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Insider Ownership, Shareholder Structures and Corporate Governance

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Preface

The question whether a relationship between insider ownership — i.e. direct shareholdings of managers in their firms — and corporate performance exists increasingly attracts attention in academia as well as in investment practice. The introduction of the German Entrepreneurial Index (GEX) through Germany's leading stock exchange operator Deutsche Börse AG along with its remarkable performance may have contributed to this development as well. The concept of this new stock index is based on both theoretical and empirical research. Departing from the owner-management conflict, which has already been extensively discussed in literature, the quintessence of these works is that management's incentives can be considerably improved, if managers also benefit from the success of their firms through direct shareholdings.

The work on hand is an important contribution to this research strand especially as most of the relevant empirical studies refer to Anglo-Saxon capital markets. This fact may not be neglected in the comparison of corresponding empirical studies as insider ownership in these countries is mainly driven by share-based compensation schemes. Furthermore, these countries do not have a notable tradition of midsize family owned companies, as they are common in Germany and other Continental European countries. Therefore, this study investigates the relationship between insider ownership and corporate performance on the basis of a new and unique data set. From a methodical point of view, this data set has the advantage that econometrical biases may be less severe than in comparable Anglo-Saxon studies as the determinants of insider ownership are rather exogenous for the case of Germany. The results of this study are very interesting from both an academic and practical perspective. They provide evidence that the development of investment strategies should not disregard companies' ownership structures. Finally, this work constitutes the first comprehensive overview on the development of shareholder structures of German listed stock corporations.

München, 21 January 2007

Prof. Dr. Christoph Kaserer

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I owe a special debt to several colleagues and friends which supported me over the last three years. Firstly, Martin Brixner was my CEFS colleague from the first hour and made the experience of building up and working at the Center an exciting and enjoyable effort. His helpfulness remains unmatched and without his enduring support this thesis would never have been finished on LaTeX as it is. Special thanks for their probing questions and tedious reviewing are to Markus Ampenberger, Benedikt Kormaier, Felix Moldenhauer, Oliver Klöckner, Peter Heister, Christopher Angelo and Bes Achi. I have also benefited from the discussions with and experience of all my colleagues at the CEFS which are not limited to Dr. Christian Diller, Dr. Christian Fingerle, Annabel Geidner, Dr. Thorsten Groth, Kay Müller, Dr. Eva Nathusius, PD Dr. Niklas Wagner and Dr. Simon Wahl.

I was fortunate to enjoy the help of several excellent research assistants: Marcus Hampl, Marcus Duttler and Viktoria Hajas performed meticulous efforts in the process of collecting and structuring shareholder data. Their work was a great help and they contributed to the pleasant working environment at the CEFS. And my thanks as well to Tina Kaltenecker and Monika Paul for helping in so many aspects of the daily work.

I must acknowledge explicitly the Deutsche Börse AG for the co-operation in the German Entrepreneurial Index (GEX) project which initially triggered my interest to examine insider ownership on the German capital market. Insights from this practical project contributed to this academic work. Furthermore, the help in providing stock exchange data was of enormous help.

Without the emotional support of family and friends this project would never have been finished. When I acknowledge that Karin supported me in all thinkable aspects throughout the times of writing this thesis I can only hint at her contribution. I also want to thank my brothers, family and friends for moral support in completing the dissertation. Finally, I would like to thank my parents very much who supported me throughout my education in a unique and outstanding manner. This work is dedicated to them.

Even with all this help and support I am certain that flaws remain. They are the author's responsibility alone.

Frankfurt-on-Main, 29 January, 2007

Dr. Benjamin Moldenhauer

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List of Abbreviations

2SLS .... Two-Stage Least Square

3SLS .... Three-Stage Least Square

AG .... Aktiengesellschaft (“Limited Liability Stock Corporation”)

AktG .... Aktiengesetz (“Stock Corporation Act”)

AMEX ..... American Stock Exchange

ANOVA .... Analysis of Variance

AnSVG ..... Anlegerschutzverbesserungsgesetz (“Investor Protection Improvement Act”)

APM .... Alternative Performance Measures

BaFin .... Bundesamt für Finanzdienstleistungsaufsicht (formerly: BaWe) (“Federal Financial Supervisory Authority”)

BaWe .... Bundesaufsichtsamt für den Wertpapierhandel (now: BaFin) (“Federal Financial Supervisory Authority”)

BetrVG ..... Betriebsverfassungsgesetz (“Works Constitution Act”)

BilKoG ..... Bilanzkontrollgesetz (“Balance Sheet Auditing Law”)

BilReG ..... Bilanzrechtsreformgesetz (“Accounting Law Reform”)

bn .... billion

CAR .... Cumulative Abnormal Return

CEO .... Chief Executive Officer

cf. .... confer

CG .... Corporate Governance

DCGK ...... Deutscher Corporate Governance Kodex (“German Corporate Governance Code”)

e.g. .... exempli gratia (“for example”)

