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# The Paradox of Disclosure

Master Thesis  
20 points

Supervisor  
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Field of Study  
Business Law and Business Administration

Semester 9

# Summary

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*Title* The Paradox of Disclosure  
*Course* Master Thesis in Business Law, 20 Swedish credits (30 ECTS)  
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*Abstract* The paper presents the development and outlines initiatives taken by the Swedish government, and the European Union in order to address issues of declining trust and confidence for the business society. The paper will be structured and partly analyzed based on institutional theory, introducing regulative, normative and cognitive perspectives of the issues. Relevant corporate theories are creating fundament for the applied institutional theory to follow. Several legislative proposals will be comprehensively presented in the regulative pillar of the theory, accompanied with the Swedish Code of Corporate Governance in the normative. The cognitive pillar of the institutional theory is accommodating the patterns that the initiatives aim to address, and therefore extra aspects of trust and behavioural patterns is outlined herein. Furthermore, the model will be redesigned and used to emphasize the ability for an institution to affect other pillars than those where access is approved.

The proposals for legislation is targeting aspects of enhanced transparency, through disclosure standards and deciding exclusivity by corporate organs on executive compensation. Focus is to create comprehensive understanding of the development for the actions taken by the government and the European Union. Conflicts between business purposes and intervening legislative initiatives, and there from deriving contra productive consequences will be presented. Tendencies and trends, more or less connected with stricter legislative and regulative standards are briefly introduced.

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# Abbreviations

ABB	Asea Brown Boveri
ABL	The Swedish Company Act (Aktiebolagslagen 2005:551)
CEO	Chief Executive officer
CFO	Chief Financial officer
Commission	The European Commission
EC	Treaty establishing the European Community (Rome Treaty 1958) or European Community
EU or Union	The European Union or Treaty on European Union
IPO	Initial Public Offering
NBK	The Swedish Industry and Commerce Stock Exchange Committee, Näringslivets börskommitte
OMX-S / SAX	Stockholm Stock Exchange
Prop.	Proposition (Preparatory work from the Swedish Government)
SEC	Securities and Exchange Commission
SEK	Swedish Kronor
SOX	Sarbanes-Oxley Act
USD	US Dollar
SOU	Swedish Government Official Reports
ÅRL	The Swedish Annual Accounts Act (Årsredovisningslagen 1995:1554)

# 1 Introduction

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*The following chapters will introduce the reader to the purpose, issues, methodology and theoretical framework of the paper. Moreover, it aims to create a holistic understanding of the subject, and to simplify the contextual fit into the legal and business environment.*

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## 1.1 Background

Charles-Louis de Secondat, Baron de la Brède et de Montesquieu, better known as simply Montesquieu, probably did not know that his ideas about separation of powers would come to foster societies and affect peoples' lives on a daily basis ever since. Many great thinkers have developed thoughts in the same line as Montesquieu. Berle and Means stated in the 1930<sup>s</sup> that the main problem in a company was to separate ownership and control.<sup>1</sup>

Since Enron filed for bankruptcy protection in December 2001 in the US, the company has become epitome to the downfall of one of the largest and most profitable companies in America to one of the largest bankruptcy filings in history. Interestingly, Enron was considered one of the healthiest and best-governed companies shortly before management's misbehaviour became public. Many companies were to follow-not only in the US but also in Europe. The phenomena of corporate scandals swept over much of the developed part of the globe involving many companies in different lines of businesses.<sup>2</sup>

The aftermath, in terms of new rules for transparency, has set new and changed standards for companies and other corporation-like constituencies all over the world.

