay becomes a virtual certainty, perhaps even rewarding and encouraging poor performance. (This is popularly known as the managerial power hypothesis — box 2.)

**Box 1 Riskier pay requires a risk premium**

Incentive pay can promote alignment of managerial and shareholder interests. However, from the perspective of executives it:

- introduces uncertainty about the level of remuneration eventually received (because performance hurdles are not trivial or are susceptible to forces outside their control)
- can constrain their ability to diversify their wealth, exposing them to portfolio risk

Thus, executives will require a 'risk premium' compared to a fixed cash salary. The premium required will vary with the risk aversion of the executive and the uncertainties attached to the particular pay hurdles and share price volatility for different companies.

**Box 2 The essential conditions for 'managerial power'**

According to Bebchuk and Fried, US executives dominate boards to such a degree they effectively set their own pay, subject only to so-called 'outrage' costs and constraints, that is, negative reaction by shareholders, the business media and others which can lead to reputational embarrassment.

In their view, executives (and compliant boards) have 'camouflaged' remuneration arrangements to limit external scrutiny of rising pay, using complex and hidden vehicles such as options, termination pay and company loans, that are not linked to performance hurdles. Camouflage is more likely where:

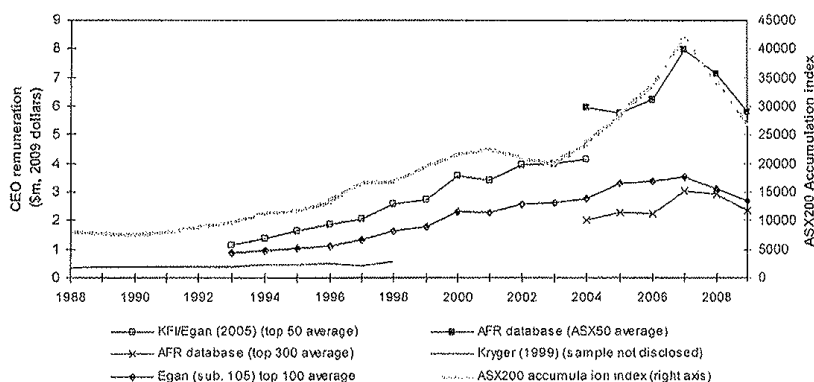
- boards are not 'independent' or procedures for setting pay are conflicted (and therefore susceptible to CEO influence)
- boards do not have the competencies to fully understand complex pay instruments
- there is limited remuneration disclosure and limited scope for shareholders to voice their (dis)approval.

**Has executive pay been 'efficient'?**

It has not been possible to ascertain conclusively whether executive pay in Australia has been appropriately set by boards. On the one hand, there are various indicators in favour:

- There has been a strong correlation between pay and company performance in aggregate, both in good times and bad (figure 6).
  - Demonstrating this relationship at a more disaggregated level has proved difficult in the absence of detailed information about performance targets, the extent of executives' total 'skin in the game', their risk preferences and the level of pay risk
- Options (which can deliver large returns in rising markets) and hidden company loans have not been widely adopted in Australia compared to the United States, and long-term incentive hurdles (at least since the early to mid 2000s) have been increasingly linked to shareholder return relative to comparable companies, constraining excessive rewards for 'good luck'.

**Figure 6 Executive pay has tracked the accumulation index**



- On a range of indicators, the boards of larger Australian companies appear to be relatively independent, with many adopting procedures (including remuneration committees) that would be expected to reduce the potential for senior executives to directly influence the setting of their own pay (box 3).

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- Australian boards have also been made increasingly accountable on remuneration matters through disclosure requirements and the (non-binding) shareholder vote on the remuneration report — which Bebchuk, for example, considers should be introduced in the United States to ‘move pay arrangements toward those that best serve shareholder interests’.

**Box 3 Australia’s corporate governance rates well**

- Australian boards are generally smaller than US boards, with few dual CEO/chairs (particularly for larger companies), and a higher proportion of non-executive directors (NEDs) and ‘independents’. Independent NEDs comprise a majority of most ASX300 company boards.
- Most large Australian companies have remuneration committees.
  - Around 75 per cent of remuneration committees in larger companies comprise only NEDs, and most remuneration committees in the top 400 companies comprise mainly *independent* NEDs, and have an independent chair.
- Each year listed companies must produce a remuneration report with pay details for top executives. Shareholders have a non-binding vote on this report.

The World Economic Forum has consistently ranked Australia in the top three countries for corporate governance since 2002-03. GovernanceMetrics International (2008) ranked corporate governance in top Australian companies fourth of 38 countries.

On the other hand, there are some reasons for having doubts:

- Not all public companies meet best practice guidelines for remuneration setting. While many of these are at the smaller end of the scale, a significant minority of remuneration committees of large companies include an executive member, and might also receive remuneration advice from consultants who undertake other work for the CEO, or who might not report directly to the board.
- Some very large termination payments appear difficult to reconcile with company and shareholder interests.
- Incentive pay invariably is challenging to design and seems to have been introduced in the 1990s without adequate understanding by some boards, with ‘permissive’ hurdles delivering strong pay growth in that decade (box 4).

**Box 4 Incentive pay: more art than science?**

Incentive pay typically comprises:

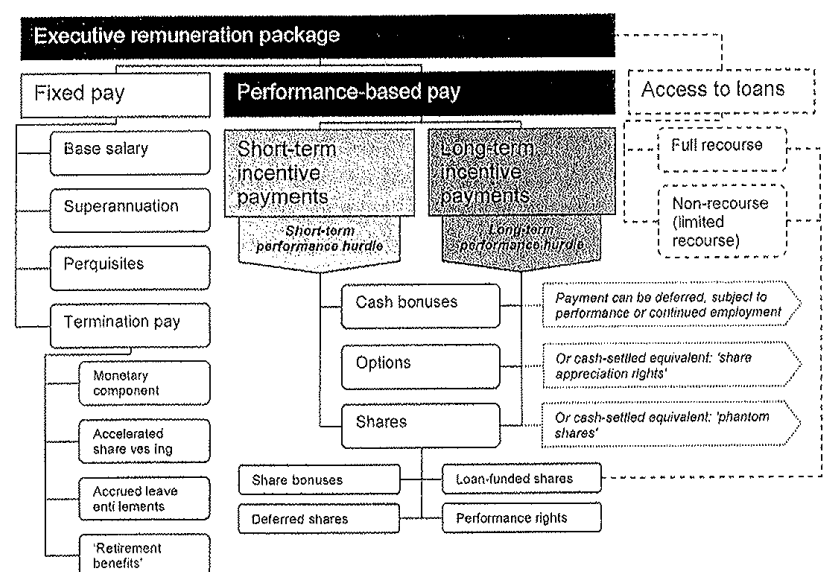
- paying executives shares or options with holding requirements. Equity directly links some of the executive's wealth to the share price (and dividends) of the company.
- awarding remuneration (cash, options or equity) when performance hurdles are met in the short term (generally one year) or long term (around three years). Short-term hurdles often relate to a company's financial performance, OH&S outcomes or business strategy implementation, whereas long-term hurdles usually relate to broader market metrics such as total shareholder return.

'Ideal' remuneration structures vary because risk preferences vary across companies and individuals. Start-up ventures are likely to have a greater risk tolerance than established companies. Some executives prefer greater certainty in remuneration and will be willing to trade off upside rewards for less downside risk.

The various pay forms and hurdles (and combinations of them) have different incentive effects. Options provide more (possibly excessive) 'upside' incentive than shares, but little downside risk. Once 'under water', they provide little incentive to drive an incremental increase in share price. Large equity holdings can promote alignment yet might make executives risk averse (especially as they approach retirement).

- The complexity of some incentive pay arrangements in more recent times (figure 7) could have allowed unanticipated upside (especially during the share market boom prior to 2007-08), yet weakened or distorted the incentive effects for executives.
  - Short-term incentives linked to inappropriate performance metrics in the finance industry in some instances encouraged excessive risk-taking, although they appear to have been far less pervasive in Australia than overseas. Such practices are the focus of the Australian Prudential Regulation Authority's new remuneration guidelines.
  - The Commission understands that executives view some complicated long-term incentives linked to share market performance as akin to a lottery, such that they have little (positive or negative) incentive effect, yet could end up delivering large payments to the executive at large cost to the company.

Figure 7 Executive pay is multi-dimensional



### Strong corporate governance is the key

As noted at the outset, the prime motivation for this inquiry is a widespread perception that executives have been rewarded for failure or simply good luck. And certainly in some periods and for some CEOs, pay outcomes appear inconsistent with a reasonably efficient executive labour market.

While the direct consequences of these for aggregate economic efficiency in the Australian context might not have been large (representing in most cases a profit transfer from shareholders to executives), instances of 'excessive' pay tied to perverse incentives could have weakened company performance. Executive remuneration outcomes also provide a window on board performance more broadly, with apparent board 'failure' fomenting disquiet among investors and the community more broadly, potentially sapping confidence and trust in equity markets.

Particularly at a time of sharemarket weakness, such disquiet has been fuelled by well-publicised examples of seemingly egregious pay outcomes, and can lead to other companies being tarred with the same brush. This should make all Australian

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companies concerned about good governance and community perceptions of their conduct.

But having examined a number of alternative measures proposed by participants, the Commission is convinced that the way forward is not to bypass the central role and responsibility of boards in remuneration-setting, especially through prescriptive regulatory measures such as mandated pay caps.

- Although they might superficially address concerns about fairness, caps on total remuneration for executives would give rise to a number of severe practical problems, due to variations in market circumstances across companies and over time. They would also disadvantage some firms over others and have undesirable commercial consequences for Australian companies relative to their competitors.
- Caps on bonuses or other elements of pay, or tax arrangements designed to have similar constraining effects, would lead to readjustment of packages in ways that could weaken incentive alignment, but with probable negligible impact on total remuneration levels.

Furthermore, the Commission considers that a binding shareholder vote on the remuneration report would be unworkable given the report's complexity and coverage, and would compromise the board's authority to negotiate with executives. (However, reducing the trigger for termination payments to require shareholder endorsement seems on balance to be warranted, and given evidence that most companies already tie termination payments to around one year's base salary, the new legislated provisions are unlikely to have significant adverse effects, while addressing shareholder and community concerns.)

In seeking to overcome the perceived problem of captured or incompetent boards, such regulatory proposals risk 'throwing the baby out with the bathwater' and making shareholders worse off — the principal-agent 'problem' cannot be eliminated without removing the wealth-creating public company structure that creates it (box 5). The only practicable means for the many thousands of diverse shareholders of a public company to achieve a remuneration structure that promotes the company's long-term interests is for them to ensure that they have an able and properly motivated agent — the board.

Accordingly, the Commission considers that the more appropriate and proportionate response is to improve corporate governance and enhance the effectiveness and credibility of boards, as well as to make boards more accountable in relation to pay setting, taking into account the need to minimise potential costs and the scope for unintended consequences.

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**Box 5      The role of boards and the principal–agent problem**

'Wide' or diverse company ownership necessitates separation of ownership from management of the company. Employing skilled, specialist managers can bring large benefits, but there is the potential for them to pursue their own objectives rather than those of the company and its shareholders. This is the principal–agent 'problem'.

The primary mechanism for ensuring managers act in the company's (and therefore shareholders') interests is shareholders electing boards which have the authority for hiring and remunerating the CEO as well as for taking decisions about company strategy and profit distribution. Importantly, company boards have a fiduciary duty to act in the interests of the *company*, not shareholders per se. This distinction is deliberate — promoting the company's interests will be in the interests of shareholders as a group over time, but is unlikely to be in the best interests of each and every shareholder all of the time. Indeed, if the board were expected to meet every shareholders' preferences, the benefits of delegating authority to it and, hence, the benefits of the widely-held public company structure, would be largely forfeited.

**Promoting communication and capabilities and minimising conflicts of interest**

Australia's regulatory framework has been progressively strengthened over time, together with industry corporate governance arrangements, balancing prescription with flexibility. There is scope to further strengthen the framework and achieve a closer alignment between the interests of executives, shareholders and the boards that represent them.

The Commission is recommending a number of reforms aimed at minimising the scope for conflicts of interest in remuneration setting and at strengthening board accountability on remuneration matters generally. Many of these complement reforms proposed by the Australian Prudential Regulation Authority for the financial sector, but with wider application.

Some of the proposals apply more strictly to larger companies than smaller ones, even though corporate governance is much closer to best practice in the former than the latter. But how well larger companies perform affects many in the community. So it is not unreasonable to expect larger companies to meet accepted best practice, while recognising the need for flexibility to accommodate the diversity of Australian companies.



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*Improving board accountability and capacities*

Boards effectively form a bridge between management and owners. Competent and independent decision making should be their hallmarks and this implies directors having an appropriate mix of skills, knowledge and experience. Yet there are concerns that de facto ‘barriers to entry’ mean that companies are not adequately tapping into, and utilising, available talent for board membership, including women.

While resorting to mechanisms such as strict quotas would risk promoting diversity at the expense of merit and hence company performance, the Commission strongly endorses the ASX Corporate Governance Council proposal for companies to report publicly on progress in achieving their own declared targets. Greater transparency around selection of board candidates regardless of gender should also be encouraged.

An additional measure to ameliorate perceptions of a directors’ ‘club’ would be to give shareholders a say on proposals by the board to limit board vacancies. It seems appropriate that boards that wish to invoke the ‘no vacancy rule’ in relation to the election of directors explain their reasons and seek shareholder approval by way of an ordinary resolution. If that resolution were rejected, vacancies would be declared to the maximum in the company’s constitution for that annual general meeting. The board should still retain the right to appoint a director at any time throughout the year (subject to the usual confirmation at the next annual general meeting) and to fill, or leave vacant, casual vacancies at any time.

*Avoiding conflicts of interest*

Minimising scope for executives to influence the design of their own remuneration is fundamental to good governance and trust. The Commission accordingly proposes:

- strengthening requirements for the establishment of remuneration committees, the independence of their membership and their interaction with company executives, particularly for the top 300 companies
- requiring remuneration consultants to report directly to the board or remuneration committee (without constraining scope for them to consult with management)
- disclosure in remuneration reports of the use of remuneration consultants.

Further desirable measures would be to exclude executives and directors from voting their own shares or undirected proxies on the remuneration report and related resolutions. While these measures go beyond normal conflict-of-interest voting

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exclusions, the vote on the remuneration report is atypical because it is advisory only, and should aim to capture views on the report of those external to its development.

*Enhanced disclosure and communication*

The usefulness of remuneration reports to investors has been constrained by their length and complexity, as well as by 'boiler-plate' and some crucial omissions. There will always be tension between readability and the desire of investors and advisers for comprehensive reporting, but some changes would improve the balance:

- Plain English presentation would promote investor understanding of executive pay. Company efforts to improve the readability of their reports would be bolstered by guidance on best practice, with boards encouraged to include a discussion of their approach to remuneration setting and the variables and risks considered, as outlined below.
- Reporting of total *actual* pay would be useful to investors (to reconcile with initial estimates and expectations) as would fuller reporting of performance hurdles, taking account of commercial sensitivities. Including a summary of executives' total equity holdings in the company would also be useful (although this would duplicate material already in the annual report). While shareholdings are not remuneration, they are an important indicator of 'skin in the game' and incentive alignment, and thus an important complement to incentive pay arrangements.
- The remuneration report should be confined to 'key management personnel', with possible scope to confine detailed reporting to the CEO and other executives on the board (with information being consolidated for other key management personnel).

There also appears to be scope to streamline the architecture of disclosure requirements, with positive payoffs for readability and compliance costs. To this end, the Commission is recommending the establishment of an expert panel under the auspices of the Australian Securities and Investments Commission, to advise it on how best to revise the architecture of section 300A of the *Corporations Act 2001 (Cwlth)* and the relevant regulations to achieve recommended enhancements.

*Promoting efficient incentive alignment*

While there is no single 'right' pay structure for aligning incentives, investors might be reassured if boards have, for example, undertaken prudent risk assessments and

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sensitivity analysis in crafting incentive pay arrangements, as well as considered the scope for simpler and potentially less costly pay structures. The Commission has outlined a 'checklist' for good remuneration practice to enhance the information content of companies' remuneration reports.

Hedging by executives against company-specific risks associated with equity-based remuneration could weaken the intended link between pay and performance in remuneration packages. Although the practice appears uncommon, in line with policies of many companies, hedging of unvested equity and vested equity subject to holding locks should be prohibited.

Furthermore, scope to defer taxation of long-term equity incentives (those at risk of forfeiture) beyond departure could facilitate deferment of remuneration, thereby promoting better alignment of incentives in the latter years of an executive's term, as well as giving the board scope to 'claw back' payments made to executives in the event of unacceptable post-departure outcomes.

#### *Encouraging shareholder engagement*

Despite initial scepticism by business, the non-binding vote on the remuneration report appears to have fostered more productive engagement between shareholders and boards. Most boards have proven sensitive to significant minority 'no' votes and many amend executive remuneration in anticipation or in response. Yet there are instances where companies have received significant consecutive 'no' votes on their remuneration report — in 2008 and 2009 the Commission estimates that almost 5 per cent of ASX200 companies received two consecutive no votes of 25 per cent or more. In addition, the average level of 'no' votes has been gradually increasing.

The Commission therefore sees a case for increasing shareholder leverage through the vote on the remuneration report, to target seemingly unresponsive boards in a bid to promote better dialogue between them and their shareholders. But it also recognises that any measures need to be balanced against the desirability of maintaining both the board's authority to set executive pay, and the integrity and benefits of the non-binding vote itself.

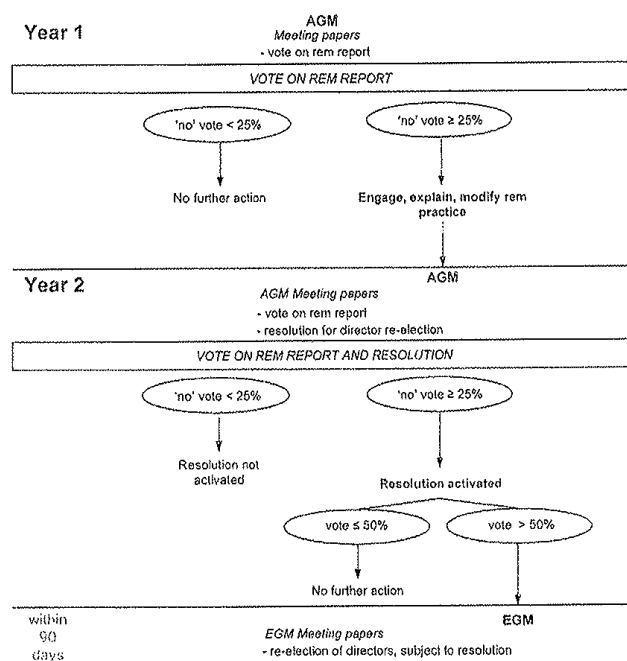
Accordingly, the Commission proposes that:

- Companies be required to explain in the remuneration report their response to a 'no' vote of 25 per cent or more the previous year. In essence, this would codify what many companies do voluntarily.