ECGN ...... European Corporate Governance Network

EDGAR .... Electronic Data Gathering, Analysis, and Retrieval System

et al. .... et alii (“and the following”)

EU	European Union
EUR	Euro
excl.	excluding
FCF	Free Cash Flow
FMFG	Finanzmarktförderungsgesetz (“Financial Market Promotion Law”)
GDP	Gross Domestic Product
GEX	German Entrepreneurial Index
GmbH	Gesellschaft mit beschränkter Haftung (“Limited Liability Company”)
HGB	Handelsgesetzbuch (“Commercial Code”)
i.e.	id est (“that is”)
IFRS	International Financial Reporting Standards
inc.	incorporated
incl.	including
InsO	Insolvenzordnung (“Insolvency Statute”)
InvG	Investmentgesetz (“Investment Act”)
IPO	Initial Public Offering
IV	Instrumental Variable
KAGG	Gesetz über Kapitalanlagegesellschaften (“Investment Companies Act”)
KapAEG	Kapitalaufnahmeerleichterungsgesetz (“Law to Ease Capital Procurement”)
KapInHaG	Kapitalmarktinformationshaftungsgesetz (“Law Governing Liability for Capital Market Information”)
KapMuG	Kapitalanleger-Musterverfahrensgesetz (“Capital Markets Model Case Act”)
KonTraG	Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (“Law on Control and Transparency in the Corporate Sector”)

KStG .... Körperschaftsteuergesetz (“Corporation Tax Law”)

KuMaKV ... Verordnung zur Konkretisierung des Verbotes der Kurs- und Marktpreismanipulation (“Regulation for the Concretion of the Prohibition of Stock Price and Market Price Manipulation”)

LBO .... Leveraged Buy-Out

LSX .... London Stock Exchange

m .... million

M&A .... Mergers & Acquisitions

MaKonV .... Marktmanipulations-Konkretisierungsverordnung (“Regulations for the Concretion of the Prohibition of Market Manipulation”)

N.N. .... nomen nescio (“name unknown”)

Nasdaq ..... National Association of Securities Dealers Automated Quotation System

NPV .... Net Present Value

NYSE ...... New York Stock Exchange

OLS .... Ordinary Least Square

OSE .... Oslo Stock Exchange

p./ pp. ...... page/ pages

p.a. .... per annum (“yearly”)

R&D .... Research and Development

S.p.A. ...... Società per azioni

S&P 500 .... Standard & Poor’s 500 Stock Index

SEC .... Security Exchange Commission

SOX .... Sarbanes-Oxley Act

SSRN ...... Social Sciences Research Network

StückAG .... Stückaktiengesetz (“Law on Admission of Nonpar Shares”)

TransPuG ... Transparenz- und Publizitätsgesetz (“Transparency and Disclosure Law”)

TUG	Transparenzrichtlinie-Umsetzungsgesetz (“Transparency Directive Ratification Act”)
U.K.	United Kingdom
U.S.	United States of America
UBGG	Gesetz über Unternehmensbeteiligungsgesellschaften (“Law on Private Equity Companies”)
UMAG	Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (“Act on Corporate Integrity and Modernization of Rescission Law”)
UmwG	Umwandlungsgesetz (“Restructuring Act”)
USD	United States Dollar
VAG	Versicherungsaufsichtsgesetz (“German Insurance Supervision Act”)
VIF	Variance Inflation Factor
VorstOG	Vorstandsvergütungs-Offenlegungsgesetz (“Management Compensation Disclosure Act”)
vs.	versus
WpÜG	Wertpapiererwerbs- und Übernahmegesetz (“Acquisition and Takeover Act”)
WpHG	Wertpapierhandelsgesetz (“Securities Trading Act”)

1 Corporate Governance and the Role of Insider Ownership

1.1 Why Do Corporate Governance and Insider Ownership Matter?

In the aftermath of large corporate scandals as Enron, Inc. (U.S.), MCI Worldcom, Inc. (U.S.), Parmalat S.p.A. (Italy) and Bankgesellschaft Berlin AG (Germany), public discussion about *corporate governance* has increased dramatically. The consequences of individual managers' criminal and selfish behavior in such cases are dire and diverse: The wealth of shareholders and creditors of the affected companies was diminished, investors' trust in corporate managers has been ruined on a much broader scale and policy makers reacted by initiating and passing numerous regulations. For example, the introduction of the Sarbanes-Oxley Act (SOX) in the U.S. in 2002 aimed at preventing the recurrence of such cases but also imposes significant administrative costs.[1] Often, the occurrence of such scandals is reasoned by a *failure* of corporate governance. Though the diversity of definitions of corporate governance will be dealt with later on in section 2.1, it should be noted that corporate governance is commonly referred to in at least three different contexts: First, as already mentioned, in public discussion, the criminal and deceptive activities of corporate managers and the resulting corporate scandals are often attributed to a lack of adequate corporate governance. Second, in academic discussion, corporate governance primarily deals with the question of how to prevent corporate managers from misusing corporate resources and how to ensure that managers act in the best interest of those who provide funds, i.e. the shareholders. The second meaning, even though similar at the fist glance, must be clearly differentiated from illegal practices and corporate scandals[2]: It usually assumes that managers act in accordance with law but managers are also seen as individuals which pursue their own — and not necessarily shareholders' — interests. Third, from an economics and law perspective, corporate governance often refers to the whole system of corporate governance, i.e. the institutional characteristics and regulations, which may vary significantly across countries. The study at hand[3] will (almost) exclusively focus on the second aspect, i.e. the question of