In Sweden, the manufacturing company ABB, partly Swiss-owned, signed two of its senior managers, including CEO Percy Barnevik, a "well-developed" pension and personal benefit package. More recently, the insurance company Skandia AB, was targeted for a large investigation after suspicions about self-dealing of corporate housing and luxury renovations of apartments, with Skandia to bear the costs. The misbehaviours concerning the apartments was just the tip of an iceberg; eventually cap-less stock option plans and other substantial financial benefit packages for senior

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<sup>1</sup> Berle, A., Means, G., (1932) *The modern corporation and the private property*, Harcourt, Brace and World, New York

<sup>2</sup> Corporate scandals that swept over the world have once again made shareholders aware of the agency problem. Enron, World Com and several others in the US, Vivendi, Parmalat and Royal Ahold in Europe. See Pergola, C., Sprung, P., (2005) *Developing a Genuine Anti-Fraud Environment*, Risk Management Journal, Vol. 52

management were brought to light. Several former Skandia executives are now facing criminal trials for their acts, while Percy Barnevik and others settled with ABB, eventually paying back large sums to the company and its shareholders.<sup>3</sup>

Many of the so-called corporate scandals have earned enormous interest from the mass media. Especially those where an easy bought logic was presented; outrageously compensated executives and a poor performing company, potentially with lay-offs, compared against each other in a simple regression analysis rendered most reactions.

Corporate governance standards and transparency were suddenly topics discussed more frequently than ever before across all levels of society. Eventually, this and other factors, such as the development of the Sarbanes-Oxley Act<sup>4</sup> in the US, led to an initiative by the Swedish government to establish a committee aimed to examine the declining level of trust for companies throughout society and reforming the company act. This organ eventually came to develop a corporate governance code addressing the above-mentioned issues.<sup>5</sup>

Transparency was one of the key principles throughout the committee's process.<sup>6</sup>

In the US, one might have thought that the "Halcyon days" of executive compensation were over. But recently, Exxon Mobile, the world's largest company in terms of market capitalization, created headlines and proved the opposite, releasing the actual figures and value (about \$183,1M and another \$69M worth in stock options) of the compensation and pension scheme for their retiring CEO Lee Raymond.<sup>7</sup>

One focus of this paper is to describe changes in disclosure regulations on executive compensation that derive directly from the Report: Swedish Business Society and Trust, i.e. the result of the Commission on Business Confidence, as well as initiatives on this area that have been taken at the European Union level. Hence, in Sweden laws and recommendations have emerged from the preparatory work of developing a corporate governance code. Regarding initiatives at the EU level, special interest is given to the

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<sup>3</sup> Former Skandia AB CEO Lars-Erik Pettersson was convicted by the first court instance in Sweden and sentenced to two years of imprisonment. See Mål nr. 8413-03 Stockholms Tingsrätt Avd. 14, Rotel 1401 from 2006-05-24 and Dagens Industri "Guilty" Wednesday 2006-05-24 also Hill, J., G., "Regulating Executive Remuneration: International Developments in the Post-Scandal Era", European Company Law, Vol. 3, Issue 2 April 2006

<sup>4</sup> The Sarbanes-Oxley Act is a framework that grinds responsibilities by the parties of a corporation, especially the directors and management. It also introduces new accounting and financial statements standards through extended power of the Securities and Exchange Commission (SEC). The SEC has initiated several new laws deriving from the Sarbanes-Oxley Act.

<sup>5</sup> The Commission on Business Confidence, SOU 2004:47

<sup>6</sup> Swedish Code of Corporate Governance, Report of the Code Group, SOU 2004:130

<sup>7</sup> Washington Post "Gold-Plated Exit for Exxon CEO" 2006-04-13

development process in the EU parallel to the one in Sweden in order to establish comprehensive understanding of aim and reasoning for the initiatives as such. Specifically, proposals and regulations targeting individual basis disclosure, i.e. per person information, is the focus of the paper. Furthermore, adjustment to decision-making competences between the corporate bodies, as well as compensation policies will be examined following the proposal to legislation deriving from the Report of Committee on Business Confidence.<sup>8</sup>

The common strategy has been to enhance transparency on executive compensation through new disclosure standards, aiming at the same goal: to restore trust among interfacing constituencies. Shareholders and society in general have been frequently appointed as main targets for these actions. The same applies for both Sweden and the EU.