- Where there is a second consecutive vote against the remuneration report of 25 per cent or more, a separate 're-election' resolution would be put automatically at that annual general meeting (and included in voting papers circulated prior to the meeting), to the effect that all elected directors who signed the directors' report for that year face re-election at an extraordinary general meeting (to be held within 90 days). To pass, this re-election resolution would require a majority of eligible votes cast. (See figure 8)

This approach enables shareholders to voice their opinion on the remuneration report through a non-binding vote and then decide whether stronger action is required by voting on a separate re-election resolution where the board appears unresponsive to their concerns.

Figure 8 Two-strikes plus a resolution to 'spill' the board



Compared with a mechanism where a second substantial vote against the remuneration report automatically triggered a vote on directors, the insertion of a separate resolution for directors to face re-election would significantly reduce any

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downside risks for the operation of boards and stability of companies, or the willingness of shareholders to vote against a remuneration report. (Typically a high vote against a remuneration report does not translate into a vote against directors standing for re-election.) Yet the mechanism would still hold to account those boards considered deficient in relation to executive pay practices. In short, shareholders would be given control over the message they wished to send to boards, encouraging all boards to maintain a commitment to the development of well-structured pay arrangements.

*A future review of the reforms*

No intervention is costless or without risk. There will be compliance costs as well as more subtle behavioural consequences. The Commission accordingly 'stress tested' its proposed reforms in a Discussion Draft and has made modifications since to take account of a number of valid concerns. Nevertheless, it would be desirable for the Australian Government to conduct a review within five years into the operation, impacts and effectiveness of any reforms flowing from this report, as well as the recently-introduced changes to shareholder approval of termination payments.

**Summing up**

The Commission considers that, collectively, these changes would significantly strengthen corporate governance and alignment of interests — giving shareholders better information and more 'say' on pay.

In doing so, they should reduce the likelihood in future of inappropriate remuneration outcomes, especially those that shareholders would find objectionable, and help secure greater public confidence in the corporate sector. They would not, however, put an end to high pay for executives of the largest companies where warranted to secure the best people and motivate them in line with shareholders' interests.

Finally, the Commission acknowledges that its proposed reforms may require boards to pay more attention to executive remuneration than some have done in the past. In the Commission's view, this is called for and will complement rather than compete with other key board responsibilities. Appropriate remuneration structures for executives not only reflect on board competence, but are integral to the successful implementation of corporate strategies and thus the creation of shareholder wealth.

## The recommendations at a glance

<i>Recommendation</i>	<i>Targeted benefits</i>
<b>Board capacities</b>	
1. Any declaration of 'no vacancy' at an AGM to be agreed to by shareholders.	<ul style="list-style-type: none"> <li>Increases shareholder's input on board size and composition and addresses perceptions of a 'directors' club'.</li> </ul>
Finding 1: <i>Support an 'if not, why not' requirement for boards to report progress against gender objectives.</i>	<ul style="list-style-type: none"> <li>Encourages boards to draw more widely from the available talent pool.</li> </ul>
<b>Conflicts of interest</b>	
2. On an 'if not why not' basis: <ul style="list-style-type: none"> <li>remuneration committees to comprise at least three members, all non-executive directors, with a majority and the chair independent</li> <li>companies to have a charter setting out procedures for non-committee members attending meetings.</li> </ul>	<ul style="list-style-type: none"> <li>Constrains executive influence on pay.</li> <li>Promotes best practice for all listed companies.</li> </ul>
3. For ASX300 companies, executives to be prohibited from sitting on remuneration committees. (Listing rule)	<ul style="list-style-type: none"> <li>Constrains executive influence on pay.</li> <li>Aligns with APRA initiative for finance sector and targets companies able to meet compliance cost.</li> </ul>
4. Prohibit executives and directors voting their own shares on remuneration reports.	<ul style="list-style-type: none"> <li>Increases shareholder signal on non-binding vote.</li> </ul>
5. Prohibit executives hedging unvested equity remuneration or vested equity subject to holding locks.	<ul style="list-style-type: none"> <li>Improves alignment between executives and shareholders.</li> <li>Engenders confidence in pay practices.</li> </ul>
6. Prohibit executives and directors voting undirected proxies on remuneration reports.	<ul style="list-style-type: none"> <li>Increases shareholder signal on non-binding vote.</li> </ul>
7. Require proxy holders to cast all their directed proxies on remuneration reports.	<ul style="list-style-type: none"> <li>Increases shareholder signal on non-binding vote.</li> </ul>
<b>Disclosure</b>	
8. Improve information content and accessibility of remuneration reports through: <ul style="list-style-type: none"> <li>a plain English summary of remuneration policies</li> <li>reporting actual remuneration received and total company shareholdings of individuals in the report.</li> <li>Expert panel to advise on revised Corporations Act architecture to support changes.</li> </ul>	<ul style="list-style-type: none"> <li>Better informed shareholders.</li> <li>Reduced confusion (and misreporting) about pay structures.</li> <li>Enhanced engagement between boards and shareholders.</li> </ul>
9. Remuneration disclosures to be confined to key management personnel.	<ul style="list-style-type: none"> <li>Aligns Act with accounting standards.</li> <li>Reduces compliance costs.</li> <li>Improves readability.</li> </ul>

(Continued next page)

**The recommendations at a glance** (continued)

<i>Recommendation</i>	<i>Targeted benefits</i>
10. Companies to disclose executive remuneration advisers, who appointed them, who they reported to and the nature of any other work undertaken for the company. ('if not, why not')	<ul style="list-style-type: none"> <li>• Constrains executive influence on pay through transparency.</li> <li>• Promotes best practice for all listed companies.</li> </ul>
11. For ASX300 companies, advisers on executive pay to be commissioned by, and their advice provided directly to, the board, independent of management. (Listing rule)	<ul style="list-style-type: none"> <li>• Constrains executive influence on pay.</li> <li>• Aligns with APRA initiative for finance sector.</li> <li>• Targets companies able to meet costs.</li> </ul>
12. Institutional investors to voluntarily disclose how they have voted on remuneration reports (and other remuneration-related issues).	<ul style="list-style-type: none"> <li>• Better informed (potential) investors.</li> <li>• Targets agency issues, particularly for compulsory superannuation contributors.</li> </ul>
<b>Remuneration principles</b>	
13. Remove cessation of employment as the taxation point for deferred equity subject to risk of forfeiture.	<ul style="list-style-type: none"> <li>• Removes barrier to deferred remuneration.</li> <li>• Consistent with longer term alignment.</li> <li>• Removes need for special tax rulings.</li> </ul>
Finding 2: Remuneration 'check list' for boards to improve information content in remuneration reports.	<ul style="list-style-type: none"> <li>• Enhanced quality of disclosure.</li> <li>• Provides guidance to encourage and promote better remuneration practices.</li> </ul>
<b>Shareholder engagement</b>	
14. Confirm allowance of electronic voting without amendment of company constitutions.	<ul style="list-style-type: none"> <li>• Improves efficiency and integrity of shareholder voting.</li> <li>• Potential for cost savings.</li> </ul>
15. 'Two strikes and re-election resolution': <ul style="list-style-type: none"> <li>• 25 per cent 'no' vote on remuneration report triggers reporting obligation on how concerns addressed</li> <li>• subsequent 'no' vote of 25 per cent activates a resolution for elected directors to submit for re-election within 90 days.</li> </ul>	<ul style="list-style-type: none"> <li>• Increases shareholder signalling and power.</li> <li>• Increases pressure on companies to respond to shareholder concerns.</li> <li>• Targets unresponsive boards.</li> </ul>
<b>Implementation issues</b>	
16. The Australian Government to implement intent of recommendations 2, 3, 10 and 11 by legislation if the ASX and Corporate Governance Council do not make requisite changes.	<ul style="list-style-type: none"> <li>• Ensures potential benefits from recommended reforms can be achieved.</li> </ul>
17. Review within five years to consider: <ul style="list-style-type: none"> <li>• the effectiveness and efficiency of the reforms, including to termination payments and employee share schemes</li> <li>• the regulatory architecture.</li> </ul>	<ul style="list-style-type: none"> <li>• Evaluation of efficacy and economic impact of reforms.</li> <li>• Identification of any unexpected outcomes that warrant corrective action.</li> </ul>

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## Recommendations and findings

### Recommendations

#### RECOMMENDATION 1

*For the election of directors at a general meeting, where the board seeks to declare no vacancies and the number of directors is less than the constitutional maximum, approval should be sought from shareholders by way of an ordinary resolution at that general meeting.*

*Boards would retain their powers to appoint directors and fill or leave vacant casual vacancies throughout the year.*

*This recommendation should be effected through amendments to the Corporations Act 2001 and relevant regulations.*

#### RECOMMENDATION 2

*The ASX Corporate Governance Council should introduce an 'if not, why not' recommendation specifying that remuneration committees:*

- have at least three members*
- comprise non-executive directors, a majority of whom are independent*
- be chaired by an independent director*
- have a charter setting out procedures for non-committee members attending meetings.*

#### RECOMMENDATION 3

*In conjunction with recommendation 2, a new ASX listing rule should specify that all ASX300 companies have a remuneration committee and that it should comprise solely non-executive directors.*

#### RECOMMENDATION 4

*The Corporations Act 2001 should specify that company executives identified as key management personnel and all directors be prohibited from voting their shares on remuneration reports and any resolutions related to those reports.*

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RECOMMENDATIONS XXXVII  
AND FINDINGS



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RECOMMENDATION 5

*The Corporations Act 2001 should specify that companies prohibit their executives from hedging unvested equity remuneration or vested equity subject to holding locks.*

RECOMMENDATION 6

*The Corporations Act 2001 and relevant ASX listing rules should be amended to prohibit company executives identified as key management personnel and all directors from voting undirected proxies on remuneration reports and any resolutions related to those reports.*

RECOMMENDATION 7

*The Corporations Act 2001 should be amended to require proxy holders, except in exceptional circumstances, to cast all of their directed proxies on remuneration reports and any resolutions related to those reports.*

RECOMMENDATION 8

*The usefulness of remuneration reports to investors has been diminished by their complexity and by crucial omissions. Remuneration reports should include:*

- *a plain English summary statement of companies' remuneration policies*
- *actual levels of remuneration received by the individuals named in the report*
- *total company shareholdings of the individuals named in the report.*

*The Australian Government should establish an expert panel under the auspices of the Australian Securities and Investments Commission to advise it on how best to revise the architecture of section 300A of the Corporations Act 2001 and the relevant regulations to support these changes.*

The convened expert panel should take account of the Commission's:

- detailed guidance on the requirements for recommendation 8 (see chapter 8).
- 'check list' of information which should, where relevant, be reflected in remuneration reports (section 11.5).

## RECOMMENDATION 9

*Section 300A of the Corporations Act 2001 should be amended to reflect that individual remuneration disclosures be confined to key management personnel. The additional requirement for the disclosure of the top five executives should be removed.*

## RECOMMENDATION 10

*The ASX Corporate Governance Council should make a recommendation that companies disclose the expert advisers they have used in relation to the remuneration of directors and key management personnel, who appointed them, who they reported to and the nature of other work undertaken for the company by those advisers.*

## RECOMMENDATION 11

*The ASX listing rules should require that, where an ASX300 company's remuneration committee (or board) makes use of expert advisers on matters pertaining to the remuneration of directors and key management personnel, those advisers be commissioned by, and their advice provided directly to, the remuneration committee or board, independent of management. Confirmation of this arrangement should be disclosed in the company's remuneration report.*

## RECOMMENDATION 12

*Institutional investors — particularly superannuation funds — should disclose, at least on an annual basis, how they have voted on remuneration reports and other remuneration-related issues. Initially this should be progressed on a voluntary basis by institutions in collaboration with their industry organisations. The Australian Securities and Investments Commission should monitor progress in relation to superannuation funds regulated under the Superannuation Industry (Supervision) Act 1993.*

## RECOMMENDATION 13

*The Australian Government should make legislative changes to remove the cessation of employment trigger for taxation of equity or rights that qualify for tax deferral and are subject to risk of forfeiture. These equity-based payments should be taxed at the earliest of: the point at which ownership of, and free title to, the shares or rights is transferred to the employee, or seven years after the employee acquires the shares.*

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RECOMMENDATION 14

*The Australian Securities and Investments Commission should issue a public confirmation to companies that electronic voting is legally permissible without the need for constitutional amendments — as recommended in 2008 by the Parliamentary Joint Committee on Corporations and Financial Services.*

RECOMMENDATION 15

*The Corporations Act 2001 should be amended such that:*

- *where a company's remuneration report receives a 'no' vote of 25 per cent or more of eligible votes cast at an annual general meeting (AGM), the board be required to explain in its subsequent report how shareholder concerns were addressed and, if they have not been, the reasons why*
- *where the subsequent remuneration report receives a 'no' vote of 25 per cent or more of eligible votes cast at the next AGM, a resolution be put that the elected directors who signed the directors' report for that meeting stand for re-election at an extraordinary general meeting (the re-election resolution). Notice of the re-election resolution would be contained in the meeting papers for that AGM. If it were carried by more than 50 per cent of eligible votes cast, the board would be required to give notice that such an extraordinary general meeting will be held within 90 days.*

Definitions and machinery

- 'Elected directors' — excludes any director not required to submit for election (managing directors) under ASX listing rules.
- 'Eligible votes cast' — directors and executives identified as key management personnel would be ineligible to vote their own shares, or undirected proxies held by them, in relation to remuneration reports or the re-election resolution. Normal voting protocols would apply to the re-election of directors.
- 'Director re-election' — if the re-election resolution is carried, all board members would continue in their positions until the EGM, at which time elected directors would present individually for re-election. The terms of appointments for re-elected directors would continue as if uninterrupted.
- Re-setting the mechanism — If the re-election resolution is activated, irrespective of whether or not it is carried, the entire process would be re-set. However, the requirement to explain how shareholder concerns were addressed in the subsequent remuneration report would stand.

## RECOMMENDATION 16

*If the Australian Securities Exchange does not give effect to recommendations 3 or 11 and/or the Australian Securities Exchange Corporate Governance Council does not give effect to recommendations 2 or 10, the Australian Government should give consideration to putting into effect the intent of those recommendations through legislative means.*

## RECOMMENDATION 17

*There should be a review of the corporate governance arrangements that emanate from the Australian Government's response to this report. The review should be conducted no later than five years from the introduction of the new arrangements. In particular, the review should consider:*

- *the effectiveness and efficiency of the reforms in meeting their objectives both individually and as a package, including recent legislative reforms to termination payments and employee share schemes*
- *any changes to the regulatory architecture that affects the operations of, or the balance of responsibilities between, the Corporations Act 2001, the Australian Securities Exchange listing rules and the Australian Securities Exchange Corporate Governance Council's principles and recommendations.*

## Findings

## FINDING 1

*The continuing marked under-representation of women on boards indicates that boards are not drawing sufficiently widely from available talent. Given the lack of progress in addressing this, the Commission strongly endorses the initiatives by the ASX Corporate Governance Council:*

- *to require companies to adopt and disclose, on an 'if not, why not' basis, their progress against gender objectives set by their boards*
- *to encourage nomination committees to review the proportion of women at all levels in the company and disclose annually the skills and diversity criteria used for board appointments.*

*Outcomes should be reviewed three years after the measures have been introduced, including to determine whether the principles and recommendations should be upgraded to a listing rule by the Australian Securities Exchange.*

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FINDING 2

*Remuneration structures are company and context-specific and a matter for boards to resolve rather than being amenable to prescriptive direction. That said, some key dimensions often warrant being explained clearly to shareholders and, where appropriate, could usefully be addressed in companies' treatment of their remuneration policies in the remuneration report:*

- how the remuneration policy aligns with the company's strategic directions, its desired risk profile and with shareholder interests*
- how the mix of base pay and incentives relates to the remuneration policy*
- how comparator groups for benchmarking executive remuneration and setting performance hurdles and metrics were selected, and how such benchmarks have been applied*
- how incentive pay arrangements were subjected to sensitivity analysis to determine the impact of unexpected changes (for example, in the share price), and how any deferral principles and forfeiture conditions would operate*
- whether any 'incentive-compatible' constraints or caps apply to guard against extreme outcomes from formula-based contractual obligations*
- whether alternatives to incentives linked to complex hurdles have been considered (for example, short-term incentives delivered as equity subject to holding locks)*
- whether employment contracts have been designed to the degree allowable by law, to inoculate against the possibility of having to 'buy out' poorly performing executives in order to avoid litigation*
- whether post-remuneration evaluations have been conducted to assess outcomes, their relationship to the remuneration policy and the integrity of any initial sensitivity analysis.*

## **EXECUTIVE REMUNERATION IN AUSTRALIA**

*Presentation by Prof. Allan Fels*



the Australia and New Zealand  
**School of Government**

### **Executive Remuneration in Australia**

Professor Allan Fels, AO  
Dean, the Australia and New Zealand School of Government  
Associate Commissioner Productivity Commission (for the inquiry into  
Executive Pay)

OECD Competition Committee, Paris, 17 February 2010

## Strong Growth in Executive Remuneration

- Strong growth in executive remuneration from the 1990s to 2007
- Pay for Top 100 CEOs grew 13% real from mid 90's to 2000 and then 6% real annually to 2007
- Since 2007 has fallen by 16% a year
  - ❖ Largely accounted for by increased use of pay structures linked to company performance
  - ❖ Instances of large payments despite poor company performance have fuelled community concerns that executive remuneration is out of control.

2

## Levels of Pay

- Executive pay varies greatly across Australia's 2000 public companies from \$7.2 million for top 20 CEO's to \$260,000 for CEO's of the smallest listed companies
- Executive pay for the top 20 CEOs is about 110 times average weekly earnings and has grown much faster
- Australian executives are paid in line with smaller European countries, but below the UK and USA (the global outlier)

3

## Economic and Corporate Governance Drivers

- Drivers of executive remuneration have included:–
  - ❖ Liberalisation of the Australian economy and global competition
  - ❖ Increased company size
  - ❖ Shift to incentive pay structures
  - ❖ Deficiencies in corporate governance of pay
  - ❖ Strong correlation between pay and market capitalisation

4



## An Efficient Market?

- Some past trend and specific pay outcomes appear inconsistent with an efficient executive labour market and possibly weakened company performance
  - ❖ Incentive pay (imported) from the United States and introduced without appropriate hurdles, spurred pay rises in the 1990's
  - ❖ The 'good luck' factor (stock market upward movement triggers pay rises for 'undeserving' individual executives)
  - ❖ Complex incentive pay may have delivered unanticipated 'upside'.
- Issues of 'hurdles' that must be jumped before bonuses paid
- Some excessive termination payments
- Not much evidence in Australia that financial sector bonuses associated with inappropriate risk taking – but rules in that sector being tightened.

5





## Policy Approaches

- The way forward is not to bypass central role of boards
- Capping pay or introducing a binding shareholder vote would be impractical and costly

6

## Improving Corporate Governance

- Instead, the corporate governance framework should be strengthened by:
  - ❖ Removing conflicts of interest through independent remuneration committees and improved processes for use of remuneration consultants;
  - ❖ Promoting board accountability and shareholder engagement, through enhanced pay disclosure and strengthening consequences for those boards that are unresponsive to shareholders 'say on pay'.

