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Commentary

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COMMENTARIES

*Howard Sherman**

My thanks to Professors Karmel and Fanto for the opportunity to be here today. This seminar, like other Brooklyn Law School events I have attended, is an important part of the ongoing educational process for me and other participants in global finance and corporate governance.

I would like to focus my remarks on Professor Fanto's paper. I agree with your general assessment that change is already occurring within France and that domestic institutions, rather than United States investors, have been the ones shaping the French corporate governance system. To date, the United States institutional investor has in fact had a negligible impact on French corporate governance and the privatization process. I think that over time, however, the United States institutional investor will become an important catalyst for change in France.

The reasons are straightforward. There is a growing competition for capital around the world. If the *noyau dur*, or core shareholder groups, are indeed only a temporary arrangement as the government claims, France will be forced to go to the public equity markets more and more and of course will want to access the United States market. And United States capital has a cost. Not just a financial cost, but more and more the United States institutional investor has demands relating to corporate governance.

This is not a whim for United States institutions. It is a legal requirement of the Pension and Welfare Benefits Administration (PWBA) of the United States Department of Labor (DOL), which oversees private (ERISA) pension plans, the largest category of institutional investors in the United States. In July 1994, PWBA issued a new release (94-2) concerning ERISA plans' obligations to vote proxies. PWBA stated that

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proxy votes are financial assets, and as such must be managed as carefully as any other pension plan asset. This means that proxies cannot be voted blindly for management but must be voted with an eye towards protecting the financial interests of pension plan participants and beneficiaries. In its last release PWBA for the very first time stated that these rules extended to foreign proxy votes.

France has not been on my clients' radar screens to date because the market is too thin for the problems to be apparent to most United States institutions. A few scandals have caught our eye, of course. Crédit Lyonnais was one; the aborted Volvo/Renault merger was another. But to date, it has not been one of the countries where my clients have felt a need to be active, mainly because United States holdings in France are not as large as elsewhere in Europe, and because the local institutions have not taken the initiative.

But I think that is going to change as United States holdings grow and as governance issues become more widely discussed within France. Perhaps I can be most helpful here by explaining a bit about what I do, who I work with, and what they're up to. My firm advises and/or votes for more than 250 institutional investors, primarily in the United States but also some institutions in Canada, the United Kingdom and Australia. Our clients tend to be the largest in their respective market and represent more than $1 trillion in combined assets.

Three or four years ago, when our clients first wanted to vote their foreign proxies they simply couldn't do it in a cost-effective manner. There was a firm that would send someone to vote in person for you at a foreign shareholders meeting, but as you can imagine it was a very expensive proposition.

As a result the institutional investors turned to their global custody banks to develop global proxy voting services. These are major banks like the Boston Safe, Chase Manhattan, Morgan Stanley, Northern Trust and State Street that are the official holders of institutional shares. These global custody banks in turn hire a bank within the local market — it could be Banque Indosuez or Paribas in France — to act as their representative. The global custodians and their French agent banks have put together a network that provides translated meeting information for most French AGMs or EGMs for the clients of the global custodian. To vote, you simply contact your global custodian. The message is relayed to the appropriate bank in France and that French bank, if it's doing its job, will execute the vote on your behalf.

In addition, there are now different services that provide additional research on French proxy voting and corporate governance issues for the global investor. My firm does a lot of it for the United States market with the help of Sophie L'Helias, with whom we have a strategic alliance. These developments have helped increase the number of United States institutions who can vote in France in a timely, informed and cost-effective manner.

I wanted to comment on the United States activist funds which do more than vote proxies. As Professor Fanto pointed out, by and large the activists have been public pension funds. Yet for all the press the activists get, there aren't that many of them. CalPERS, the New York City Employees' Retirement System, State of Wisconsin Investment Board and a few others are the obvious players. I do not think France can expect major initiatives by these funds just yet. There is a great reluctance to be seen as the "Ugly American" abroad. The activists are more focused on fulfilling their fiduciary duties by voting proxies and by gathering information and developing relationships with domestic institutions right now.