Abolishment of corporate ethics in general, and a tendency of financially draining companies in order to gain personal monetary winning (excessive self-dealing and general opportunism) in particular, seem to be the problem at hand. A problem-phenomenon that is travelling with diplomatic status at the speed of light! Corporate scandals appear to have ruined trust for not only the involved former executives and management, some of them obviously eventually convicted for their wrongdoing, but also for the business establishment on a wider scale. Hence, this has even negatively impacted other societal constituencies, and some would argue that it brought deep contempt and disbelief even for the institution of corporations.

Obviously, a society-wide trust inflation has to be addressed!

One of the most fundamental institutions found in society is government. Its intervention, often through legislation, is of certain interest when addressing issues of an ethical and moral nature. The initiatives to address corporate governance issues, will in this paper be structured based on institutional theory including regulative, normative and cognitive pillars.<sup>9</sup> The purpose of this is to highlight some of the potential conflicts that might arise between business and legal aims. Possible counter-productive consequences emerging from such action will be discussed.

Other theories used and considered applicable in this paper is separation of ownership and control, i.e. the agency problem and information asymmetry. Particularly, issues that might arise due to separation between managerial and ownership interest in executive remuneration will be studied.

*“In judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren’t encouraging.”*<sup>10</sup>

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<sup>8</sup> The Prop. 2005/6:186 will become effective July 1, 2006

<sup>9</sup> This theory is further outlined in chapter 3.3 of this thesis

<sup>10</sup> Warren Buffett, February 2004



## 1.2 Purpose

New disclosure standards on executive remuneration will be examined in this paper. Relevant aspects especially of the development of the European Union recommendation<sup>11</sup> “Fostering an Appropriate Regime for the Remuneration of Directors of Listed Companies” will be put in perspective to the Swedish development and standards. Other relevant semi-regulative work will also be taken into account in order to bring forward some of the most important characteristics of self-regulating soft-laws. I will, throughout the paper, emphasize on aspects and considerations made when discussing the development of the regulation regarding disclosure of executive compensation on an individual basis. The work of the Committee on Business Confidence, and deriving from their Report: Swedish Business Society and Trust, are also important amendments and changes to the Swedish Company Act. Herein proposals for adjustments of decision-making competences between company bodies, as well as compensation policies are to be found. They will be presented in the paper in order to establish an even more comprehensive understanding of the process of determining executive compensation.

Furthermore, I will describe some of the potential conflicts that might arise when legislation as well as other presented regulative and self-regulating standards are intervening in business life, i.e. what is the flip-side of aiming to make remuneration and compensation schemes more transparent through stricter disclosure standards. Institutional theory, including a regulative, normative and cognitive perspective will be used as framework, aiming to distinguish the numerous problems connected to the initiative into subparts. Potential aspects i.e. counter-productive consequences that might derive out of the conflict between the different aspects of institutional theory and between legislation and business in general will be presented.

*First, I will examine new disclosure standards on executive compensation. Specifically the proposed changes and amendment (Proposition 2005/06:186) to Chapter 5, 20§ The Swedish Annual Accounts Act (1995:1554). Relevant and comparable parts of the Commission's recommendation<sup>12</sup> will be used in order to pinpoint aspects of the new rules. Furthermore, proposed changes and amendments to Chapter 7 and 8 of The Swedish Company Act (2005:551), regarding decision-making competence and compensation policies will also be taken into account in order to create a comprehensive understanding on the process of determining executive compensation.*

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<sup>11</sup> Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companiesText with EEA relevance, OJ L 385 , 29/12/2004

<sup>12</sup> Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companiesText with EEA relevance, OJ L 385 , 29/12/2004

*Secondly, I shall discuss and describe the origin, background and purpose of the rules in Sweden and on the EU level. I will establish understanding of the problem based out of institutional theory i.e. regulative, normative and cognitive perspectives. The focus is the aim of the initiatives i.e. the new rules that address declining confidence for corporations throughout society in general, and the agency problem, focusing on new disclosure rules that target individual compensation disclosure aiming to enhance transparency towards shareholders and others.*