7

## Recommendations

- Removal of various conflicts of interest
  - ❖ Independent remuneration committees
  - ❖ Executives not to sit on remuneration committees
  - ❖ Executives and directors not to vote their shares on remuneration reports
  - ❖ Prohibit Executives and Directors from voting undirected proxies on remuneration reports
  - ❖ Require proxy holders to cast all their directed proxies on remuneration reports

8

## Improved Disclosure

- Plain English summary of remuneration policy
- Report actual remuneration received
- Companies to disclose executive remuneration advisors and their relationship with company
- Remuneration advisors to work directly to the Board not to management

9

## Improved 'Say on Pay'

The 'two strikes' recommendation:

- Where company's remuneration report receives a 'no' vote of 25% or more, the board be required to explain in subsequent report how shareholder concerns were addressed, and if not, explain why.
- Where subsequent remuneration report receives a 'no' vote of 25% or more at next AGM, a resolution be put that elected directors who signed report, stand for re-election.

## WHAT ROLE FOR GOVERNMENT OWNERSHIP IN BUSINESS AND WHAT IS THE BEST FORM OF OVERSIGHT

*Note by Prof. Daniel Sokol*<sup>1</sup>

### 1. Introduction

There are important theoretical differences between SOEs and publicly traded corporations. In a number of substantive areas, it is typically more difficult to effectively monitor SOEs than private firms. Good corporate governance may provide firms with an edge over competitor firms. Good governance may improve resource availability within the firm and “better” corporate governance may lead to improved performance.<sup>2</sup>

Key theoretical insights a half century ago from Alchian and Stigler suggest that competitive industries make it more difficult for managerial slack.<sup>3</sup> Competition, therefore, can be a substitute for good corporate governance. Empirical work suggests that the inverse is also true. In industries that are not competitive, corporate governance seems to have little impact.<sup>4</sup> This is not to suggest that competition and corporate governance are perfect substitutes. Where there is no competition within an industry, good corporate governance is less necessary than in situations where there is robust competition. Because of the imperfect substitutability of corporate governance and competition policy, jurisdictions may need only chose one form of regulation to ensure economic gain for society.

In itself, the lack of effective corporate governance would not be fatal if some of the SOE anti-competitive distortions could be remedied under antitrust law. However, a review of antitrust decisions on the issue of predatory pricing by SOEs reveals that antitrust is equally ineffective in its attempts to monitor SOE bad behaviour. This chapter does not suggest that better corporate governance will necessarily cure the type of anti-competitive behaviour that antitrust remedies. Rather, it makes the point that SOEs from a standpoint of efficiency create problems and that improved corporate governance and effective competition policy are substitutes that could lead to more efficient outcomes regarding SOEs. Predatory pricing is not the only form of exclusionary anti-competitive behaviour that an SOE can undertake. However, it is an area which illustrates a gap between how laws generally apply to all firms without taking into account the different dynamics between private and state ownership. This chapter does not make the claim that good corporate governance will prevent antitrust violations. The linkage between corporate governance and antitrust is more indirect. Both are possible legal/regulatory tools to address inefficiencies regarding SOEs. However, one could make the case that with bad corporate governance in which directors are reckless, antitrust and other violations might be more likely.

Section 1.2 provides an analysis of the difference between public (government) and private (generally publicly listed) ownership in terms of incentives and mechanisms of control of corporate governance. Section III provides an analysis of competition policy predatory pricing tests that could limit the potential anti-competitive harm that SOEs might create. Section IV concludes and offers a series of recommendations on improved corporate governance and competition law and policy of SOEs.

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<sup>1</sup> Assistant Professor, University of Florida Levin College of Law. This chapter draws upon related work published as D. Daniel Sokol, *Competition Policy and Comparative Corporate Governance of State Owned Enterprises*, 2009 BYU L. Rev. 101 (2009).

<sup>2</sup> Rene Stulz, *Globalization, Corporate Finance and the Cost of Capital*, 12 J. Applied Corp. Fin. 3 (1999).

<sup>3</sup> Armen A. Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. Pol. Econ. 211 (1950); George J. Stigler, *The Economics of Scale*, 1 J. L. Econ 54 (1958).

<sup>4</sup> Xavier Giroud and Holger M. Mueller, “Does Corporate Governance Matter in Competitive Industries?”, ECGI - Finance Working Paper No. 185/2007 (February 2008) available at <http://ssrn.com/abstract=1006118>.

## 2. Private vs. Government control of firms

### 2.1 SOEs generally

SOEs are different from private firms in that the profit motive in an SOE may not exist.<sup>5</sup> Some SOE functions may be based on non-financial goals. One potential problem with state ownership is that it may be used for political objectives. Some objectives for SOEs may include employment, social goals, or capital formation. This is not to suggest there are not some situations in which SOEs should play a role in the economy. The most persuasive defence of state ownership is market failure. There may also be a need for intervention for social reasons to redistribute to the very poor. Moreover, SOEs may be desirable if a public good needs to be provided and if quality is difficult to specify in a contract.<sup>6</sup> These goals, however, for the most part are not based upon an efficiency rationale.

Some SOEs may not be about profit maximisation because they are in regulated industries in which regulators pressure firms to undertake certain policies with outcomes to benefit politicians rather than shareholders.<sup>7</sup> Government must balance its role as regulator with its role as the owner of a firm. Bureaucrats may have an incentive to protect SOEs from competition when bureaucrats serve as both regulators and market participants. Bureaucrats also have an incentive to increase the size of bureaucracy (such as an SOE) because the increased size and scope of a bureaucracy provides them with greater prestige and the ability to advance their careers.<sup>8</sup>

The lack of an efficiency rationale changes the incentives for an SOE. Since SOEs lack shareholders because they are owned by the government, the ultimate shareholder equivalent in an SOE is the country's citizens. Yet, there is a potentially significant agency cost problem in the arrangement in which citizen's interests are not aligned with SOE management, directors and regulatory overseers. Behaviour of firms in state hands will be less aligned with owner welfare because the types of incentives used to align behaviour that the market provides are either non-existent or more limited when dealing with SOEs.

Owners do not have direct ownership rights in the SOE. Therefore they do not receive the proceeds of the firm. Unlike private firms, there is a restricted ownership right in the SOE. Transferability of shares in private firms means that there is exit by shareholders dissatisfied with managerial decision-making. This is also an important control mechanism, as a lower share price creates a threat to management through the market for corporate control, which SOEs do not face. The fundamental principal-agent in the SOE context is one that "exists between taxpayers and the government rather than between the owner, which is actually the government, and the state-owned enterprises."<sup>9</sup> Thus, this relationship leads to higher agency costs that would exist with management and owners of private firms. The various internal and external mechanisms that limit agency cost problems in private firms are far less effective for SOEs, as the various traditional governance mechanisms may not fit an SOE that may not be motivated by profit.

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<sup>5</sup> Michael Trebilcock & Edward Iacobucci, *Privatization and Accountability*, 116 Harv. L. Rev. 1422, 1425 (2003).

<sup>6</sup> Timothy Besley & Mairteesh Ghatak, *Government Versus Private Ownership of Public Goods*, 116 Q.J. Econ. 1343 (2001).

<sup>7</sup> Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. Pol. Econ. 225 (1990).

<sup>8</sup> William A. Niskanen, *Bureaucracy and Public Economics* (1994).

<sup>9</sup> Yoichi Takahashi, "Does discipline by SOE bonds work? – Japan's experience with Zaito reform." Paper for conference on corporate governance of state-owned enterprises in China, Beijing, 18-19 January 2000. OECD, Development Research Centre of the State Council of PRC, ADB at 2.

SOEs may not exist to maximise “shareholder” (citizen) value. There may be non-commercial activities that an SOE pursues and potential political interference in the day-to-day management of SOEs. Worse, if the political elements of government decide SOE policy, this takes independence and authority away from the SOE board of directors. There is a growing literature in the United States on shareholder democracy and accountability of boards and management.<sup>10</sup> Whatever such issues exist among publicly traded firms, the accountability problems of board and management are more severe in SOEs, yet have received less attention.

Further, government may create an uneven-playing field in those markets where an SOE competes with private firms.<sup>11</sup> Government has an interest in ensuring that its state owned firms succeed. As such, the government as regulator may restrict competition by providing various benefits to SOEs that it does not offer to other firms. Though this might result in direct preferences, some of the preferences might be indirect, such as implicit loan guarantees for favourable lending, regulatory preferences such as the creation of a large monopoly position in related industries, limitations on foreign ownership, or implicit subsidies through a lack of taxation or more lax corporate governance requirements vis-à-vis private firms. The nature of SOE regulation might be arbitrary where the only predictability in regulation may be that government looks to protect its SOE over all other goals.<sup>12</sup> High barriers to entry limit the ability of the market, through competition, to serve as a check on the poor decision-making of SOEs.

Alchian made a theoretical prediction that since private firms behaved differently than state owned firms, the performance of each type of firm would vary, with private firms more successful than state owned firms.<sup>13</sup> The costs of decision-making remain less concentrated in private firms than in SOEs and there is more accountability in private firms based on the outcome of such decisions. It is more difficult to constrain public actors than private ones because there is less accountability for making a mistake. Indeed, there is a risk that management may not have an accurate sense of the organisational structure of an SOE (more than of a private firm) because of greater principal-agent problems. An SOE may have many sub principal agent problems because of what may be an overly complex chain of command. This reduces accountability, especially when there are multiple principals (assuming that one can always identify the principals). Managers in SOEs are less likely to be fired by the board for making a bad decision and the state is more likely to bail out a mismanaged SOE. From a theoretical standpoint, we should expect to see improved performance of a private firm because the incentives between management and shareholders will be better aligned for better performance in firms.<sup>14</sup> Empirical work on the difference in performance between state owned and privatised firms confirms this theoretical insight.<sup>15</sup> For example, Shirley and Walsh find that among 52 studies they survey, in only 5 of the 52 studies do SOEs outperform private firms.<sup>16</sup>

<sup>10</sup> See e.g., Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833 (2005); Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 Harv. L. Rev. 1784 (2006).

<sup>11</sup> Eleanor M. Fox, *An Anti-Monopoly Law for China - Scaling the Walls of Protectionist Government Restraints*, 75 Antitrust L.J. 173, 178-79 (2008).

<sup>12</sup> Timothy Irwin & Chiaki Yamamoto, “Some Options for Improving the Governance of State-owned Electricity Utilities,” World Bank Energy and Mining Sector Board Discussion Paper Series no. 11 (2004) at 7.

<sup>13</sup> Armen Alchian, *Some Economics of Property Rights*, 30 *Il Politico* 816 (1965).

<sup>14</sup> Jean-Jacques Laffont & Jean Tirole, *Privatization and Incentives*, 7 *J. L. Econ. & Org.* 84 (1991); David E. M. Sappington & Joseph E. Stiglitz, *Privatization, Information and Incentives*, 6 *J. Pol’y Analysis & Mgmt.* 567 (1987); Carl Shapiro & Robert D. Willig, “Economic Rationales For the Scope of Privatization,” in *The Political Economy of Public Sector Reform and Privatization* (Ezra Suleiman & John Waterbury eds., 1990).

<sup>15</sup> Belen Villalonga, *Privatization and Efficiency: Differentiating Ownership Effects from Political, Organizational, and Dynamic Effects*, 42 *J. Econ. Behavior & Org.* 43 (2000).

<sup>16</sup> Mary M. Shirley & Patrick Walsh, “Public vs. Private Ownership: The Current State of the Debate,” World Bank Policy Research Working Paper No. 2420 (2001).

## 2.2 *Internal controls*

### 2.2.1 *Corporations*

#### *Managerial ownership and pay*

Jensen and Meckling in their seminal work on agency costs found that increased managerial ownership led to reduced of agency costs and thus increased maximisation of the firm.<sup>17</sup> Work by other scholars yields similar conclusions.<sup>18</sup> Building from this insight, some scholars have qualified the role that management's ownership of a firm plays in improved firm outcomes. Too high an ownership level may reduce corporate performance because it may reduce the ability to dismiss ineffective management. Yet, some level of corporate ownership by management may increase firm performance.<sup>19</sup> In many cases, SOE managers do not face the types of financial rewards of private firms. SOE managers cannot be rewarded additional compensation based on the increase of the stock price of the SOE.

#### *Board oversight*

A firm has a board of directors rather than an executive who rules by fiat because deliberation of a group with complementary skills should lead to better business outcomes. The board serves to monitor managers on behalf of shareholders. In theory, the board protects shareholders from potentially risk and costly managerial mistakes in strategy. The board also provides oversight to ensure that management does not shirk its responsibilities.

In SOEs the voice of any shareholder equivalent (a voter) and cannot easily be aggregated the way that institutional investors can aggregate votes because of collective action problems.<sup>20</sup> The organisational costs of most SOEs are larger because it is more difficult to fire people in government than in private firms – SOEs are less responsive to market forces.

Other factors distinguish corporate governance of SOEs. Property rights in private firms are transferable. An SOE lacks such transferability. The only way that SOE shareholder equivalents can vote with their feet is indirectly through national elections, where a new party might impose a different set of priorities for SOEs. The effect is a disconnect between present behaviour and future outcome that a listed stock provides non-government owned firms. Because of the non-transferability of ownership, there is less incentive to monitor because the principal cannot create more value that she can then capture through a sale of the ownership stake.<sup>21</sup> Without effective monitoring, it is easier for managers in SOEs to make bad decisions because of a lack of accountability for the consequences that such decisions otherwise would entail. SOE managers and directors do not face repercussions such as termination for poor decision-making.

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<sup>17</sup> Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976).

<sup>18</sup> John J. McConnell & Henri Servaes, *Equity Ownership and the Two Faces of Debt*, 39 J. Fin. Econ. 131 (1995); Eric R. Gedajlovic & Daniel M. Shapiro, *Management and Ownership Effects: Evidence from Five Countries*, 19 Strategic Mgmt. J. 533 (1998); Benjamin E. Hermalin & Michael S. Weisbach, *The Effects of Board Composition and Direct Incentives on Firm Performance*, 20 Fin. Mgmt. 101 (1991).

<sup>19</sup> Randall Morck, Andrei Shleifer, & Robert Vishny, *Management Ownership and Market Valuation: An Empirical Analysis*, 20 J. Fin. Econ. 293 (1988).

<sup>20</sup> See generally, Mancur Olson, *The Logic of Collection Action: Public Goods and the Theory of Groups* (1965).

<sup>21</sup> Louis De Alessi, *The Economics of Property Rights: A Review of the Evidence*, in *Research in Law and Economics* 27-28 (Richard O. Zerbe, ed.) (1980).

## 2.3 *External controls*

External controls refer to elements outside of the firm that limit agency costs of managers. Such elements include the market for corporate control, the equity market, the bond market, the market for managers and bankruptcy.

### 2.3.1 *Market for corporate control*

Henry Manne first identified the market for corporate control that impacts firm behaviour.<sup>22</sup> Managers may be replaced through take-overs. If management decision-making is poor, this will be reflected in a depressed stock price for the firm. If management is ineffective, the stock price of the corporation should fall. A lower stock price due to poor management is an invitation for a potential takeover. A takeover is more likely because the corporation can be bought on the cheap.

The possibility of takeover via a hostile acquisition such as a tender offer or proxy contest creates incentives for managers within the firm. These incentives discipline managerial behaviour. In a takeover, the new owners are likely to replace poorly performing managers. Conversely, if management performs well, the stock price of the corporation is more likely to rise. This will reduce the possibility of takeover of the corporation because the cost of shares increases, which reduces the difference between the potential arbitrage of current versus potential share price.<sup>23</sup> Managers therefore should keep their jobs when they perform well.

Though control problems will occur even in private firms, these distortions are not as severe as those of government owned firms. SOEs are not subject to the same sorts of repercussions from bad management. Because of government ownership, SOEs need not face acquisition threats from firms that may be able to unlock value from the firm through better management. Unlike private firms, SOEs do not operate under hard budget constraints. Instead, they operate under what economists term “soft” budget constraints. These constraints are “soft” because another institution (in our case, another part of government) will pay the shortfall for mismanagement of the SOE. Such firms do not fear the negative consequences of bad mistakes because even a chronic loss making firm will be bailed out by the state.<sup>24</sup> Managers of the SOE will expect this external financial assistance and as such, may not undertake the types of sound and profitable strategies of private firms.

### 2.3.2 *Equity*

Publicly traded shares of stock provide information on the relative state of a firm. The capital markets provide a signal about the valuation based on discounted value of profits of a firm which is based on the current and future state of the management team and its decisions.<sup>25</sup> We assume that the market appropriately prices the value of the ownership right. Even, however, if the market does not, it is still a better indicator of the value based on performance than measures of public sector performance management. SOEs are not publicly traded so they lack this signal of firm performance that equity markets provide.

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<sup>22</sup> Henry Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110 (1965).

<sup>23</sup> Jonathan Macey, *Corporate Governance* 119 (2008); Daniel Fischel, *The Corporate Governance Movement*, 35 Vand. L. Rev. 1259, 1264 (1982).

<sup>24</sup> Janos Kornai, *The Soft Budget Constraint*, 39 *Kyklos* 3 (1986); Janos Kornai & Eric Maskin & Gerard Roland, *Understanding the Soft Budget Constraint*, 41 J. Econ. Lit. 1095 (2003).

<sup>25</sup> Kenneth R. Ferris & Barbara S. Pècherot Petitt, *Valuation: Avoiding the Winner's Curse* 74 (2002).



### 2.3.3 *Debt*

Debt is a mechanism to control and measure the performance of the firm. If a firm issues debt, there are consequences on firm management. Debt reduces free cash flow, thus disciplining management because there is less money to spend due to the need to service the debt. Firms that are poorly managed and are in financial difficulty will have a poor debt rating. If a firm has a poor debt rating, it will be more expensive for a firm to borrow money since the rating will reflect the possibility that the debt may not be repaid. Banks frequently review credit decisions. Moreover, credit rating agency such as Moody's and Standard & Poor's ("S&P") rate borrowers and update such ratings. These regular recalibrations in the market for debt send a signal about the health of a given firm. If a firm's rating were to deteriorate, it would signal to the market that the firm has undertaken harmful decisions that have increased firm risk.

There should be a risk premium associated with borrowing money for an SOE. This means that banks should lend debt with worse grades since SOEs are more likely to be poorly managed relative to private firms. However, because the government either explicitly or tacitly guarantees this debt (which it does not do for most private firms), SOEs have an advantage over their private competitors.

### 2.3.4 *Market for managers*

An informal mechanism to reduce agency costs is the reputation of managers. Success or failure at a firm in theory would affect the ability of managers to negotiate their next contract and therefore future wages.<sup>26</sup> Therefore, reputational consequences may force a manager to better run a firm to preserve his/her reputation going forward. Moreover, for managers at the end of their career, reputation still may be an important factor in leaving behind a "legacy" at a firm. This is not to suggest that some managers will be willing to risk long term reputation for short term gain. Corporate scandals such as WorldCom, Enron, and Tyco teach us otherwise. Rather, in a number of cases reputation does serve to limit agency cost problems and the Enron's of the world are most likely outliers.