1 Cf. Ziener, Riecke, Hussla and Fockenbrock (2006), p. 2.

2 See Helmis (2002), p. 2.

3 The terms *this study* or *this analysis* will always refer to the works at hand in the following if not stated otherwise.

how conflicts of interest between managers and shareholder can be prevented or resolved. Thereby, the role of ownership structures — and especially insider ownership — will be at the very focus. To begin with, the importance of corporate governance and ownership structures in general and for the German capital market will be highlighted.

Besides public discussion, also academic research extensively deals with corporate governance. A search at the Social Sciences Research Network (SSRN)[4] for scientific papers submitted between August 2, 2005 and August 2, 2006 containing "Corporate Governance" in the title yields a total of 227 hits.[5] Thereby, also the question of how corporate governance affects corporate performance has attracted broad attention: For example, GOMPERS, ISHII AND METRICK (2003) report that a trading strategy according to which firms with bad corporate governance, i.e. low shareholder rights ("dictatorship firms"), are sold and those with good corporate governance, i.e. strong shareholder rights ("democracy firms"), are bought yields abnormal annual returns of 8.5%.[6] Similarly, in a recent survey among German listed companies 62.2% state that high standards in corporate governance have a "high" or "very high" importance for their stock market performance.[7] But what constitutes good corporate governance or how can it be measured? The number of possible approaches is large: Some studies examine the compliance with (newly introduced) corporate governance codes while others analyze the effectiveness of single corporate governance mechanisms, e.g. supervisory board composition, compensation or control through the takeover market.[8] A less obvious aspect refers to the ownership structures of public stock corporations, which have far-reaching implications for potential corporate governance issues.

A prominent, current example illustrating the importance of ownership structures in the case of public German stock corporations is the case of Deutsche Börse AG. In 2005, foreign institutional investors opposed the plans of the Chief Executive Officer (CEO) to acquire the London Stock Exchange (LSE). The

4 For more information refer to the website http://papers.ssrn.com.

5 Good surveys of corporate governance and overviews of the fast growing theoretical and empirical literature are provided amongst others by Shleifer and Vishny (1997); Farinha (2003); Gillan (2006).

6 See Gompers, Ishii and Metrick (2003), p. 144. Cf. Daouk, Lee and Ng (2006).

7 See ergo Kommunikation (2005), p. 51.

8 See section 2.2.

CEO initially dismissed institutional investors concerns, last but not least because of their historical comparatively minor weight. However, the institutional investors revolted effectively and finally achieved the denial of the takeover attempt as well as the resignation of the CEO and the supervisory board chairman.[9] Besides outside blockholders, as in the case of Deutsche Börse AG, also the shareholdings of insiders, i.e. the members of the management and supervisory boards, might play an important role. In the case of significant insider ownership[10] levels, corporate managers also become shareholders themselves and the typical conflicts of interest between both groups may be alleviated or the interests might even become aligned. Similar arguments also can be applied to the advantages of family firms, where management and ownership usually are still (partially) united in the hands of the (founding) family. Therefore, the discussion about family firms should be seen closely related to the discussion about the effects of insider ownership. For example, family firms are often perceived to be less short-term oriented and more focused on value than on mere growth.[11] Nevertheless, family firms sometimes are also characterized by a bad reputation as outside (minority) shareholder are supposed to become expropriated by potent family shareholders.[12] As empirical research about the relationship between ownership — and especially insider ownership — and performance is rare and ambiguous for the case of Germany, these arguments should be regarded as speculations in the first place.

The question of how insider dominated firms perform on the stock market becomes even more important if one argues that the ambiguity regarding their performance might play a role in the underdevelopment of the German capital market. This underdevelopment is a topic which has attracted widespread discussion in the past.[13] Even though the importance of the German capital market has clearly increased in the last decade, a closer look at the actual figures still reveals a significant backlog demand in capital market development.

9 See Kamp and Krieger (2005), pp. 54-56.

10 *Insider ownership* refers to the absolute level of shareholdings by corporate insiders as members of the management and supervisory boards. It has to be differentiated from *insider trading* which refers to the fact that corporate managers buy or sell shares in their own company. The latter is problematic (and illegal) if the managers act on information which is not available to other (outsider) market participants.

11 See footnote 880; Weishaupt (2005).

12 Cf. Hajek (2004), pp. 114-117; Göcmen and Meyer (2004), p. 25; N.N. (2004), p. 35; Dostert (2004), p. 21; Gröneweg (2004), p. 22.

13 See Monopolkommission (1998), pp. 18-63.