*Finally, I would like to emphasize possible<sup>13</sup> conflicts between business interests and aspects on one hand, and enhanced disclosure through legislation on the other. Here I will introduce institutional theory to highlight tendencies and potential counter-productive consequences from disclosing executive compensation.*

### **1.3 Problem Statement**

The question at hand is:

*Is disclosure of executive compensation and other recent initiatives by the Swedish government and the thereby enhanced transparency, a sufficient recipe for addressing issues of declining trust for executives among shareholders and society in general?*

To answer this question in a pragmatic way, I will examine the aim and development of Swedish standards compared to the mentioned EU level initiative. This will clarify, and support understanding of the current situation. The European Union is analyzed due to its' immense effect and influence on Swedish legal structure and development. Institutional theory is used in order to highlight and analyse the most important potential problems that might arise between legal and business aims.

### **1.4 Methodological approach**

The broad basis of this thesis, where both legal and business issues, separately as well as through their interaction, are examined requires, a broad methodological approach. This is necessary to cover the different aspects of the paper. Legal dogmatic method will be used in order to examine the new regulative proposals deriving from the Committee on Business Confidence Report: Swedish Business Society and Trust.

Furthermore, it is important to emphasize the intention of applying the institutional model throughout this paper. Normally, the theory is examined

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<sup>13</sup> Since the rules are relatively new there is no actual data to be found regarding the topic, therefore potential consequences have been used in order to discuss problems that might arise, and tendencies that already have been recognized by business press and others.

out of three perspectives in the following order: Regulative, Normative and Cognitive. I will instead modify the model and start with the cognitive aspects, that I mean constituted basis for the initiatives by the Swedish government when initiating the Commission of Business Confidence. Unacceptable behaviour, mismanagement, general unethical i.e. cognitive, became public and based on this the government realized that something had to be done. Hence, I will use the model but apply the theory “backwards”. When conducting a document study scholars argue that it is hard to distinguish between inductive versus deductive and qualitative versus quantitative approaches. Since I am working with a wide range of written material, stemming out of different research families I will use combinations of them in order to sufficiently address the issues in my thesis.

## **1.5 Outline**

The second chapter of this thesis aims to introduce the reader to the methodological considerations made for this paper. These considerations will be presented and put in the context of what part and purpose they aim to address and fulfil.

In the third chapter, a frame of reference covering all relevant corporate theories and business principles that constitute the basis for the coming analysis and conclusive part of the paper will be examined.

In the fourth part of this thesis, the institutional approach will be applied and will contain five parts including: general introduction, cognitive, regulative, normative as well as a part covering the European Union.

The fifth chapter constitutes the analysis, which will highlight the most important factors based on the material presented in this paper in order to simplify and to a certain extent justify the following chapter.

Finally, I will close the paper with a conclusive part on all previous chapters and analytical reasoning. A short introduction to further ideas, followed by the bibliography will constitute the last pages of this thesis.

## **1.6 Delimitations**

The tendency to include a broad variety of legal as well as business disciplines in corporate governance, complicates the ability to distinguish terminology. Since issues related to disclosure on executive compensation is focus of this paper, I will use the term corporate governance as a description of the broader academic body, and instead consider executive compensation and other related terminology as subordinated the larger term corporate governance.

Due to the general interest, and to signalize that this is an area of importance, the Swedish government wants to follow the development closely. Evaluation will take place as soon as such measurements can be made and enough time has elapsed in order to get a plausible result.<sup>14</sup> Hence, the relative age of this discussion, as emphasized by the Swedish government, and the actual problem of measuring confidence have restricted the analysis of my paper to focus on potential consequences which derive from the initiatives taken by the government in Sweden and to some extent the Commission on the EU level.

### **1.6.1 Geographical Delimitation**

Sweden as an object of study needs no further explanation. The European Union and the gaining attention from the Commission on the area is accurate and confirmed through e.g. the recommendation, which is further presented in chapter 4 of this thesis. Therefore I will emphasize on these two geographical / regional areas.