In SOEs, managers may be poorly monitored relative to private firms. With SOEs, it is more difficult to measure reputation based on performance. Because of the lack of external controls such as access to the capital markets for equity and debt, it is more difficult to rate the performance of managers.<sup>27</sup> However, because the firm may not be profit maximising, managers will be secure in their jobs regard-less of firm performance. Many potential managers will choose careers in the private sector rather than the public sector because of greater pay, greater potential upside incentives for increased pay and in terms of risk taking and innovation. This is not to suggest that other excellent people do not choose government service within an SOE out of a sense of civic duty or altruistic motivations. Rather, for those managers in SOEs who are inferior to their counterparts in private firms, there is greater job security. With market based accountability in private firms, it is easier to fire under-performing managers. At SOEs, it is more difficult to fire under-performers because standards are not clear or not important.

### 2.3.5 *Bankruptcy*

Forced exit through bankruptcy is a potential outcome for a poorly managed firm. Bankruptcy is one mechanism by which firms exit the market. It is the legal process through which the exit process unfolds for financially distressed firms. The risk of bankruptcy and possible liquidation forces many firms to undertake less risk because of the potential negative consequences of overly risky strategies. In contrast to

<sup>26</sup> Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. Pol. Econ. 288, 292 (1980).

<sup>27</sup> Michael Trebilcock & Edward Iacobucci, *Privatization and Accountability*, 116 Harv. L. Rev. 1422, 1428 (2003).

private firms, SOEs generally do not go bankrupt (though countries sometimes do).<sup>28</sup> The lack of bankruptcy means that SOE managers do not face the same constraints as private firms for making mistakes. Without the potential spectre of bankruptcy, SOEs might expand businesses even if there is not a profit making case to do so.

### 3. Competition and SOEs

*Ex ante*, the competition issues involving SOEs can be addressed somewhat by corporate governance in terms of structuring the incentives of a firm to behave more like private firms, with an efficiency rationale. Without soft budget constraints, an SOE cannot get away with predatory pricing so easily. *Ex post*, competitive distortions can be solved through antitrust, which provides the potential of relief against anti-competition abuses.

#### 3.1 Incentives for SOE anti-competitive behaviour

Competition is the foundation for a market economy. Market competition has profound effects upon firms. It eliminates inefficient firms.<sup>29</sup> Moreover, it can make the monitoring of firms more effective.<sup>30</sup>

Governments may erect many types of regulatory barriers to limit competition.<sup>31</sup> For example, bias by the government to protect SOEs may take the form of favourable lending rates *vis-à-vis* private firms. SOEs therefore may have a different cost of capital than do private firms. This may have an effect of an implicit subsidy for SOEs. Government may open its purse to provide for lower borrowing rates than market rates. SOEs also may benefit from discriminatory regulation. SOEs may not be required to pay taxes or may be immune from antitrust. Moreover, SOEs may benefit from information asymmetries. Information asymmetries occur where SOEs have data that private competitors do not where the government collects the data. An SOE can use its economies of scope to create high barriers to entry that effectively forecloses competition by efficient competitors.<sup>32</sup> Because of cost structure and incentives of an SOE, SOEs are more successful in their attempts to prevent foreign entry than similarly situated private firms.<sup>33</sup>

#### 3.2 Revenue maximisation as an SOE goal

Because of the soft budget constraint, SOEs may have goals other than profit maximisation, such as revenue maximisation.<sup>34</sup> Government support of SOEs through government created distortions (e.g., a large reserve sector, implicit loan guarantees, and preferences for zoning) allows SOEs to price below its marginal cost due to the explicit and implicit subsidies that governments grant SOEs and not their private

<sup>28</sup> OECD, Corporate Governance of State-Owned Enterprises: A Survey of OECD Countries 14 (2005).

<sup>29</sup> Armen A. Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. Pol. Econ. 211 (1950).

<sup>30</sup> Edward P. Lazear & Sherwin Rosen, *Rank-Order Tournaments as Optimum Labor Contracts*, 89 J. Pol. Econ. 841 (1981).

<sup>31</sup> Eleanor M. Fox, *Economic Development, Poverty, and Antitrust: The Other Path*, 13 SW. J. L. & Trade Am. 211, 224 (2007); Timothy J. Muris, *Principles for a Successful Competition Agency*, 72 U. Chi. L. Rev. 165, 170 (2005).

<sup>32</sup> John C. Panzer, "Interactions Between Regulatory and Antitrust Policies in a Liberalized Postal Sector," working paper 2008 at 5.

<sup>33</sup> Anusha Chari and Nandini Gupta, "The Political Economy of Foreign Entry Liberalization," NBER Working Paper (2005).

<sup>34</sup> John R. Lott, *Are Predatory Commitments Credible?: Who Should the Courts Believe?* 77 (1999).

competitors. This creates a situation, unlike the typical US antitrust predation case, which does not require recoupment for successful SOE predation.<sup>35</sup>

The ability of SOEs to engage in non-recoupment predatory pricing poses an important question. If consumers do not see higher prices as a result of the predation, is there any consumer harm? When an SOE can pursue a successful predation strategy, this reduces the resources of a competitor to innovate or operate. The “but for” case is that there might have been even lower prices and more innovation. Successful predation also may have reputational effects if a firm competes in multiple product markets. This reputational effect creates a credible threat that allows firms to reap the benefits of predation even in markets in which they did not predate. This in turn negatively affects the overall market. When predator firms benefit, this reduces consumer welfare. An increasing economic literature notes that predatory pricing may be rational in other settings for profit maximising firms as well.<sup>36</sup> How to address issues of predation outside of the SOE context is beyond the scope of this Chapter.

Predation must be distinguished from raising a rival’s cost.<sup>37</sup> Predation in non-SOE settings requires antitrust to think about short run benefits versus long run costs. In raising the cost of rivals, the goal is to increase the price of output for rivals rather than decrease price. A successful raising a rival’s cost strategy would be one in which the dominant firm average costs increase less than the incremental costs of a rival. This allows a dominant firm to create an asymmetric impact on costs relative to its rivals.<sup>38</sup>

The ultimate goal of raising a rival’s cost is different than predation. A successful raising a rival’s cost strategy does not require the firm with higher costs to exit the market, merely to allow the dominant firm to raise its price above the competitive level.<sup>39</sup> As Sappington and Sidak suggest, “Consequently, even though an SOE may value the profit that its anticompetitive activities can generate less highly than does a private profit-maximising firm, the SOE may still find it optimal to pursue aggressively anticompetitive activities that expand its own output and revenue.”<sup>40</sup> Given that an SOE may have revenue rather than profit enhancement objectives, it can more effectively absorb the cost of raising the costs of its private rivals. It can do so because the government acts to constrain rival firms.<sup>41</sup> When an SOE can pursue an effective raising a rival’s cost strategy, it can expand its scope. Predation or raising rivals’ cost takes away the ability for competitors to invest in increase research and development and limits the ability to roll out new

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<sup>35</sup> David E.M. Sappington and J. Gregory Sidak, *Competition Law for State-Owned Enterprises*, 71 Antitrust L.J. 479, 522-23 (2003).

<sup>36</sup> Patrick Bolton, Joseph F. Brodley & Michael H. Riordan, *Predatory Pricing: Strategic Theory and Legal Policy*, 88 GEO. L. J. 2239, 2241 (2000) (describing that “modern economic analysis has developed coherent theories of predation that contravene earlier economic writing claiming that predatory pricing conduct is irrational” and thus that “the consensus view in modern economics [is] that predatory pricing can be a successful and fully rational business strategy.”).

<sup>37</sup> Deborah Cope, *Regulating Market Activities in the Public Sector*, 7 OECD J. Comp. L. & Pol’y 32, 38-40 (2005); David E.M. Sappington & J. Gregory Sidak, *Competition Law for State-Owned Enterprises*, 71 Antitrust L.J. 479, 496 (2003).

<sup>38</sup> Stephen Martin, *Advanced Industrial Economics*, 2d ed. 244-246 (2002).

<sup>39</sup> Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals’ Costs to Achieve Power over Price*, 96 Yale L.J. 209, 242 (1986).

<sup>40</sup> David E.M. Sappington & J. Gregory Sidak, *Competition Law for State-Owned Enterprises*, 71 Antitrust L.J. 479 (2003).

<sup>41</sup> David T. Scheffman & Richard S. Higgins, *20 Years of Raising Rivals’ Costs: History, Assessment, and Future*, 12 Geo. Mason L. Rev. 371, 376 (2003).

products and services and processes that increase dynamic gains from innovation.<sup>42</sup> SOEs may have particular incentive to raise the costs of its rivals. As the rival's marginal cost increases, it may be costly to the SOE but it simultaneously increases the demand for the SOEs product or service. Since the SOE is a revenue maximiser, it benefits from the increased demand.<sup>43</sup>

### 3.3 *Antitrust solution*

Monopolisation creates a consumer welfare loss. There are a number of different cost based tests that antitrust law uses to combat predatory pricing abuses.<sup>44</sup> Antitrust may be a possible solution to anti-competitive conduct when there is no direct immunity of regulated industries (and many SOEs are in regulated industries). However, a lack of immunity does not entail that antitrust will be an effective tool to remedy anti-competitive conduct. In many cases, SOEs may be dominant in their relevant markets. When this is the case, SOEs have the potential to monopolise. This makes the ability to utilise antitrust effectively more important. Yet, domestic antitrust law may not apply the types of analytical tools to remedy anti-competitive conduct by SOEs. The general state of antitrust law enforcement in most jurisdictions does not recognise that sustained predation below cost is possible without recoupment because it is based on the premise of profit maximising firms rather than employment and/or revenue maximising firms. Moreover, antitrust law is ill equipped to address predation by SOEs because antitrust uses the same cost test for both private firms and SOEs. That is, current antitrust tests do not impute the various government preferences into the actual costs of SOEs.

Because of the inability to obtain quantitative data to determine the full extent of the costs of SOEs worldwide, this article employs a qualitative rather than quantitative research method. In such circumstances, a case study approach may be the most effective way to ground analysis in experience rather than mere theory.<sup>45</sup> This chapter uses multiple qualitative case studies to illustrate the impact of the difficulty of antitrust to address anti-competitive behaviour by SOEs. Case studies provide an explanatory theory that has high construct validity and accommodates complex causal relations. Multiple case studies provide for more meaningful comparisons across cases and for better generalisations for the case studies.<sup>46</sup>

## 4. **United States**

The basis for monopolisation claims under US antitrust law derives from Section 2 of the Sherman Act, although other antitrust laws implicate single firm conduct<sup>47</sup> Case law has developed regarding the appropriate test to use for predation, though at lower court levels the standards are still not exactly clear.<sup>48</sup>

<sup>42</sup> Eleanor M. Fox, *US and European Merger Policy--fault Lines and Bridges: Mergers That Create Incentives for Exclusionary Practices*, 10 Geo. Mason L. Rev. 471, 474 fn 14 (2002) (citing *United States v. Microsoft Corp.*, 253 F.3d 34, 50-53 (D.C. Cir. 2001)).

<sup>43</sup> David E.M. Sappington & J. Gregory Sidak, *Incentives for Anticompetitive Behavior by Public Enterprises*, 22 Rev. Indus. Org. 183, 196-97 (2003).

<sup>44</sup> Raising rival's cost is not a judicial antitrust claim but is a theoretical tool to frame exclusionary behavior. Oftentimes courts use the theory of raising rival's costs without explicit mention of it.

<sup>45</sup> Gary King, Robert O. Keohane & Sidney Verba, *Designing Social Inquiry* 67 (1994).

<sup>46</sup> Christopher H. Achen & Duncan Snidal, *Rational Deterrence Theory and Comparative Case Studies*, 41 World Politics 143, 146 (1989). A danger of case studies is the possibility of selection bias.

<sup>47</sup> 15 U.S.C.A. § 2.

<sup>48</sup> Daniel A. Crane, *The Paradox of Predatory Pricing*, 91 Cornell L. Rev. 1, 7-9 (2005)(also noting that plaintiffs recast predatory behavior into other antitrust classifications of harm to overcome courts' reluctance to find for plaintiffs on predation claims).

The seminal Supreme Court case in this area is that of *Brooke Group v. Brown & Williamson Tobacco Corp.*<sup>49</sup> Under *Brooke Group*, two factors must be met in a successful predatory pricing claim. First, a plaintiff must show that the prices at issue “are below an appropriate measure of its rival’s costs.”<sup>50</sup> Second, that must be a showing “that the competitor had ... a dangerous probability, of recouping its investment in below-cost prices.”<sup>51</sup> Two recent Supreme Court cases, *Linkline*<sup>52</sup> and *Weyerhaeuser*, upheld the *Brooke Group* approach.<sup>53</sup> Circuit courts across the United States have interpreted the *Brooke Group* case differently.<sup>54</sup> For example, *US v. AMR*, the 5<sup>th</sup> Circuit “decline[d] to dictate a definitive cost measure for all cases” although it used an average avoidable cost test in that particular case.<sup>55</sup>

One reason that there are few predatory pricing cases is because of the Supreme Courts’ concern of the potential for type II errors of mistaken prosecution. As the Supreme Court notes, “mistaken inferences in cases like this one are especially costly, because they chill the very conduct the antitrust laws are designed to protect.”<sup>56</sup> As such, the Court has created various procedural hurdles for plaintiffs in predatory pricing cases. Many of the same behaviours that could lead to allegations of predatory pricing are precisely the ones that could increase competitions, such as price cuts. The Supreme Court most recently restated this explicitly in *Weyerhaeuser*.<sup>57</sup>

There are a number of reasons why SOE antitrust cases are not typical in the United States. Many are state action cases that involve decisions based on whether or not the state action has been clearly articulated rather than on substantive claims of anti-competitive conduct. However, there has been a recent Supreme Court case regarding a postal SOE. As with other US cases involving SOEs, this case was not decided upon the merits but on whether or not antitrust immunity applied.

The Supreme Court found that the Sherman Act did not apply to the post office in *United States Postal Service v. Flamingo Industries*.<sup>58</sup> Among the claims that Flamingo made was that the USPS sought to create a monopoly in mail sack production and that it could do so in large part because of its monopoly in the postal reserve sector. In *Flamingo*, the Supreme Court stated that the USPS was a part of the federal government and therefore not under the purview of the antitrust laws of the United States.<sup>59</sup> In a departure from the prevailing economic literature on SOEs, the Supreme Court reasoned that the USPS’ “powers are

<sup>49</sup> 509 U.S. 209 (1993).

<sup>50</sup> *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 222 (1993).

<sup>51</sup> *Id.* at 224 (1993).

<sup>52</sup> *Pacific Bell Telephone Co. v. Linkline Communications, Inc.*, 129 S.Ct. 1109 (2009) (supporting the use of predatory pricing tests in the retail cost context of a price squeeze claim).

<sup>53</sup> *Weyerhaeuser Co. v. Ross-Simmons Hardwood Co.*, 127 S. Ct. 1069 (2007) (upholding the cost test in predatory buying circumstances).

<sup>54</sup> Daniel A. Crane, *Rules Versus Standards in Antitrust Adjudication*, 64 Wash. & Lee. L. Rev. 49 (2007).

<sup>55</sup> *United States v. AMR Corp.*, 335 F.3d 1109, 1115, 1116 (10th Cir. 2003).

<sup>56</sup> *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 597 (1986).

<sup>57</sup> *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co., Inc.*, 127 S.Ct. 1069, 1077 (2007) citing to *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 at 226, 113 S.Ct. 2578 (“The costs of erroneous findings of pre-datory-pricing liability are quite high because the mechanism by which a firm engages in predatory pricing--lowering prices--is the same mechanism by which a firm stimulates competition, and therefore mistaken liability findings would chill the very conduct the antitrust laws are designed to protect.”).

<sup>58</sup> 540 U.S. 736 (2004). Since then, the 2007 Act explicitly allows for the application of antitrust to the USPS.

<sup>59</sup> *United States Postal Serv. v. Flamingo Indus.*, 540 U.S. 736, 749 (2004).

more limited than those of private businesses. It lacks the prototypical means of engaging in anti-competitive behaviour: the power to set prices.”<sup>60</sup> Under this flawed reasoning, an SOE does not have an incentive to drive competitors out of business. As discussed earlier in this Chapter, economic theory suggests that an SOE may have other motivations than profit maximisation. Even if an SOE does concern itself at times with profit, it is also motivated by revenue maximisation and by an interest in increasing the scope of its services and its number of employees.<sup>61</sup> The reasoning of the Supreme Court ignores the possibility of no-recoupment predation because of government ownership and of raising rivals’ cost strategies.

A second weakness of the Supreme Court decision was its reliance of the Postal Commission, the sector regulator, to overcome potential anti-competitive behaviour by the USPS.<sup>62</sup> The old Postal Rate Commission, where the Commission lacked a subpoena power and the ability to mandate that the USPS provide it with data. Whatever data it received came voluntarily from the USPS.<sup>63</sup> Such a situation created additional information asymmetries between the regulator and the regulated industry and makes it more difficult to detect the anti-competitive cross subsidies between the postal and express delivery sectors.

Because of the weakness of the postal regulator, antitrust would have been the only alternative to remedy the anti-competitive behaviour. The Postal Commission that existed at the time of the decision in 2004 was a weak regulator. Unlike regulators in other network industries such as electricity or telecommunications, the Postal Commission could not set rates. Rather, it could only recommend rate changes and such recommendations can be over-ridden by the USPS board of directors.<sup>64</sup> Yet, somehow, in spite of a regulator that lacks the ability to set prices and to have its dictates followed, the Court found that regulatory oversight was a factor that prevented USPS from monopolisation.

In any determination of whether to bring an antitrust case, the first and perhaps most important issue is one of assembling evidence. Even if the USPS was subject to antitrust law at the time, bringing such a case would have been very difficult, even had there been an effective measure of cost predation that took into account government advantages granted to the USPS.

The existing US predatory pricing methodologies, as noted in the previous discussion, require recoupment. While this might make sense for private firms that operate based on profit, a cost based test is ineffective for government owned firms with soft budget constraints that might maximise revenue rather than profit.

*Flamingo* also underscores how important the predation and raising rival’s cost claims are in terms of understanding the potential anti-competitive harm on the part of the postal service. Since the USPS defines the size of its reserve sector broadly, it has an incentive to increase the definition of the reserve sector to reduce competition.<sup>65</sup> This limits the potential scope and scale of competitors in the non-reserve and related

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<sup>60</sup> *United States Postal Serv. v. Flamingo Indus.*, 540 U.S. 736, 748 (2004).

<sup>61</sup> David E.M. Sappington & J. Gregory Sidak, *Competition Law for State-Owned Enterprises*, 71 *Antitrust L.J.* 479 (2003); Rick Geddes, *Do Vital Economists Reach a Policy Conclusion on Postal Reform?*, 1 *Eco. J. Watch* 61 (2004).

<sup>62</sup> *United States Postal Serv. v. Flamingo Indus.*, 540 U.S. 736, 747 (2004).

<sup>63</sup> R. Richard Geddes, *Reform of the U.S. Postal Service*, 19 *J. Econ. Persp.* 217, 219 (2005).