To that end, the United States Council of Institutional Investors is now working with its counterparts in London and throughout Europe and Australia to form what they're calling the International Corporate Governance Organization (ICGO). The ICGO is meant to be a clearinghouse for local market standards of conduct and governance procedures. It could also become a conduit for cross-border shareholder initiatives.

As for the issues of concern to my firm and our clients, we begin with the *noyau dur*. The French core shareholder structure parallels the control of the banks in Germany and Switzerland, and of the *keiretsu* in Japan. These closely controlled systems have many benefits. They foster relationship investing, allow for long-term planning, and put expertise from related companies in the hands of management. In many ways the United States is trying to modify our corporate governance system to enjoy these and other benefits of European and Japanese systems.

But I think at the end of the day these systems severely limit corporate competitiveness and foster a lack of accountability. We are seeing that right now in Germany with

Metallgesellschaft, which shows what can happen when you have a closely knit system with the top management very comfortable with one another, thinking they're paying attention when in reality they're not.

In Japan, the stock market decline over the last few years demonstrate the dangers of a system like this. Emergency measures from the Ministry of Finance were necessary to prevent massive sales of cross-holdings within each *keiretsu*. That's no way to run a modern economy and is indicative of the risk of having shareownership too concentrated within a few core groups.

While the rationale for the *noyau dur*, to give newly privatized French companies a chance to get on their feet, makes eminent sense, my first question about French corporate governance is whether this is a system that is viable over the long-term.

However, neither my firm nor its clients are in a position to radically alter the very make-up of a foreign market. As many questions as there may be about French governance, it's patently impossible for United States institutional investors to undue the basic system. What we try to do instead is to identify specific issues that can be called externalities of the basic system. They generally occur in markets where there are powerful groups holding all the shares and where minority shareholder rights are questionable.

The government's golden share is one example. The fact that it has only been used once does not make it less of a problem. Its very presence is disturbing to a minority shareholder. You don't know when the French government is going to choose to use its golden share. As we saw in Volvo/Renault, its presence can abort profitable transactions for minority shareholders. It is an anachronism that should be done away with. If the French government chooses to have ability to protect domestic companies there are a lot of other ways to go about it than through an anomaly in the securities market.

In the similar vein the lack of protection for minority shareholders in takeover situations comes up time and time again. We have seen it very recently in Au Printemps/La Redoute. Without strong legal protection, minority shareholders in France will be forced to accept a price that isn't as much as the controlling shareholders have received in a takeover situation. It is plainly unfair and one of the easiest ways to lose money investing abroad.

Another issue of interest to my clients is the lack of disclosure of executive compensation. No one really knows what the top management is earning or whether it has a meaningful correlation to performance. As a result, it is an area where French regulatory authorities and the Bourse could do some good.

Among the markets we cover, France tends to have the longest proxy statements. One reason is that shareholders are asked to approve each class of security that comprises the French company's capital structure each year. While we look out for capital authorization requests that seem excessive, we are not about to tell Elf Aquitaine it does not need authority to issue bonds next year. We really focus on proposals requesting shareholder approval of shares specifically designated to be used in the event of a hostile takeover. Given that these shares could be used to defeat a worthy offer, they are anathema to many United States institutional investors. My firm recommends a vote against these proposals as a matter of course.

The fact that these issues do not yet face meaningful opposition within France is indicative of the mentality in the French system, in that companies do not belong to their owners, the shareholders. They exist to perpetuate jobs and to promote French national interests. While these are admirable and understandable goals, they do not reflect the reality of a modern publicly held corporation. If France wants to become a true global market and the Bourse a truly global exchange, French corporations need to look beyond the *noyau dur* for capital. Through this process they will be exposed to alternative views of corporate governance. This should be a healthy process for France and one in which the United States institutional investor can be a useful catalyst for change.