From both a legal and business perspective, there is no doubt that one of the most dominant sources of influence generating codifications and other regulative framework is the US. The per se fact of being the largest economy on earth with companies acting on almost every market, thus influencing other legal traditions and business environments around the world. Therefore, some references will be made to this legal body as well, without intention, as with Sweden and the EU to do any comprehensive analysis.

In order to illustrate specifically interesting conditions, few references are made to other countries.

### **1.6.2 Legal Delimitation**

The focus is the Swedish perspective; however, a number of comparative snapshots are, as already mentioned, made with selected parts of the EU recommendation. The aim of presenting the development within the EU, will also be accomplished by some Union characteristics, in order to show similarities but also to highlight some issues such as for example: harmonisation within the Union. Hence, the part on the European Union will not be as comprehensive as the Swedish part in some regards, but in others, where the reader already is assumed to possess basic facts about the Swedish situation and not that of the EU, it will be more comprehensive. I have intentionally narrowed my focus area to rules targeting and discussing disclosure of executive compensation on an individual basis. This is done in order to avoid the excessive descriptive part of an essay that the opposite

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<sup>14</sup> Prop. 2005/06:186

would mean. In the regulative part of the paper, the proposal to amend and changes to legislation regarding exclusive decision competences and compensation guidelines will be introduced. This is done in order to create comprehensive understanding of the process of determining executive compensation.

One aim has been to reduce the amount of similar legal regulations presented in this work that would otherwise lead to a repetitive result with large amounts of overlapping legal texts.

I will introduce legislative proposals (Prop. 2005/6:186) on disclosure standards deriving from the Report: Swedish Business Society and Trust<sup>15</sup>, focusing on enhancement of regulative standards regarding disclosure on executive compensation. Focus will be on the proposed amendments<sup>16</sup> to The Swedish Annual Accounts Act (Årsredovisningslagen 1995:1554). I will also introduce amendments and proposal to changes in the Swedish Company Act (2005:551) regarding adjustment of decision-making competence between company organs/bodies, and a new mandatory item on the shareholder meeting agenda; compensation policies. The proposal to the Company Act will basically be introduced in order to allow comprehensive understanding of the process of determining executive compensation.

Soft law is gaining importance, not the least through the Swedish Code for Corporate Governance, bi-product of the mentioned report that I will return to later on in this paper. The magnitude of soft law as such is clearly stated in law source hierarchy<sup>17</sup>; it is considered least important after codifications and some other regulative standards according to the established hierarchy of legal material.<sup>18</sup> Therefore, only selected soft laws with immense relevance will be considered despite the extensive range of soft-law norms.

Based on the just mentioned hierarchy of legal material i.e. sources, no comparison will be made between the regulative and normative contents of the respective “pillars” as such. Such analysis is rather superfluous in this context, where the development and even more the categorization and the thereby connected consequences within the pillars is focus.

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<sup>15</sup> Discussion with Jakob Aspegren Swedish Department of Justice, division for Corporate and Business law and corporate Governance, stating that the Prop. 2005/6:186 is the only legislative work so far deriving from the report: Swedish Business society and trust (The Commission on Business Confidence, SOU 2004:47) and Swedish Code of Corporate Governance.

<sup>16</sup> Prop. 2005/06:186

<sup>17</sup> Bernitz, U., (2002) *Finna Rätt – Juristers källmaterial och arbetsmetoder*, 7:e upplagan, Elanders Gotab, Stockholm

<sup>18</sup> Hellner Jan, (2001) *Metodproblem i rättsvetenskapen – studier i förmögenhetsrätt*, Elanders Gotab, Stockholm

The purpose of the thesis contains no attempt to examine specific accounting disclosure standards. However, such standards may appear in the paper but without the aim of presenting them further.<sup>19</sup>

### **1.6.3 Corporate Theory Delimitating Considerations**

Institutional theory is introduced in order to create a holistic understanding of the issues from a threefold perspective: regulative, normative and cognitive. Subsequently the framework will be used to analyze and draw conclusions based on the three different “pillars” just mentioned above. Potential conflicts of integration and other aspects will be discussed in the analytical part in order to support the forthcoming conclusive reasoning of this paper. One part of the analysis, regarding the further developed thoughts already mentioned about the conflict between legal and business purposes. This part will focus on contra-productive consequences.