<sup>64</sup> 39 U.S.C. §§ 3625, 3628.

<sup>65</sup> Compare the US reserve sector to the EU’s postal liberalization that significantly reduces the reserve sector. Directive 97/67/EC, as amended by Directive 2002/39/EC).

sectors.<sup>66</sup> The USPS also has a monopoly over the mail box itself. It is unique in the world in this monopoly over the mail box.<sup>67</sup>

Under the Postal Act in place at the time of Flamingo,<sup>68</sup> the US government offered the USPS credit guarantees through direct borrowing from the Federal Financing Bank. The credit guarantee allowed the USPS to provide a 12.5 basis point premium for its debt above the US Treasury bond rate<sup>69</sup> This financing provided lower rates for the USPS than private firms. The Supreme Court failed to understand that the USPS has the power of eminent domain. It also has the power to self zone, while express delivery competitors must apply for local zoning permits.<sup>70</sup> Private firms must go through the costly and time consuming process to set up an effective distribution network.

Competition in postal and express delivery was not robust under the old Postal Act. Evidence suggests that the USPS uses its monopoly over delivery to cross subsidise its express delivery service where it faces competition.<sup>71</sup> This behaviour can be traced to the 1970 Postal Reorganisation Act. The Act increased cross subsidies to the competitive mail classes.<sup>72</sup> For example, the rate increase of first class post to 25 cents occurred while the Postal Service decreased the price of next day express service even though the express service arm was already in the red. This postal rate increase coincided with a reduction in the amount charged on foreign express delivery by the USPS from \$18 to \$8.75. As a result, revenue increased for the USPS.<sup>73</sup>

## 5. European Union

Article 82 is the article of the Treaty of Rome that addresses an abuse of a dominant position under EC law and therefore the basis for a predatory pricing claim. A number of different elements make up the criteria for a predatory pricing case for purposes of EC law. These are – sacrifice, anti-competitive foreclosure, and efficiencies.<sup>74</sup> A “sacrifice” by a firm may be predatory if through evidence, a plaintiff can show that conduct entails a sacrifice (loss) for the dominant firm, which the firm undertakes deliberately. Sacrifice does not require any single cost benchmark. Rather, such a sacrifice occurs, according to the new EC Dominance Guidance paper when a firm: (a) charges a lower price for some portion or all of its output

<sup>66</sup> This is particularly true when the SOE exhibits cost complementarities in its production technology. David E.M. Sappington & J. Gregory Sidak, *Incentives for Anticompetitive Behavior by Public Enterprises*, 22 Rev. Indus. Org. 183, 198 (2003).

<sup>67</sup> *United States Postal Serv. v. Council of Greenburgh Civic Ass'ns*, 453 U.S. 114 (1981); Damien Gérardin & J. Gregory Sidak, *The Future of the U.S. Postal Service: American and European Perspectives After the Presidential Commission and Flamingo Industries*, 28 World Competition: L. & Econ. Rev. 163 (2005); R. Richard Geddes, “Anticompetitive Behavior in Postal Services,” in *Competing with the Government: Anticompetitive Behavior and Public Enterprises* 88 (R. Richard Geddes ed., 2004).

<sup>68</sup> The new Postal Reorganization Act of 2007 was in part a consequence of *Flamingo*.

<sup>69</sup> R. Richard Geddes, “Case Studies of Anticompetitive SOE Behavior,” in *Competing with the Government: Anticompetitive Behavior and Public Enterprises* 30-31 (R. Richard Geddes ed., 2004).

<sup>70</sup> *Id.* at 34.

<sup>71</sup> R. Richard Geddes, “Anticompetitive Behavior in Postal Services,” in *Competing with the Government: Anticompetitive Behavior and Public Enterprises* 93-97 (R. Richard Geddes ed., 2004).

<sup>72</sup> Rick Geddes, *Saving the Mail: How to Solve the Problems of the U.S. Postal Service* 5 (2003).

<sup>73</sup> John R. Lott, *Are predatory commitments credible? who should the courts believe?* 69 (1999).

<sup>74</sup> European Commission, “Guidance on the Commission's Enforcement Priorities in Applying Article 82 EC Treaty to Abusive Exclusionary Conduct by Dominant Undertakings,” available at <http://ec.europa.eu/competition/antitrust/art82/guidance.pdf>.

over the relevant time period at issue; (b) expands its output over the relevant time period; or (c) incurs avoidable losses.<sup>75</sup> The first cost benchmark that begins current EC analysis is average avoidable cost. The commission's thought is that AAC is often the same as AVC (since it is the variable costs that can be avoided).<sup>76</sup> Pricing below AAC is therefore seen as sacrifice. The EU courts have yet to use the AAC benchmark. In most cases AVC and AAC will be the same, as often only variable costs can be avoided. The distinction between the two thus depends on the facts of the case.<sup>77</sup>

EC case law supports the sacrifice approach currently under-taken by the Commission. The seminal case of *AKZO Chemie v Commission* involving chemical products held: "A dominant undertaking has no interest in applying such prices except that of eliminating competitors so as to enable it subsequently to raise its price by taking advantage of its monopolistic position, since each sale generates a loss..."<sup>78</sup> In *Akzo*, the pricing strategy undertaken by AKZO Chemie required a sacrifice involved pricing at below the average total cost. The ECJ found that when (a) prices are below AVC; or (b) prices are below ATC but above AVC and it is possible to prove that the firm has intended to eliminate competitors. A line of cases has developed this approach further. In *Tetra Pak II*,<sup>79</sup> a case involving the manufacture of aseptic and non-aseptic cartons, and in *France Télécom*,<sup>80</sup> a case involving charging of below-cost prices for ADSL high-speed Internet services, the European Court of Justice held that the Commission could use two separate cost measures. In *France Télécom*, the court reaffirmed a lack of recoupment for institutional reasons. The court reasoned that to demonstrate recoupment would increase the evidentiary burden upon plaintiffs. This reasoning provides an opening that might allow for cases against SOEs to be successful, though it does not recognise that SOEs might never need recoupment in the first place.

France Télécom also discusses, however, that recoupment may be entertained where prices are below Average Total Cost (ATC) and above AVC. In such circumstances, proof of recoupment may show eliminatory intent.<sup>81</sup> The Commission entertains predation claims between AVC and ATC because "Such prices can drive from the market undertakings which are perhaps as efficient as the dominant undertaking but which, because of their smaller financial resources, are incapable of withstanding the competition waged against them."<sup>82</sup> This Commission belief in the importance of protecting less efficient competitors goes to the idea embodied in Article 82 of protecting the competitive process.<sup>83</sup>

The above cases all dealt with situations in which there was only a single product market. In *Deutsche Post AG*, the Commission examined different product markets, in which it used Long Run Average Incremental Costs for those non-common fixed costs. *Deutsche Post AG* is also the case most on point in EC jurisprudence on SOEs regarding predatory pricing involved the European Commission investigation *Deutsche Post AG* ("DPAG") for abuse of a dominant position in Germany. At the time of the initial complaint against DPAG, DPAG was a 100 percent SOE. The Commission found that because of the

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<sup>75</sup> Id. at ¶ 63.

<sup>76</sup> Note however that when AVC and ACC are dissimilar that the Commission believes that ACC is a better indicator of avoided costs.

<sup>77</sup> Guidance on the Commission's Enforcement Priorities in Applying Article 82 EC Treaty to Abusive Exclusionary Conduct by Dominant Undertakings at FN 40.

<sup>78</sup> Case 62/86 *AKZO Chemie v. Commission* [1991] ECR I-3359, paragraph 71.

<sup>79</sup> Case C-333/94 P *Tetra Pak International SA v. Commission* [1996] ECR I-595I.

<sup>80</sup> Case C-202/07 P, *France Télécom v. Commission*, judgment of 2 April 2007.

<sup>81</sup> Id. at para 111.

<sup>82</sup> Case 62/86 *AKZO Chemie v Commission* [1991] ECR I-3359, paragraph 72.

<sup>83</sup> Alison Jones, Brenda Sufrin & Brenda Smith, *EC Competition Law* 3d ed. 337 (2007).



excess revenue produced from the reserve area, the reserve area could serve as a “likely and permanent source of funding” for cross subsidisation because the revenues in the reserve sector exceeded the costs.<sup>84</sup>

The Commission held that between 1990 and 1995, DPAG’s revenue was below its incremental cost of providing mail order parcel services. This allowed DPAG to successfully pursue predation. It did so through the cross subsidisation of activities in the competitive sector by revenues from the reserve sector.<sup>85</sup> The Commission also discovered a longer lasting (1974-2000) anti-competitive fidelity rebate scheme.<sup>86</sup> The cross subsidisation of DPAG enabled it to tie its fidelity program for mail parcel services even though the parcel services was less efficient than its competitors. The fidelity rebates prevented entry into the parcel services market by other firms through tying. New entrants could not generate a critical mass necessary to sustain entry into the market. This is an understanding of raising rival’s costs even though it is not explicit. Because of the lack of critical mass, it was not possible for mail order traders to set up an alternative delivery network infrastructure to that of DPAG. The cost structure of the DPAG parcel services market was such that between 1990 and 1995, every DPAG sale presented a loss. In the medium term, this was not in the economic interest of DPAG. In the long term, continuing this line of business prevented entry by competitors. The Commission fined DPAG €24 million and forbade any such conduct in the future. It also imposed a structural remedy to separate DPAG’s commercial parcel services from its reserved sector services. Given that the cost of the penalty was less than the gains of anti-competitive conduct, it is unclear that this remedy created a chilling effect on anti-competitive behaviour. The case did not need to get to particulars of what constituted a “cost” for purposes of LRAIC cost methodology so we lack an understanding on whether a different cost test would have been used for SOEs.

## 6. South Africa

South Africa’s abuse of dominance provisions can be found in Section 8(d)(iv) of the South African Competition Act 89 of 1998, specifically “selling goods or services below their marginal or average variable cost.” In spite of a specific test in the statute, South African case law from the Competition Tribunal explains that other cost based tests may be used beyond that of MC and AVC.<sup>87</sup> The elements for a successful predation claim include a showing of dominance based on market share and market power, that the goods or services are sold below MC or AVC and that efficiency defences do not outweigh competitive harm.<sup>88</sup> The Commission has addressed frequent challenges recently against SOEs for unfair

<sup>84</sup> Case COMP/35.141, *Deutsche Post AG*, 2001 OJ (L 125) 27, para (6). More recently, the Commission has suggested that cross-subsidies may be predatory, even in situations where the predator firm is not dominant in the predation market. (“The Commission may also pursue predatory practices by dominant undertakings on secondary markets on which they are not yet dominant. ... While the dominant firm does not need to predate to protect its dominant position in the market protected by legal monopoly, it may use the profits gained in the monopoly market to cross-subsidize its activities in another market and thereby threaten to eliminate effective competition in that other market.”). Guidance on the Commission's Enforcement Priorities in Applying Article 82 EC Treaty to Abusive Exclusionary Conduct by Dominant Undertakings at FN 39.

<sup>85</sup> Case COMP/35.141, *Deutsche Post AG*, 2001 OJ (L 125) 27, para (6).

<sup>86</sup> DPAG had entered into standard form contract fidelity agreements in which firms had to entrust all mail order parcels to DPAG. Case at para 34.

<sup>87</sup> *Nationwide Airlines and South African Airways* (92/IR/Oct00) (“[T]he complainant is not bound to follow the prescribed cost formula suggested in 8(d)(iv). In other words if a complainant, relying on section 8(c), can show that a respondents costs are below some other appropriate measure of costs not mentioned in the section it may prevail provided it adduces additional evidence of predation beyond mere evidence of costs. To determine what that should be we need to examine the phenomenon of predatory pricing and then examine some of the approaches taken in other jurisdictions.”).

<sup>88</sup> South African Competition Act 89 of 1998 § 7.

competition and abuse of their dominant market position. One case addresses predatory pricing by an SOE, *South Africa Airways*. In that case, the Competition Tribunal of South Africa ruled against the plaintiff based on an AVC test.<sup>89</sup> The Tribunal noted that it was open to the use of other tests. However, there was no explicit discussion of cost based tests for SOEs and whether it would be different for non-SOEs.

## 7. Korea

There are two bases for a predatory pricing claim under Korean law, called the Monopoly Regulation and Fair Trade Act, Article 3-2 prohibits the abuse of dominant positions; and Article 23 of the Act that prohibits unfair business practices and applies to predatory pricing by non-dominant firms. Unlike other jurisdictions, Korea does not utilise a cost based test for predation. Rather, Korean predatory decisions focus on whether or not alleged predatory pricing was “fair.” According to Korea’s predatory pricing test, price could be above average total cost and still be predatory intent is relevant, and there must be market foreclosure or consumer harm.

A series of examples of Korean case law provides a sense of what constitutes unfair competition. In the *Cadland* case,<sup>90</sup> the KFTC argued that Cadland purchased software from an American company but then bid at 1 won to provide Korean Electric with thousands of copies of this software (though the case does not specify the amount of the US purchase, presumably it was at an amount greater than 1 won). The KFTC argued that Cadland was willing to do this because once Korean Electric starts using its software, Cadland would have locked in future business worth millions, making this contract essentially a long term deal.<sup>91</sup> Such underbidding conduct, according to the KFTC, constituted an unfair and anti-competitive practice. This line of reasoning holds for other Korean predatory pricing cases, such as *Samsung Tesco*,<sup>92</sup> and predatory bidding cases such as *Ahnkook*,<sup>93</sup> *Lucky*,<sup>94</sup> and *Sangyong*.<sup>95</sup>

In *Samsung Tesco*, Samsung Tesco paid Coca Cola 984 won (approximately \$0.73 per 1.5 litre) to distribute Coca Cola in its stores from August 30, 2000 through November 2, 2000. However, Samsung Tesco sold Coca Cola below its cost at 390 won to 890 won (approximately \$0.25 to \$0.65) in order to attract more customers. KFTC concluded that this was anti-competitive. The case does not offer specifics as to whether or not there was some sort of short term price cutting defence that might have been part of some sort of loss leader promotion. A pro-competitive defence is possible under Korean predatory pricing law although the case does not mention if Samsung Tesco made such a defence.

The Korean Supreme Court ruled against predatory pricing in a claim that the KFTC brought in *Hyundai Information Technology Co.*<sup>96</sup> In *Hyundai*, the city of Incheon offered a contract for software with an estimated price of 972 million won (approximately \$700,000). Three companies bid. Hyundai Information Technology Co. bid at 29 million won (approximately \$21,000), Daewoo Information Systems Co. bid at 195 million won (about \$141,000), and Samsung SDS bid at 330 million won (approximately

<sup>89</sup> *Nationwide Airlines and South African Airways* (92/IR/Oct00).

<sup>90</sup> *KFTC v. Cadland Co.*, [1996] KFTC 96-18.

<sup>91</sup> The KFTC estimated that the winner of this bid would be guaranteed to get about 3 billion won, or about \$2.2 million, worth of future business.

<sup>92</sup> *KFTC v. Samsung Tesco Co.*, [2001] KFTC 2001-31.

<sup>93</sup> *KFTC v. Ahnkook Co.*, [1994] KFTC 94-328.

<sup>94</sup> *KFTC v. Lucky Brands Co.*, [1983] KFTC 83-12.

<sup>95</sup> *Sangyong Co.*, Case No. 9512.1241 (cease/desist letter from KFTC).

<sup>96</sup> *Hyundai Information Technology Co. v. KFTC*, Feb. 11, 1999.

\$240,000). Daewoo and Samsung complained to the KFTC and the KFTC intervened. The parties litigated the case went to the Korean Supreme Court. The Supreme Court held for Hyundai. It ruled that Hyundai's bid of 29 million won did not violate Korea's competition law because: 1) all other bidders bid below the City's estimated price, and 2) the contract was for a software system that did not have any entrenched long term derivative benefits attached to it. The second factor distinguished it from the fact pattern in *Cadland*.

## 8. Chile

Article 3<sup>c</sup> of the Chilean Competition Act prohibits predatory practices that abuse a dominant position. So far, there has been only one predatory pricing case in Chile's antitrust jurisprudence, *James Hardie Fibrocementos Limitada*.<sup>97</sup> The Tribunal held with fixed assets that produced both products, each product was above AVC. Moreover, there was no recoupment in another market. On appeal, the Supreme Court reversed and held that James Hardie conducted predatory pricing in the first market by selling below ATC and then recouped its losses in the second market. This case involved a private firm rather than an SOE. The issue of what constituted a cost did not come up in terms of the analysis of either the Tribunal or the Supreme Court, merely the allocation of costs as to AVC. Chilean case law is therefore silent on what outcome would be likely for a predatory firm with a soft budget constraint.

## 9. Canada

The Competition Act governs Canadian competition law. Predatory pricing analysis is a sub-area of abuse of dominance, section 79(1) of the Act.<sup>98</sup> Moreover, Article 50 provides for penalties for unreasonably low prices under section 50 of the Act.<sup>99</sup> In 2008, the Canadian Competition Bureau published its Predatory Pricing Enforcement Guidelines, which present the state of the art thinking on Canadian predatory pricing policy.<sup>100</sup> The most recent Canadian predatory pricing case is *Air Canada*, which utilised an AAC test. *Air Canada* marked a shift from the AVC test previously adopted under *R. v. Hoffmann La Roche Ltd.*<sup>101</sup> In *Air Canada*, the litigation focused on what constituted an avoidable cost for an airline route. For example, whether to prohibit starting an unprofitable route even if it adds value to the network via more travellers using the network might make economic sense because revenues might increase on other routes. Whether to count such routes, called those "beyond contribution", as an avoidable cost would impact whether such conduct could be shown as predatory.<sup>102</sup> The Tribunal held that Air Canada had engaged in predatory pricing below AAC on two routes. However, the Commission ultimately dropped the case because of Air Canada's entry into bankruptcy and changes that occurred in Canada's airline sector. As the cost based tests all deal with private firms, it is unclear how soft budget constraints might be counted as costs. However, the Air Canada decision suggests that judicial administrability might have been

<sup>97</sup> *James Hardie Fibrocementos Limitada*, sentence of the Supreme Court of November 29, 2006, sentence of the Tribunal for the Defense of Competition of June 13, 2006.

<sup>98</sup> *Canada (Commissioner of Competition) v. Air Canada* (2003), 26 C.P.R.(4th) 476 (Comp.Trib.); *Canada (Director of Investigation and Research) v. Tele-Direct (Publications) Inc.* (1997), 73 C.P.R. (3d) 1.

<sup>99</sup> *R. v. Hoffmann La Roche Ltd.* (1980), 28 O.R. (2d) 164 (H.C.J.) affirmed 33 O.R. (2d) 694 (C.A.); *R. v. Consumers Glass Co.* (1981), 33 O.R. (2d) 228 *Consumers Glass Co.*

<sup>100</sup> Canada, Predatory Pricing Enforcement Guidelines (2008), available at <http://www.cb-bc.gc.ca/eic/site/cb-bc.nsf/eng/02713.html>.

<sup>101</sup> *R. v. Hoffmann La Roche Ltd.* (1980), 28 O.R. (2d) 164 (H.C.J.), affirmed 33 O.R. (2d) 694 (C.A.).