The agency theory and the asymmetry of information found therein is briefly presented in order to create a reference framework that aims to pinpoint the broad but still basic issues. The presence of the issues found therein are simply the problems that the initiatives aims to address, thus the basic problems for this entire thesis. Agency theory will hereinafter be referred to in the general discussion of corporate governance and specifically in conjunction with the main focus; restoring a proposed imbalance between agents and principals through new disclosure standards, as well as addressing issues of declining trust for corporate constituencies among society in general.

Society, as an explicit target for these initiatives constitutes the background upon which I present the stakeholder theory, only focusing on this group. The other relationship that is clearly stated as target and goal, owners and the company / managers is as already mentioned through the agency theory.

Trust, obviously a central concept throughout the entire discussion on measurements to be taken in Sweden and at the EU level. Trust is however not as frequent in the basic discussion by leading scholars on corporate governance as a concept. Since trust implies a vague and rather philosophical and anthropological aspect, I will not examine trust any deeper in this meaning. Trust just as business ethics, as well as ethics in general, concede the importance of morality as a cornerstone. However, definitions of morality are probably something that fills more pages than most other subjects in academic discussions do. Therefore, the philosophical question about the origin of ethics and its evolvement and heritage will not

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<sup>19</sup> It is estimated to take about 100,000 working hours to implement the new rules for non-US companies according to over 50% of the companies that are having a revenue exceeding \$20 billion. (Svenska Dagbladet, Näringsliv 2005-04-27 “Ny USA-lag kostar dryg miljard för de svenska storbolagen”, Interview with Peter Strandh, Internal Audit Expert at Ernst&Young)

be found in this paper. Nevertheless, it is always tempting and interesting to reinvent the discussion about morality, but it is not the right place to do it in a corporate law and business thesis. Neither is the purpose of this paper to introduce the different aspects of legal philosophy theory. Instead, I will only use small parts, or fractions of the reasoning about morality, ethics and other philosophy related theories when applicable

## **1.7 Target Group**

This paper is written for the cause of academia, i.e. individuals interested in corporate governance in general and executive compensation issues in particular. I would appreciate any interest that this paper will draw, and any contribution it would make to others.

## 2 Methodology

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*This chapter will outline the methodological considerations made in the process of writing this thesis. These considerations are essential and important, especially since this paper is broad in nature i.e. targeting more than one classic research area being legal and business. Therefore the methodological reasoning will be made from more than one perspective.*

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Within legal as well as business scientific studies scholars present their material based on different methodological approaches. An approach should define considerations made during the initial stage of the academic work in order to reach a scientific outcome.

The purpose of this paper is as mentioned relatively broad in scope, and therefore requires a methodological orientation towards both legal and business methodological theories. In order to justify the analysis and conclusions in the final part of the thesis, relevant methodological aspects of the considerations on how to get there will be made in this chapter. Business thesis and legal academic work normally differs in terms of methodological approaches.<sup>20</sup>

The area that this paper covers is to some extent equivalent to an integrative study. To a certain extent I will try to contribute to an interdisciplinary understanding of the issues by presenting a topic that touches upon legal, business and to some extent ethical principles. Hence, presenting the findings and analyzing them with academic references will hopefully provide an outcome, comprehensive from all of the above mentioned perspectives. Aim is to address the current situation and different aspects of both legal and business issues and the potential conflicts that might arise between them in this context.

### 2.1 Research Approach

Following the reasoning above, a combined research paper like this based on two distinct academic backgrounds also requires a parallel methodological take-off. On the one hand traditional legal dogmatic method and on the other research methods for social sciences, this will justify and to some extent simplify the interdisciplinary discussion to follow.