<sup>102</sup> *Canada (Commissioner of Competition) v. Air Canada* (2003), 26 C.P.R.(4th) 476 (Comp.Trib.) at para. 301.

a factor in how costs are to be calculated because of the fear that plaintiffs would be unable to carry out complex cost calculations.<sup>103</sup>

## 10. New Zealand

The generic prohibition for abuse of dominance under the Commerce Act is in Section 36. There is only one case to date on predatory pricing, *Carter Holt Harvey Building Products Group Ltd v CC*.<sup>104</sup> The case involved differentiated products in the building insulation markets.<sup>105</sup> The case is not explicit as to the particular price test, though in investigations the New Zealand Competition Commission has used both AVC and AAC.<sup>106</sup> This case is analogous to one in Australia, which New Zealand looks to for guidance in its antitrust jurisprudence. In the Australian case *Boral Besser Masonry Ltd v ACCC*, the court did not explicitly adopt a single price test.<sup>107</sup> There is no predatory pricing case specific to New Zealand SOEs. However, it is unlikely that it would be possible to win such a case in New Zealand as the Privy Council stated that recoupment is a requirement in a successful claim of predatory pricing.<sup>108</sup>

## 11. Japan

Two sets of provisions under the Japanese Act Concerning Prohibition of Private Monopolisation and Maintenance of Fair Trade address predatory pricing. The first is Article 3 prohibition against monopolisation. The second is Article 19, which prohibits unfair trade practices. Section 6 of Article 19 proscribes predatory pricing. According to Section 6, “excessively below the cost incurred in the said supply” is interpreted as below AVC, and “a low consideration” is interpreted as below ATC.<sup>109</sup> Judicially, the AVC standard has been recognised in the private action *Daikoku* decision<sup>110</sup> whereas the *Hamaguchi Petroleum* decision recognised above AVC but below ATC test.<sup>111</sup>

A private suit, *Yamato v. Japan Post*<sup>112</sup> concerned predatory pricing by Japan Post. Both the Tokyo District Court and Tokyo High Court rejected Yamato’s claim made pursuant to Article 24. The Tokyo High Court rejected the assertion by the plaintiff that Japan Post’s cost in commercial parcel delivery should be calculated on “stand-alone” basis (separated from Japan Post’s regulated postal delivery). The

<sup>103</sup> Cyril Ritter, *Predatory Pricing Law in Canada, Australia and New Zealand: Recent Developments*, 2005 Euro. Comp. L. Rev. 48, 52.

<sup>104</sup> *Carter Holt Harvey Building Products Group Ltd v CC* [2006] 1 NZLR 145; (2004) 11 TCLR 200 (PC).

<sup>105</sup> The court stated, “INZCO could recoup the cost of the Wool Line special pricing arrangement if the scheme meant that NWP was constrained from expanding in the market or eliminated from it. The recoupment would take the form of maintaining the list prices of Pink Batts at levels that were otherwise threatened by NWP, and at the same time increasing its market share for Pink Batts and other INZCO products.” *CC v Carter Holt Harvey Building Products Ltd* (2000) 9 TCLR 535, Supplementary Judgement of Professor Lattimore, paragraph 51.

<sup>106</sup> New Zealand Commerce Commission, 2008 Unilateral Conduct Working Group Questionnaire submission to the ICN (on file with the author).

<sup>107</sup> *Boral Besser Masonry Ltd v ACCC* (2003) 195 ALR 609; (2003) 215 CLR 374.

<sup>108</sup> *Id.* at. 469-470.

<sup>109</sup> Available at <http://www.cas.go.jp/jp/seisaku/hourei/data/utp.pdf>.

<sup>110</sup> Tokyo High Court decision, Case number 2002 (Ne) 1413 (29 September 2004).

<sup>111</sup> JFTC remedy order, 53 Shnketsushu 867-68 (16 May 2006).

<sup>112</sup> Tokyo High Court decision, 2006 (Ne) No. 1078, LEX/DB Legal Database No. 28140088 (28 November 2007).

Court opined that it is economically rational for an enterprise, when it enters into new business, to make use of its resources in its existing business. Separate from the case, The Japan Federal Trade Commission (“JFTC”) published its opinion on the case as a study group report in 2006. The JFTC study group opinion was hostile to the position of Japan Post, advocating “stand-alone” basis (at least regarding Japan Post pre-privatisation) should be the method of allocating common fixed costs when a monopolist in market A entered market B.<sup>113</sup> The Tokyo High Court in *Yamato* rejected the idea of a standalone basis because the stand-alone cost method was not mature as a legal test. As a general matter, JFTC’s regulatory standard on low pricing is that it usually considers pricing below purchase price illegal when it harms competition.<sup>114</sup> One problem in the *Yamato* case had to do with evidence because the JFTC did not first bring a case of its own. *Yamato* could not obtain necessary cost data of the Japan Post to prove its sales below cost arguments. Therefore, it tried to rely on unfair advantage such as the tax exempt status the Japan Post enjoys relative to private companies.

There have been some other state owned enterprise predatory pricing cases in Japan. All of them are private suits. Nearly all of the decisions held for the defendants.<sup>115</sup> The only exception is the Tokyo District Court decision in the *Slaughterhouse* case.<sup>116</sup> The Supreme Court opined in that case that the Antimonopoly Act was applicable to low pricing by the Tokyo Municipal Slaughter House that cross-subsidised its sales. Nevertheless, the District Court found the low pricing to be legal since the pricing did not harm fair competition as slaughterhouses outside Tokyo were as inexpensive as the defendant.

## 12. Conclusions

SOEs remain an important part of economic life in many countries. SOE corporate governance seems to be better when there is more accountability. There is more accountability when SOE governance statutes reflect those of private firms. Predatory pricing jurisprudence does not distinguish between private and government firms even though the incentives may be different given the soft budget constraints of government firms.

The next stage in research in the area of competition and corporate governance of SOEs is to undertake a full cross country comparison and to do so across a number of different types of SOEs, rather than in just one sector to examine all cases and determine how the law in practice matches the law on the books for both corporate and antitrust laws. This is a significant task. The government oversight across SOEs varies both across and within countries. In some countries there are sector regulators or multiple regulators (sector, financial, etc.) to overview the SOE. In other countries there is a general SOE law. With the creation of such a database, it would be possible to undertake cross country quantitative analysis to learn more about some dynamics of SOEs.

Below this chapter offers a number of recommendations that would improve competition and corporate governance of SOEs.

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<sup>113</sup> <http://www.jftc.go.jp/e-page/pressreleases/2006/July/060721.pdf>.

<sup>114</sup> See JFTC, Guidelines Concerning Unfair Price Cutting under the Antimonopoly Act (20 November 1984), translation available at <http://www.jftc.go.jp/epage/legislation/ama/pricecutting.pdf> (visited 25 November 2008).

<sup>115</sup> *Postcard case* (Osaka High Court in 1994); *Bus for Aged Citizens case* (Yamaguchi District Court Shimonoseki Branch in 2006).

<sup>116</sup> The Supreme Court: Tokyo Municipal Slaughter House decision Supreme Court decision, 43 (12) Minshu 2078, 2083 (14 December 1999).

### 12.1 *Improved external oversight*

An annual performance review beyond annual reports may be necessary to encourage good corporate governance of SOEs. This would benchmark the SOE relative to other SOEs in the same sector in other countries and establish how well the corporation is meeting its target relative to similar entities elsewhere.<sup>117</sup> The benchmarking would include specific metrics to measure financial, management and service aspects of the SOE relative to other SOEs.<sup>118</sup> Benchmarking across countries is made difficult by the various different goals that SOEs might have across countries.

Separate oversight functions for financial and management/ regulation across government agencies would reduce opportunities for regulatory capture. Other types of oversight include mandating accounting of SOEs by private auditing firms rather than by another part of government. This would reduce the possibility of government self dealing that might limit a full discovery of the condition of SOEs in auditing results. Part of an improvement in oversight would include an increase in effective penalties for bad oversight and management, particularly when SOEs engage in anti-competitive actions. There is a need for personal sanctions for bad behaviour on the part of SOE managers such as the loss of job for SOE executives and barring work from other parts of government for a set time period after they are fired from SOE management. Another potential penalty would be for an SOE that is caught engaging in unlawful anti-competitive activity or bad corporate governance to enter into a process of structural separation between the statutory monopoly business and the competitive business.

Codes of conduct should be established and enforced between regulated and unregulated entities. Where SOEs could compete based on efficiency concerns, they should not be allowed to potentially utilise moneys from its non-profit making function in anti-competitive ways.

Another method of external oversight is through the capital markets. Governments should make SOEs go to capital market for loans. This will encourage SOEs to be disciplined to pay back the loans, so long as there are no soft budget constraints. If governments implicitly guarantee loans, this solution is not viable because the worse the governance of the firm, the better the rate because the more likely the government is to guarantee repayment of the loans.

### 12.2 *Improve internal corporate governance*

It is important to improve the quality of internal corporate governance of SOEs. The corporate social responsibility movement and the shareholder democracy movement that seek to empower share-holders to provide for greater accountability have been issues of significant attention in both academic and policy circles. If we are to take the corporate social responsibility movement seriously, it is particularly necessary to do so with regard to SOEs. Governance is more opaque and less responsive to shareholders of SOEs than of publicly traded firms. This would entail greater penalties for a fiduciary breach on the part of the SOE board. This should include steep financial penalties for managers and directors that breach their

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<sup>117</sup> Maria Luisa Corton & Sanford V. Berg, *Benchmarking Central American Water Utilities*, 30 *Utilities Pol'y* 1 (2008); Céline Nauges & Caroline van den Berg, *Economies of Density, Scale and Scope in the Water Supply and Sewerage Sector: A Study of Four Developing and Transition Economies*, 34 *J. Reg. Econ.* 144 (2008).

<sup>118</sup> Antonio Estache, Sergio Perelman & Lourdes Trujillo, "Infrastructure Performance and Reform in Developing and Transition Economies: Evidence from a Survey of Productivity Measures," (2005), World Bank Policy Research Working Paper No. 3514 (providing a framework benchmarking); Céline Nauges & Caroline Berg, *Economies of Density, Scale and Scope in the Water Supply and Sewerage Sector: A Study of Four Developing and Transition Economies*, 34 *J. Reg. Econ.* 111 (2008) (using panel data for cross country benchmarking).

duties. Governments should strive to increase the use of non-governmental appointed directors on the board of SOEs. The state should reduce the number of political appointments on SOE boards and increase the number of directors who have previous business experience that would be useful in running a company. There might be some informal norms such as shaming that might improve corporate governance. For shaming sanctions to be successful, there needs to be enough transparency for information about bad corporate governance of SOEs to emerge and a sense in a given country that the lack of accountability is something for which one should be ashamed.

### 12.3 Corporatisation of SOEs

Some countries have shifted the nature of SOE governance to move to a more corporatized form of governance. In postal delivery, most EU countries' postal operators have a corporatized form.<sup>119</sup> SOE management and directors may be mandated to have specific skills and/or experience.<sup>120</sup> Creating a competency profile provides a set of standards by which government can require effective managers. Policy targets, including financial goals, would create quantifiable targets for the SOE to meet. The failure to meet such targets could lead to the ouster of SOE leadership. This process would align management's interest more with residual owners because management would have incentive to create a more efficient SOE.

Corporatisation has proven to be an intermediate step for SOEs that reduces some incentives for mismanagement due to soft budget constraints and a lack of internal and external accountability by making the SOE act more like a private firm.<sup>121</sup> Corporatisation forces firms to ask if there are better ways to achieve lower costs. If an SOE is in a corporatized form, it is easier to keep track of the performance because of better and more information. Some empirical work supports the proposition that corporatisation can improve the efficiency of SOEs.<sup>122</sup> In most cases, this is a second best solution. If there are strong concerns about managerial incentives of SOEs, corporatisation is not equivalent to privatisation.<sup>123</sup> However, if privatisation is not possible politically, corporatisation may be a second best solution or an intermediary step to privatisation.

Where there has been increased commercialisation and corporatisation of SOE postal incumbents, SOEs behave more like private companies. Generally, this has been successful and not surprisingly, it is successful in precisely those countries that provide for greater competition.<sup>124</sup> Thus competition and good

<sup>119</sup> WIK Consult GmbH, "Main developments in the postal sector (2004-2006)," (2006), available at [http://ec.europa.eu/internal\\_market/post/doc/studies/2006-wik-final\\_en.pdf](http://ec.europa.eu/internal_market/post/doc/studies/2006-wik-final_en.pdf).

<sup>120</sup> David F. Scott, "Strengthening the Governance and Performance of State-Owned Financial Institutions," World Bank Policy Research Working Paper No. 4321 (2007).

<sup>121</sup> José A. Gómez-Ibáñez, "Alternatives to Infrastructure Privatization Revisited: Public Enterprise Reform from the 1960s to the 1980s," World Bank Policy Research Working Paper No. 4391, 25-27 (2007).

<sup>122</sup> Varouj A. Aivazian, Ying Ge and Jiaping Qiu, *Can Corporatization Improve the Performance of SOEs Even Without Privatization?*, 11 J. Corp. Fin. 791 (2005) (analyzing corporatized Chinese SOE performance).

<sup>123</sup> Andrei Shleifer, *State Versus Private Ownership*, 12 J. Econ. Persp. 133 (1998) (claiming that private ownership is superior to government ownership because private ownership creates incentives to reduce costs while government officials have incentives to supply monopoly rents); Timothy Besley & Maitreesh Ghatak, *Government Versus Private Ownership of Public Goods*, 116 Q. J. Econ. 1343, 1343-44 (2001) (arguing that government ownership should be limited only in situations where the SOE project creates primarily public goods and the government values those goods more than anyone else).

<sup>124</sup> Michael A. Crew & Paul R. Kleindorfer, "Developing Policies for the Future of the United States Postal Service," in *Competitive Transformation of the Postal and Delivery Sector* (Michael A. Crew & Paul R. Kleindorfer eds., 2003).

corporate governance indeed seem to be somewhat substitutable. A successful commercialisation provides an example of how to limit some of the impulse of a SOE postal incumbent to raise the cost of rivals. Let us examine the case of New Zealand. Prior to its transformation, New Zealand Post had a statutory monopoly with its large reserve sector based on parcels with a weight of less than 500g. On April 1, 1998, New Zealand removed the statutory monopoly on all letters, regardless of weight. New Zealand Post was given, for the most part, equal treatment with all other postal operators including full application of competition laws. By the end of the year, there were 17 registered postal operators within New Zealand. The majority of these competitors were small local businesses. Corporatisation of the SOE in New Zealand between 1987 and 1998 increased transparency and accountability of New Zealand Post. Staff became more productive (A staff decrease of 40 percent, fewer handles, and an increase of business of 20 percent), New Zealand Post more profitable (a \$NZ37.9 million loss became a profit of \$NZ47.7 million), prices lower (the basic letter price was at the same nominal price in 1987 and 1998), and service delivery quality improved.<sup>125</sup> New Zealand closed a third of the country's post offices. This led to remarkable results: 100 percent increase in labour productivity, 30 percent increase in mail volume and a 30 percent decrease in both the real price of postage and of costs. All of this was done while maintaining the SOE status of New Zealand Post.<sup>126</sup>

Corporatisation is not an end solution. Even if the goals of private and public firms were the same, the behavioural outcome of such firms would be different. As Alchian explains, “[B]ecause even with the same explicit organisational goals [between public and private firms], the cost-rewards system impinging on the employers and the ‘owners’ of the organisation are different.”<sup>127</sup> Not surprisingly, therefore, some corporatized SOEs do very poorly, even those in common law jurisdictions. Both USPS and Canada Post are corporatized but both maintain a significant reserve sector. Perhaps the better lesson about corporatisation is the more an SOE actually looks corporatized, with director control rather than government control and the more competition it faces to ensure that corporatisation actually matters, the more SOE outcomes may reflect those of private firms.

#### **12.4 Increase competition**

Competition means the elimination or at the very least a significant reduction of the reserve sector, such as what the EU has undertaken. It also means a limit upon incumbent firms to abuse the universal services requirement for anticompetitive purposes. As noted earlier in this article, liberalisation creates competitive pressure that will constrain poor governance from firms. Liberalisation is politically difficult.<sup>128</sup> This is especially true in the current period of world-wide economic crisis. The rhetoric of liberalisation has not matched the reality of liberalisation, where in fact some liberalisation efforts are merely a different and perhaps only somewhat less restrictive form of regulation. However, when these half hearted liberalisation schemes fail, there may be significant public resentment and then pushback against liberalisation.<sup>129</sup>

<sup>125</sup> OECD, Promoting Competition in the Postal Sector, DAF/CLP(99)22, 247-252.

<sup>126</sup> FTC, Accounting for Laws That Apply Differently to the United States Postal Service and its Private Competitors 79 (2007); available at <http://www.ftc.gov/os/2008/01/080116postal.pdf>.

<sup>127</sup> Armen Alchian, *Some Economics of Property Rights*, 30 *Il Politico* 816 (1965).

<sup>128</sup> Edward Iacobucci, Michael Trebilcock & Ralph A. Winter, *The Canadian Experience with Deregulation*, 56 *U. Toronto L.J.* 1 (2006).

<sup>129</sup> Eleanor M. Fox, *Economic Development, Poverty, and Antitrust: The Other Path*, 13 *SW. J. L. & Trade Am.* 211 (2007).



## 12.5 Privatisation

Privatisation eliminates the soft budget constraint because firms have to rely upon the market, which creates a level of financial discipline.<sup>130</sup> One legislative response to the problem of SOEs has been to privatise these enterprises. During the 1980s and 1990s, countries privatised over 100,000 firms around the world, particularly in Latin America, East Asia, and the former Soviet bloc.<sup>131</sup> SOEs are less efficient than private firms. Therefore the overall performance of SOEs vis-à-vis private firms compares poorly.<sup>132</sup> Where privatisation has not lead to greater efficiencies, in many cases it has been a result of the failure of the architects to introduce liberalisation in conjunction with privatisation. Put differently, when privatisation failed, it seems to be because of flawed design and implementation.<sup>133</sup> That is, there are potential risks to privatisation when there are situations of market failure and where there is inadequate regulation to protect the market from functioning. Empirical work in Russia suggests that privatisation without adequate regulation can lead to corporate looting.<sup>134</sup> Similarly, Carlos Slim became the world's richest man because he bought the telecom incumbent in Mexico when it was privatised and allowed to maintain its statutory monopoly in fixed line telephony.<sup>135</sup>

A difficult situation may emerge where if there is no privatisation and liberalisation in the near term, the yearly government bailout will create an even bigger mess in the long term. At that time, the effect of trying to create cost controls on SOEs may come at a higher cost. Addressing this situation means overcoming significant public choice problems not merely from SOEs but from vested private interests that benefit from the status quo. Though competition advocacy on the part of antitrust agencies may help, competition advocacy has its limits as agencies are subject to political retribution from the legislators who might not want a pro-competitive message.<sup>136</sup> For example, while the FTC has had a strong advocacy program,<sup>137</sup> it has never questioned why there should be a state action exemption nor in the postal context did it discuss the possibility of privatisation of the USPS.

## 12.6 Create an effective antitrust test

One problem with antitrust approaches to predatory pricing cost based tests is that they do not account for the government created distortion in creating a revised baseline for how to measure a cost.<sup>138</sup> One

<sup>130</sup> Emmanuelle Auriol & Pierre M. Picard, *Infrastructure and Public Utilities Privatization in Developing Countries*, 23 World Bank Econ. Rev. 77, 80 (2009) (providing a literature review).

<sup>131</sup> John Nellis & Nancy Birdsall, "Privatization Reality Check: Distributional Effects in Developing Countries" in John Nellis & Nancy Birdsall, *Reality Check: The Distributional Impact of Privatization in Developing Countries* 3, 11-12 (2005).

<sup>132</sup> Simeon Djankov & Peter Murrell, *Enterprise Restructuring in Transition: A Quantitative Survey*, 40 J. Econ. Lit. 739 (2002) (studying the effects of privatization).

<sup>133</sup> Harry M. Trebing & Sarah P. Voll, *Infrastructure Deregulation and Privatization in Industrialized and Emerging Economies*, 40 J. Econ Issues 1, 5 (2006).

<sup>134</sup> Bernard Black, *Does Corporate Governance Matter? A Crude Test Using Russian Data*, 149 U. Pa. L. Rev. 2131, 2133 (2001).

<sup>135</sup> D. Daniel Sokol, *Barriers to Entry in Mexican Telecommunications: Problems and Solutions*, 27 Brook. J. Int'l L. 1 (2001).

<sup>136</sup> D. Daniel Sokol, *Limiting Anti-Competitive Government Interventions That Benefit Special Interests*, 17 Geo. Mason L. Rev. [\_\_\_] (2009 (forthcoming)).

<sup>137</sup> Todd Zywicki, James C. Co-oper & Paul A. Pautler, *Theory and Practice of Competition Advocacy at the FTC*, 72 Antitrust L.J. 1091 (2005).

<sup>138</sup> Sidak and Sappington at 518.

conclusion from the cross country analysis is that antitrust has been ineffective, across legal origins, in accounting for the nature of SOEs in cost based tests to determine predatory pricing. Incremental cost tests may not detect potentially anti-competitive behaviour by SOEs. As Panzer suggests, “Because a revenue maximising SOE wishes to offer below cost prices on a continuing basis, it may find optimal to alter its strategic investment policies so as to distort the outcome of any incremental cost test to which rates may be subject.”<sup>139</sup> However, current predatory pricing tests do not account for this difference.

This chapter suggests that antitrust predatory pricing tests require an imputation of the various costs and benefits of government ownership and government support of SOEs. This test would measure the various indirect benefits that SOE providers receive from their governments in terms of assessing the cost floor. Part of the reason for the lack of the use of such a test may be that, in practice, a SOE often incurs both advantages and disadvantages from its state-owned status, and some of these disadvantages (e.g. loss of managerial control) may be difficult to quantify.

Administrative ease is certainly an important practical concern. Some rough rule of thumb might be proposed on these grounds. The most appropriate rule of thumb (and rule generally) will depend upon the relevant social objective. Is it clear what this objective should be? If the social objective is efficiency and through the use of antitrust law, then the contours of such a test might be based on an imputation test for SOEs.

One imprecise analogy would cost imputation in TELRIC pricing in telecommunications. The cost imputation of TELRIC pricing of the 1996 Telecom Act seems to have been unadministrable for quite some time in the US, New Zealand and other jurisdictions. However, there are also differences between SOE cost imputation and TELRIC cost imputation. TELRIC methodology was adopted primarily because of the issue of selling inputs to retail competitors. This issue, and thus the TELRIC methodology, may be less germane in many relevant settings. While TELRIC served primarily to keep the incumbent's (wholesale) prices relatively low, pricing restrictions for SOEs may serve primarily to keep the incumbent SOE's (retail) prices relatively high.

Many antitrust systems are concerned with the potential of false positives in prosecution.<sup>140</sup> This is particularly a concern in predatory pricing cases when low prices may support competition even if they harm competitors. Compounding the issue of what might go into a SOE predatory pricing test is the concern that courts may not be able to handle such complexity. That is, legal rules must be administrable. As Hovenkamp notes:

*[T]here is relatively little disagreement about the basic proposition that often our general judicial system is not competent to apply the economic theory necessary for identifying strategic theory as anticompetitive. This makes the development of simple antitrust rules critical. Antitrust decision making cannot consider every complexity that the market presents<sup>141</sup>*

Accordingly, it is better to have an easier to administer test of predation for SOEs than complex test if the error cost for the complex test would be too high. Administrability is particularly a concern regarding a predatory pricing test that would treat one form of entity differently than another and would require a complex imputation test.

<sup>139</sup> John C. Panzer, “Interactions Between Regulatory and Antitrust Policies in a Liberalized Postal Sector,” working paper 2008 at 13.

<sup>140</sup> Frank H. Easterbrook, *The Limits of Antitrust*, 63 Tex. L. Rev. 1, 2-3 (1984) (discussing the greater harms of false positives over false negatives).

<sup>141</sup> Herbert Hovenkamp, *The Antitrust Enterprise: Principle and Execution* 47 (2005).

What is not clear is whether or not a separate SOE predatory pricing test is administrable in either common law or civil law jurisdictions. Such a test would require a sense of the costs of an efficient entrant. To determine this cost, there would need to be a way to determine what costs are due to the soft budget constraint of the SOE based on its governance structure and the special privileges that the government grants it. Based on the general concern of administrability of predatory pricing, it is not clear that such a specific test, if it could be devised might be understood and administered by courts. Antitrust case law would need to catch up to economic thinking on SOEs and on government support for firms. Courts across the countries surveyed have yet to be able to show an ability to grapple with these issues effectively and seem to have some trouble even with cost based tests involving private firms. An antitrust solution needs more work both at the theoretical level and in terms of implementation within antitrust doctrine.

The premise behind much of antitrust analysis is to determine what an efficient competitor would do. However, in the case of SOEs, the problem is that an efficient new entrant would never have created the type of network that many SOEs have. European state aids jurisprudence recognises this point but most countries lack a state aids regime.<sup>142</sup>

### 12.7 *Final thoughts*

Overall, SOE competition and governance issues are difficult questions. Unfortunately, the prospects for a simple, neat rule for SOE pricing seem limited. Competition law is inadequate at present given a lack of an effective test to measure predation by SOEs as well as administrability problems. A larger competition policy may or may not be inadequate - privatisation is clearly not palatable and competition advocacy to liberalise markets may be a non-starter during the current global crisis. Public choice concerns limit regulatory liberalisation and these concerns must be overcome. Some SOEs matter more than others, particularly those in critical network industries (e.g., transport, finance, utilities). In these areas sector regulators have serious capture problems. Perhaps the world-wide macro-economic crisis will lead to a reinvigorated IMF that demands liberalisation might be the only way to create more competition. Better corporate governance, akin to the requirements of corporate governance for publicly traded firms might help. A key role of price floors for SOEs is to limit “empire building” by SOE managers. Perhaps empire building can be limited more effectively in practice via internal governance reform the ideal rules for SOE pricing may well be sector-specific.<sup>143</sup> These are themes worth developing in future scholarship.

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<sup>142</sup> *Chronopost SA, La Poste and French Republic v Ufex and others*, C-341/06 P and C-342/06 P, decided Dec. 6. 2007 at para. 38.

<sup>143</sup> Mark Armstrong & David E.M. Sappington, *Regulation, Competition, and Liberalization*, 44 J. Econ. Lit. 325, 325 (2006).

**COMPETITION POLICY AND COMPARATIVE CORPORATE  
GOVERNANCE OF STATE OWNED ENTERPRISES**

*Presentation by Prof. Daniel Sokol*

**UF** | Levin College of Law  
UNIVERSITY of FLORIDA

**Competition Policy and Comparative  
Corporate Governance of State Owned  
Enterprises**

**D. Daniel Sokol  
University of Florida  
Levin College of Law**

## SOEs and Government Support Lead to Different Outcomes

- These differences affect performance:
  - Incentives are different than private firms (Alchian, Demsetz)
  - Corporate governance and competition are substitutes (Stigler)
- Conclusions:
  - Good corporate governance mechanisms for SOEs minimizes bad management both ex ante and ex post – some SOEs are better managed than others
  - Competition Policy can reduce distortions of SOEs and state supports

## Overviews

- Private firms
- SOEs

### Private vs. Government Ownership of Firms - Internal Controls

Internal Controls	Private	Public (state owned)
Corporate form	Yes	No, but sometimes a modified yes
Managerial Ownership	Yes	No
Managerial Pay	Yes	Not so well
Board Oversight	Yes (but sometimes problematic)	Yes (but generally problematic)

### Private vs. Government Ownership of Firms - External Controls

External Controls	Private	Public (state owned)
Market for Corporate Control	Yes	No
Equity	Yes	No
Debt	Yes	Sometimes
Market for Managers	Yes	No
Bankruptcy	Yes	No

## SOE Corporate Governance

- Incentives matter in institutional design
- Some SOEs have efficiency rationale and transparency mechanisms with good boards
- The more a government treats an SOE like a private firm, the more it behaves like a private firm
- Corporatized forms of governance should yield better outcomes ... but do not always because of flaws in institutional structure

## Competition and SOEs

- How SOE behavior is different than private firm behavior
  - Revenue maximization instead of profit maximization as SOE Goal
  - SOE Incentives to Raise a Rival's Cost
  - SOE incentives to predatory price
    - Predation tests are cost based... but what are the appropriate costs?

## Antitrust Predation Cost Based Tests

- Marginal Cost
- Average Variable Cost
- Average Avoidable Cost
- Long Run Average Incremental Cost

## Antitrust Tests Across Jurisdictions

- No separate test for SOEs
- SOEs generally win in predation tests
  - Benefits of government ownership not imputed into costs
  - Benefits of government regulatory bias not imputed into costs



## Institutions Matter

- Administrability
- Domestic Regulatory Capture
- Can domestic institutions alone remedy SOE problem?
  - WTO – a disaster on this issue
  - FTAs – equally problematic
  - BITs
  - Soft law

## Recommendations

- Corporatization of SOEs
- Improved corporate oversight
- Increase competition
- Improve corporate governance
- Privatization
- Create an effective antitrust test (with cost imputation), building from Sidak & Sappington (2003a, 2003b)
  - Cost imputation has potential problems
  - Cost test may not be easy to administer given institutional weakness of the judiciary and regulators
- One size does not fit all - different solutions based on different sectors and different types of SOE problems needed

**NEW LEARNING ON CORPORATE GOVERNANCE  
AND COMPETITION POLICY**

*Presentation by Prof. Spencer Weber Waller*

**New Learning on Corporate  
Governance and Competition Policy**

Spencer Weber Waller  
Professor and Director  
Institute for Consumer Antitrust Studies  
Loyola University Chicago School of Law  
OECD Roundtable February 17, 2009



## Using Business Theory in Antitrust Law

- Part of a Larger Project on Better Using Business Theory in Business Law
- Strategic Management and Marketing Discussed in *The Language of Law and the Language of Business*, 52 CASE WEST. RES. L. REV. 283 (2001), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=253732](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=253732) and *The Uses of Business Theory in Antitrust Litigation*, 47 N.Y.L.S. L. REV. 119 (2003), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=976715](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=976715) .
- Brand Management in *The Law of the Brand*, forthcoming (Deven Desai co-author).

## The Path Not Taken

- Modern Corporation Predated US Federal Antitrust Law
- Early Convergence Where Strict Anti-cartel Rules and Loose Merger Rules Partially Responsible for Initial Merger Waves
- Antitrust Split Off from Corporate Bar as Discipline and Practice Specialty Before Development of Corporate Governance Law
- Corporate Governance Came to Forefront in US with Publication of Berle and Means, [The Modern Corporation and Private Property](#) (1933)

## Centrality of Berle and Means

- Introduced Concept of Division of Ownership and Control
- Focused on Different Incentives for More Centralized Managers and Directors versus More Dispersed Owners (Shareholders)
- Introduced What Modern Commentators Would Call “Agency Costs”
- Argued for More Voting Rights, Disclosures, and Other Controls for Benefit of Owners
- Advocated Broader Social Role for Corporations as Well

## Lack of Initial Connection to Competition Policy

- Antitrust Not Significant Part of Berle and Means Analysis or Prescription
- [The Modern Corporation and Private Property](#) Published During Great Depression
- Antitrust in early 1930s Primarily Either Preempted or in Service of De Facto Cartelization of US Economy under NRA
- Antitrust Effectively Moribund in United States until NRA Held Unconstitutional
- Antitrust Enforcement Revived by Robert Jackson and Thurman Arnold Beginning in 1937

## Rise of Antitrust Renders Corporate Governance Secondary Concern

- Antitrust Enforcement Quickly Rebounds in US
- Aggressive Prosecutions and Civil Cases in Cartel, Monopolization and by 1950s Merger Area as Well
- Law Shifts toward Per Se Rules, Presumptions Against Monopolization, and Prohibition of Significant Mergers of Any Kind
- Such Limitations Far More Significant Than Corporate Governance Constraints of That Era

## The Corporation in Modern Society (Edward Mason, ed. 1960)

- This Collection of Essays Provides Snapshot of State of Concerns of its Era
- Primary Concerns are Oligopoly Status of Key US Corporations and Economic and Political Corporate Power More Generally
- Pure Corporate Governance Concerns secondary
- Reflective of Era Where Antitrust Strong and Corporate Governance Weak

## Enter the Market for Corporate Control

- Henry Manne, *The Market for Corporate Control*
- Influential Later Writings of Frank Easterbrook, Daniel Fischel, and Others
- Urged Removal of Restraints on Takeovers to Promote Efficiency, Prevent Rent Seeking, and Increase Shareholder Value
- Coincided with Weakening of Merger Control and Even Calls within Reagan Administration for Abolition of Section 7 of the Clayton Act

## Result Has Been Deeply Isolated Separate Spheres

- Both Bodies of Law have Different Histories, Different Leaders, and Largely Different Professional Organizations
- Historical Rise and Fall of Antitrust and Corporate Governance Concerns at Different Times Have Led to Very Rare Interaction
- Corporate Governance Primarily Concerned with Relationship Between Officers, Directors, and Shareholders
- Competition Policy Primarily Concerned with Relationship Between Corporations and Other Market Actors Regarding Horizontal and Vertical Relationships and Mergers and Acquisitions

## Limited Overlapping Spheres

- Substantive Law of Antitrust and Corporate Governance Hard to Directly Reconcile
- US Clayton Act Provisions on Interlocking Directorates Most Directly Relevant but Least Important Link Between two Disciplines
- Corporate Compliance Perhaps Even More Important Link But Under-Explored Area

## New Learning on Corporate Governance

- At Beginning of 21st Century Growing Body of Both Empirical and Theoretical Literature Questioning Premises and Results of Market for Corporate Control
  - Behavioral Law and Economics
    - Incentives and Rewards for Corporate Decision Makers
    - Continued Agency Costs
    - CEO Autonomy and Hubris
    - Biases Toward Mergers Even When Not Value Enhancing
  - Need for Continued Antitrust Presence in Even Pure Market for Corporate Control
    - Deter Collusive Bidding and Termination of Auctions
    - Limit Antitrust Immunities and Over-Deference to Securities Regulators

## Not All Mergers Created Equally

- Corporate Finance Literature Suggesting Many Types of Mergers Destroy Shareholder Value
- Mega-Mergers Particularly Suspect for Value Destroying Tendencies
- Mergers Dependent on Poorly Articulated Synergies Also Suspect
- May be Different Results for Industrial versus Financial or Banking Mergers
- Additional Behavioral Research Showing When Entry Occurs and When it is Effective

## Opportunities for Deeper Interaction

- On Corporate Governance Side
  - Enhanced Board Duties in Mega-Mergers Between Equals
  - Enhanced Securities Disclosure in Same Categories
  - Intermediate Standard of Review in Courts
- On Competition Side
  - Increased Attention to Categories of Deals Which Prove Value Destroying and Why
  - Better Understanding of Why Synergies Not Achieved
  - Better Understanding of Why Certain Deals are Value Enhancing
    - Efficiencies?
    - Market Power?



## Importance of Behavioral Economics

- Insights into M&A Activity
- Insights into Board and Shareholder Responses
- Insights into Post-Merger Culture Combinations and Clashes
- Insights into Entry Patterns
  - Entry May be More Prevalent but Less Effective than Normally Believed
  - Brand Positioning as Alternative to Entry Maybe Virtually Impossible

## Towards a Renewed Connection

- Renewed Attention to Corporate Finance Literature
- Increased Investment in Business Theory Generally to Supplement Economic Expertise
- Increased Attention to Behavioral Economics
- Consider Role in Corporate Governance Debate
- Reject Soft Assumption that All Mergers Efficient or Competitively Benign
- Greater Questioning of Unsupported Entry Stories

## For More Information and Full Bibliography

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- [http://papers.ssrn.com/sol3/cf\\_dev/AbsByAuth.cfm?per\\_id=145112](http://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=145112)



**BUSINESS GROUPS: CORPORATE GOVERNANCE AND ANTITRUST ISSUES <sup>1</sup>**

*Note by Mr. Yishay Yafeh and Mr. Tarun Khanna*

Diversified business (or corporate) groups are ubiquitous in most emerging markets as well as in many OECD economies (e.g. Belgium, Italy, Korea and Sweden). These groups typically consist of legally independent firms, operating in multiple (often unrelated) industries, which are bound together by persistent formal (e.g. equity) and informal (e.g. family) ties; varying degrees of participation by outside investors characterise many business groups around the world. This short manuscript focuses on two issues – the corporate governance structure of business groups and the problems associated with it; and the relation between business groups, monopoly power and competition (antitrust) policy. The academic literature on business groups has treated these two issues as distinct topics, with virtually no overlap between them; we will try (briefly) to suggest some links between the two. In addition, much of the academic literature has focused on business groups in emerging markets; this article focuses on developed economies (most, though not all, OECD countries would fall into this category).

**1. Corporate governance and agency problems in business groups**

Business groups are associated with two corporate governance problems: The first is related to minority shareholder expropriation, especially when the group is pyramidal. The second, governance problem emanates from family control, which is common in many groups.