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<sup>20</sup> Business thesis methodology is based out of research methods for social sciences while legal academic work belongs to another research tradition, according to Hellner J., (2001) "Metodproblem i rättsvetenskapen – studier i förmögenhetsrätt", Elanders Gotab, Stockholm



As mentioned legal research methods differ quite severely from those that are used in the context of business research, consequently I will in the next sub-chapter: 2.1.1, present and later use the classic legal dogmatic research approach. This methodological approach will first and foremost be used when presenting the regulative as well as the normative initiatives that have been made on the area, which are presented under the regulative chapters of the applied institutional theory. In sub-chapter: 2.1.2, the reader will be introduced to the business methodological approach.

## 2.1.1 Legal Dogmatism

The aim of the judicial academic discipline is to present positive law. Starting point for this research is the material used by courts as basis for their work. This is comprised of court rulings, preparatory legal work, regulations and precedents. In other words all sources of law.<sup>21</sup>

The former disparaging term, legal dogmatic<sup>22</sup>, has earned better reputation, now considered one of the more accepted legal methods. Legal dogmatic method aims to describe and analyze positive law, but without any further description of what specific elements of analysis this would include. Knowing law is knowing a society, and this applies to the arguing about the definition of the legal dogmatic method, i.e. a holistic review of the entire legal sphere. This often includes other judicial institutions and related work other than that of courts. Nonetheless, the ongoing discussion divides scholars. Acceptance of a thorough and wider perspective of the method, or a rather hierarchical approach, relating to rang within the sources of law.<sup>23</sup>

An interesting border lining discussion on how strict legal rules shall be interpreted is following the reasoning of Ekelöf, and his ideas on theological methodology. He advocates that the purpose of the rule and its application on clear target cases has to be put forward also when determining more complicated applications of legal rules. Big effort is put upon semantic reasoning about legible meaning of legal texts, however, Ekelöf means that this has merit but has to be distinguished between “the core of the meaning” and “the penumbra of the meaning”. However, according to this approach legal institutions shall be careful when applying legal rules on less clear situations.<sup>24</sup>

Nystöm argues more specifically on legal dogmatic methodology, and says that the legal dogmatic method without problem can be accompanied by

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<sup>21</sup> Hellner Jan, (2001) *Metodproblem i rättsvetenskapen – studier i förmögenhetsrätt*, Elanders Gotab, Stockholm

<sup>22</sup> The Swedish term legal dogmatism, Rättsdogmatik, probably has its origin in the German term Rechtsdogmatik according to: Hellner Jan, (2001) *Metodproblem i rättsvetenskapen – studier i förmögenhetsrätt*, Elanders Gotab, Stockholm

<sup>23</sup> Hellner Jan, (2001) *Metodproblem i rättsvetenskapen – studier i förmögenhetsrätt*, Elanders Gotab, Stockholm

<sup>24</sup> Ekelöf, P-O., (2002) *Rättegång I*, 8:e upplagan, Norstedts juridik, Elanders Gotab, Stockholm

other methodological frameworks. The classic legal dogmatic method shall be applied when traditional sources of law are at hand. Nevertheless, other methodological approaches, such as descriptive and generalizing i.e. deducting, are according to Nyström sufficient in highlighting other interesting aspects of an issue. Especially on areas where legal methodology is insufficient or rather where it is normally not used.<sup>25</sup>

In this thesis the legal rules will be put in their context, which is something that I will return to when discussing the initiatives by the government under the institutional theory. A question to be asked is: what sub-area was to be addressed by the government when intervening through regulative tools; the regulative, the normative, the cognitive or maybe even all of them.