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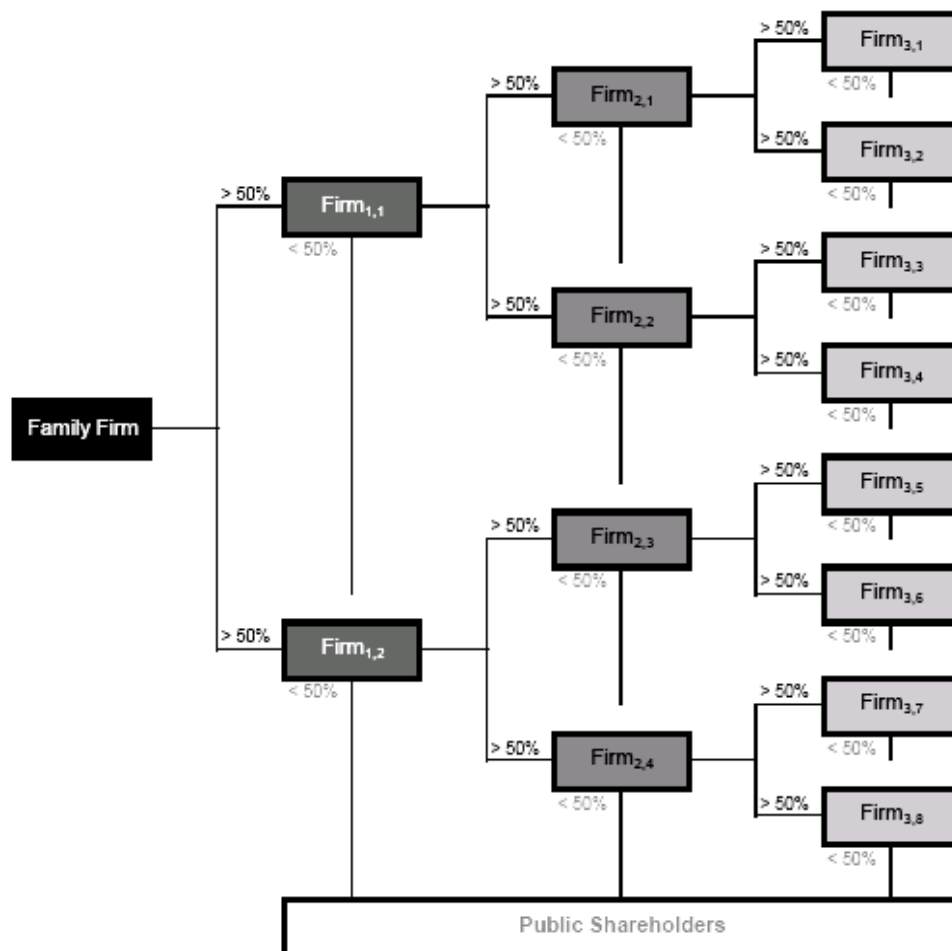
<sup>1</sup> The present paper draws on the authors' previous work, especially on parts of the article "Business Groups in Emerging Markets: Paragons or Parasites?" *Journal of Economic Literature*, Vol. 45, No. 2, June 2007, pp. 331-373.

### 1.1 Conflicts between Controlling and Minority Shareholders in Pyramidal Business Groups

Business groups are often organised in the form of control pyramids:

**Figure 1. A Stylized Control Pyramid**

A family firm controls a first tier of firms with dominant voting stakes, in this case greater than fifty percent. Each first tier firm controls several second tier firms, each of which controls yet more firms. The overall effect is to extend the family's control to encompass assets worth substantially more than its actual wealth.



This control structure generates a “wedge” between the controlling shareholders’ cash flow and control rights. For example, in Firm 3.1, the control rights of the holding family firms are absolute (100%), but the cash flow rights entitle the family to only 12 cents of every dollar of profits. This generates incentives to “tunnel” up some of the profits generated in companies in low tiers of the pyramid. “Tunnelling” (or minority shareholder expropriation) can take place through related party transactions (e.g. a company in a low tier sells inputs to, or buys products from, a company in a higher tier at non-market prices), through the provision of financing special rates (loans or equity), and through a variety of other mechanisms by which companies low in the pyramidal hierarchy can be “plundered.” There is an extensive literature that documents various forms of tunnelling in business groups;<sup>2</sup> An important implication of this

<sup>2</sup> For a summary of the evidence, see R. Morck, D. Wolfenzon, and B. Yeung (2005), “Corporate Governance, Economic Entrenchment, and Growth,” *Journal of Economic Literature*, Vol. 43, pp. 657-722.

literature is that minority shareholder expropriation impedes financial development, as buyers are reluctant to invest in the equity of firms where they know their rights are at risk, and controlling shareholders are reluctant to sell firms at low prices to alleviate fears of “tunnelling.” Despite the vast evidence on tunnelling within business groups, it is important to keep in mind that minority shareholder expropriation does not take place only in the context of groups, nor do all groups hurt minority shareholders. In addition, not all groups are pyramidal (where extra control over cash flow rights are very pronounced), and some pyramidal groups have managed to establish mechanisms (or reputation) to commit to fair treatment of minority shareholders (e.g. the Wallenberg Group in Sweden, or British family groups which operated in the colonies in Asia in the 19<sup>th</sup> and early 20<sup>th</sup> centuries and were able to raise capital in London without much fear of “tunnelling”).

## **1.2 Conflicts between controlling and minority shareholders in family-controlled groups**

The second corporate governance issue which arises often in business groups involves family control, especially around succession periods. Many groups around the world are family-controlled; there is evidence that the family structure affects the growth and structure of business groups (e.g. in Asia, the birth of a male son is related with entry into new fields); there is also evidence on various forms of family involvement in the management and control of many groups; and, finally, there is considerable evidence on the deterioration of performance in family firms (in general, not only groups) with the transfer of control from the first generation to the second. These findings are interpreted as evidence that the choice of heirs on the basis of blood relations rather than merit adversely affects firm performance. Business groups are susceptible to this problem to the extent that they are family firms (they often are, although precise figures are not always readily available). Normally, problems in family firms should not be viewed as having macro-economic significance. However, in very large business groups, micro-management problems and conflicts with minority shareholders emanating from inheritance and family control (in Samsung, for instance) may potentially have economy-wide implications.

## **2. Business groups and antitrust issues**

Business groups can restrict competition through two main channels. The first (indirect channel) is through their ties with governments, and (in the case of big groups) through regulatory capture. The second (direct channel) is through anti-competitive measures used by groups to foster collusion or to restrict competition.

### **2.1 Group-government ties and regulation**

Groups throughout the world often emerge with government support or under government auspices (for example, in 19<sup>th</sup> century Japan, in Korea of the 1960s and 1970s, or in Russia with the recent emergence of the “oligarchs”). But at some point, the balance of power tilts in favour of groups; even groups which may have served as a developmental tool of governments (more on this below), become powerful enough to possess considerable political influence (prominent examples would be Japan in the early 20<sup>th</sup> century, when big groups “owned” parties in the *Diet*; Korea after democratisation; Italy today, and many more). Groups do not always use their lobbying power to restrict competition: for example, groups in Mexico, for instance, lobbied for NAFTA in expectation of increased profits. Nevertheless, there are certainly also examples of business groups using their power and influence to hinder pro-competitive or transparency-inducing regulatory changes (e.g. in Korea).

## 2.2 *Direct effects of business groups on Monopoly power/Competition/Antitrust issues*

Industrial Organisation models suggest that business groups, often extremely diversified, vertically integrated, and with “deep pockets” (many include financial institutions; others simply include large and powerful companies) may restrict competition using (among others) the following mechanisms:

- Entry deterrence/predation: Under some circumstances, group firms may drive their rivals out of markets or deter entry due to their “deep pockets,” “first mover advantage” (in some markets) and vertical integration which may lead to foreclosure of rivals. Vertical integration, for instance, may be driven by a variety of factors including welfare improving ones (see below), but as a side-effect restrict competition. A particular form of entry deterrence associated with group firms in some countries is “financial pre-emption.” In Korea, for example, group firms were allegedly able to pre-empt competitors by accessing capital advantageously. In India, when capital was scarce some groups held on to lines of credit but did not use them, and thereby prevented other firms from entering (financial pre-emption may be less common in developed OECD economies);
- Diversified groups often face each other in many markets. This “Multi-market Contact” may (under certain conditions) facilitate collusion between rivals who face each other repeatedly in multiple markets;
- Diversified business groups (with affiliates selling multiple products) may bundle (or tie) together different group products in order to extract more rents from distributors and ultimate buyers.

These theoretical conjectures associating business groups with monopoly power have not been formally tested very often in the existing literature. The view that business groups harm competition dates back to the Great Depression in the US; one of the primary objectives of the post-war American occupation reforms in Japan was the dissolution of the pre-war *zaibatsu*, which was driven by strong views on their anti-competitive effects and the resulting social tension that may have contributed to the rise of militarism in Japan; there are also allegations that Belgian business groups facilitated the cartelisation of the Belgian coal industry in the interwar period. But these theoretical conjectures and historical anecdotes lack rigorous tests. A rare formal model (developed by Giacinta Cestone and Chiara Fumagalli) delineates conditions under which internal capital markets may be advantageous to group-affiliated firms when they try to deter entry (these do not always hold). Subsequent (yet unpublished) empirical work by the same authors (in collaboration with others) presents evidence of entry deterrence by French diversified groups.<sup>3</sup> In some countries there is continued dominance of the same groups over several decades, presumably because of entry barriers or entry deterrence; in other countries there has been considerable turnover among the top groups. It is not clear under what conditions one outcome is more likely than the other. Similarly, while some groups (or group firms) have been very profitable, the evidence suggests that not all groups enjoy very high (monopoly) profit rates. Finally, there are a variety of anecdotes about rivalry between major groups in some countries and collusion among groups in others. Overall it is surprising that no attempts have been made to use modern NEIO (New Empirical Industrial Organisation) techniques to assess the market power of business groups.

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<sup>3</sup> Earlier empirical Industrial Organisation studies did not find much evidence for anti-competitive behaviour of French groups in the 1980s or of Japanese bank-centred groups, also in the 1980s.

### 3. Three Concluding Comments

There are a variety of arguments suggesting that business groups may contribute to economic development in early stages of growth. These arguments typically invoke “missing institutions” which the groups replace — these could include an under-developed financial system which is replaced by within-group internal capital markets; inadequate labour market institutions which are replaced by within group labour training and labour markets; or an inadequate contracting environment for which intra-group transactions make up. Most of these arguments do not apply to developed (OECD) economies. One version of the missing institutions argument regards business groups as “quasi-venture capitalists” which make up for missing risk capital institutions (there are a number of on-going, unpublished and somewhat controversial studies suggesting that even in Continental Europe, some groups play an important role in patenting and innovation). In general, it is fair to say that while most of the advantages associated with groups tend to take place in less developed economies, the adverse effects of groups — their negative impact on financial development, their rent seeking/lobbying (sometimes referred to as “entrenchment”) and their adverse effects on competition — may last long after a country becomes developed. However, because of their economic power, and because of regulatory capture, it is very hard to address the economic power of entrenched business groups in countries where groups have existed for many years. The only two examples of business group dissolution, to a large extent for antitrust reasons, took place in the US during the Great Depression, and in Japan during the American Occupation — both examples of extreme economic and political circumstances.

The different reasons for the existence and operation of business groups should not be analysed separately in order to draw the right conclusions regarding social welfare. For example, vertical integration may be driven by the desire to overcome difficulties associated with incomplete contracting, and, as a side-effect, lead to foreclosure of competitors. Diversification may be driven by some entrepreneurial or other resources that the group possesses, or by an under-developed financial system, and, as a side-effect, facilitate collusion with other groups through multi-market contact. Monopoly power of groups may compensate minority shareholders for the risk of expropriation, and so forth. As noted above, however, the welfare-augmenting theories of business groups typically refer to countries in early stages of development.

Even if one concluded that groups in OECD countries are counter-productive, it is not clear what would be the best way to constrain them. Is it outright breakup? Some sort of inheritance tax, or a tax on inter-corporate transactions or inter-corporate dividends (some studies suggest that these were used effectively in the US in the 1930 to break up the power of pyramidal groups)? Other possibilities include “containment” by helping reduce entry barriers for *de novo* entrants combined with effective antitrust policy. For example, anti-trust legislation in some countries does not include considerations of “overall economic concentration” and restricts regulatory attention to concentration within a particular market. At present, there is little research on these policy issues.





**BUSINESS GROUPS IN COMPARATIVE PERSPECTIVE**

*Presentation by Mr. Yishay Yafeh*

**Business Groups  
in Comparative Perspective**

**Yishay Yafeh  
Hebrew University,  
CEPR, and ECGI  
(based on past work with Tarun  
Khanna, HBS)**

## What are BGs?

- Business Groups are ubiquitous (Korea, Thailand, Malaysia, Brazil, Argentina, Mexico, India, Italy, Belgium, Sweden...).
- Diverse (scope of activities, control structure, interactions with government and society).
- Common feature: legally independent entities, operating across industries, bound by formal and informal ties, often family ownership, varying degrees of outside participation.
- (Unlike conglomerates or franchises).

## Literature on BGs

- Two dominant perspectives: groups as diversified entities (early); and groups and “tunneling” (later; conflicts between controlling and minority shareholders).
- Some literature on rent-seeking (lobbying/political economy of groups) and a bit of IO/monopoly power .
- [Outside economics/finance: sociology lit on networks.]

## Tentative Claim

- The overall welfare effects of groups are hard to judge (multiple effects, unknown counterfactual).
- But: the “good” things that groups may do tend to happen in early stages of economic development; the “bad” things tend to persist long afterwards.
- In fairly developed economies groups can cause significant damage and policy makers should consider measures to limit this damage.

## Why Groups May be Welfare Enhancing

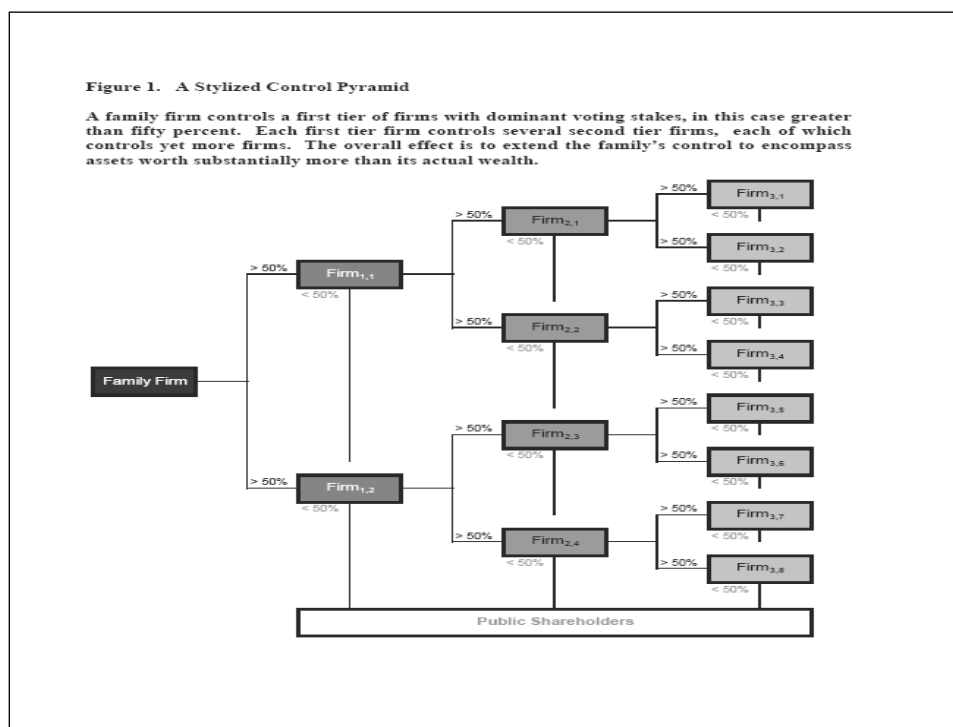
- Some BGs outside the US perform well, in contrast with the evidence on diversified entities in the US
- Claim: BG’s can make up for missing institutions? (which ones? K vs. L markets? Entrepreneurship?) – good for social welfare.
- Diversified BGs perform well for bad reasons (monopoly power, rent seeking).

## Implications for Developed Economies

- Subject to some conceptual and econometric difficulties:
- *If* groups help economic development, the evidence suggests that this happens in primarily in early stages.
- The “missing institutions” argument is implausible in the case of economically and institutionally developed countries.
- (Open question: groups as VC-substitutes in some non-Anglo Saxon countries).

## Pyramidal BGs, Corporate Governance, and Tunneling

- Vertically controlled pyramids can be used as a mechanism to expropriate minority shareholders.
- Tunneling associated with divergence between “cash flow rights” and “control rights.”



## Evidence on Tunneling

- Huge literature following LLSV.
- Pyramids and family control frequently observed where investor protection is low.
- Very convincing papers on expropriation of minority shareholders by BGs in India (Bertrand et al) and Korea (Bae et al and Joh) + many others. Some evidence also from Continental European countries.

## Tunneling –contd.

- Why do investors accept this deal?
- naïve?
- Limited options?
- Group reputation for bailouts, for lobbying, or for treating small investors fairly?
- Tunneling as a return to some group asset? (implausible in developed economies?)
- Tunneling adversely affects financial development.

## BGs as Family Firms

- Many BGs are Family Firms – that is, controlled by a founding family with varying degrees of participation by outside investors.
- One systematic study of ethnic Chinese groups in Thailand + anecdotes on family and succession issues in BGs in Korea, India and other countries.
- In family firms, performance tends to deteriorate with the transition to the 2<sup>nd</sup> generation.
- Large BG's involve large-scale risks associated with mismanagement in the 2<sup>nd</sup> generation.

## BGs and Government

- Little doubt that groups all over the world and throughout the last 130 years were formed with various degrees of government support (Table IV in Khanna and Yafeh, 2007).

## Evidence on Groups and Politics – “Entrenchment”

- But on-going relations between groups and governments more complex and less one sided: Indian government in certain phases; Chile; Samsung in Korea...
- Evolution over time: e.g. changing relations between the Japanese government and the zaibatsu (1880s to 1930s); The chaebol in the 1980s vs. earlier decades.



## How Do Groups Shape Their Environment?

- Some positive examples:
  - Group support in Mexico for NAFTA;
  - Some group support for liberalization in India.
- Also other cases:
  - Opposition to corporate governance reforms in Korea;
  - Direct involvement in politics (e.g. Italy, Korea, Thailand);
  - Influence on the media (Italy), and
  - “Entrenchment” in general: virtually impossible to dissolve established groups.

## BG’s and Monopoly Power

- Collusion (multi-market contacts);
  - Entry deterrence/predation (“deep pockets,” vertical foreclosure);
  - Bundling/tying of products;
  - Regulatory capture.
- Some supporting evidence from France;  
Some anecdotes (on profit rates or turnover of groups in some countries);  
Overall limited body of academic research.

## Implications for Groups in Developed Economies (Repeated)

- Current groups in most OECD countries operate in an institutionally developed environment – “missing institutions” arguments unlikely.
- But the welfare reducing arguments about groups are very likely to be relevant:
  - “Tunneling” and impediments to financial development;
  - “Entrenchment” and rent seeking;
  - Monopoly power;
  - Mismanagement associated with the second generation of family firms.

## Policy toward Business Groups

- In principle, all aspects of group activity should be analyzed jointly.
- Some idea of the counterfactual (what will happen without them) should be formulated.
- What policy tools to use? “Containment” probably more feasible than active dissolution.
- Containment tools: stronger/wider anti-trust laws or taxation of intra-group transfers.
- My personal preference: Tend to favor anti-trust legislation as a policy tool.

## For Example...

- Large groups should not be allowed to acquire control of a financial institution (“related lending” is risky plus ability to push rivals).
- Antitrust considerations could include overall economic power, not only industry-specific market structure.