According to Hobbes the hierarchy between the different constituencies that works with law is described in the following way:

*“The Authority of writers, without the Authority of the Commonwealth, maketh not their opinions Law, be they never so true”.*<sup>26</sup>

## 2.1.2 Relevant Business Research Methods

In academic work stemming out of business schools, scholars frequently reason about two different research approaches, inductive and deductive. The inductive approach is based out of empirical data, which is basis for the analysis and conclusions. A deductive approach is based out of theories, from which logical reasoning, conclusions and predictions about the future are drawn.<sup>27</sup>

Since empirical data on tendencies and other rather intangible attitudes among people and companies in general is hard to collect, and even more so, when considering the relative age of the focus areas and issues of this thesis. From a logical point of view this thesis will have a deductive approach. Different theories will be taken into account when examining the issues of this paper, and subsequently apply parts of the theories on an institutional theory base together with government initiatives, from which later analysis and conclusions will be drawn.

In order to present the material and to give the reader a good understanding of the background principles of relevant, to some extent legal, and business theories, a comprehensive literature study will be conducted. Due to Jacobsen, document studies are applicable when collection of primary data,

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<sup>25</sup> Nyström, B., (1990) *Mediation in labour disputes – A judicial study of the Swedish system in a comparative Nordic perspective*, Norstedts Förlag, Stockholm

<sup>26</sup> Th Hobbes, *Leviathan* (1651) chapter 26 page 143.

<sup>27</sup> Lundahl, U., Skärvad, P-H., (1999) *Utredningsmetodik för samhällsvetare och ekonomer*, Studentlitteratur, Lund and Bell, E., Bryman, A., (2003) *Business research methods*, Oxford University Press, New York

for example through interviews is hard or impossible to carry out. Extensive doctrine and other written material have been screened, from which two subgroups are easy to distinguish. Official legal texts and materials on the one hand, and published literature by both legal and business nature written by academic scholars and others, on the other hand.<sup>28</sup>

Parallel to determining between the above-mentioned inductive or deductive research approach, another consideration when conducting a study is whether to use a quantitative or qualitative research method.<sup>29</sup> Quantitative methods, where numbers, or as in this case written sources might indicate patterns, or again on issues like the ones analyzed here: tendencies. Wherefrom later the already mentioned deductive conclusions can be made. A qualitative method implies openness towards new information, which is crucial when studying for example rules and standards, where only one approach is given.<sup>30</sup>

Nonetheless, at the same time as a large part of the essay shall be considered as a quantitative and deductive document study, another part, the regulative, not only including codification proposals. But also soft laws and other recommendations should rather be categorized as inductive and qualitative. Hence, as Jacobsen, and others, emphasize: document- or literature- studies, can be considered both quantitative and qualitative. Large parts of the information is conducted from academic articles and other related work, where different opinions can be collected from different authors, there through patterns and tendencies can be recognized.<sup>31</sup>

In analysing the legal situation in Sweden and the EU, except from the above introduced legal dogmatic method, to some extent a comparative perspective will be used in the analysis to highlight the most important aspects of the development and key issues.<sup>32</sup>

This perspective is rather interdisciplinary compared to be on the one or other side of the methodological considerations arena. With help from this perspective development of both legal and business characteristics will be brought to light, even more important; issues where legal and business aspects potentially leads to conflict thanks to initiatives on the Swedish as well as the EU level will be studied. From an international business point of view, with increasing regional and global interference between competing companies, new standards if geographically limited to countries or sub-parts of regions can have immense effect on businesses.

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<sup>28</sup> Jacobsen, D., I., (2002) *Vad, hur och varför? Om metodval i företagsekonomi och andra samhällsvetenskapliga ämnen*, Studentlitteratur, Lund

<sup>29</sup> Lundahl, U., Skärvad, P-H., (1999) *Utredningsmetodik för samhällsvetare och ekonomer*, Studentlitteratur, Lund

<sup>30</sup> Jacobsen, D., I., (2002) *Vad, hur och varför? Om metodval i företagsekonomi och andra samhällsvetenskapliga ämnen*, Studentlitteratur, Lund

<sup>31</sup> Jacobsen, D., I., (2002) *Vad, hur och varför? Om metodval i företagsekonomi och andra samhällsvetenskapliga ämnen*, Studentlitteratur, Lund

<sup>32</sup> Rienecker, L., Jörgensen, P., S., (2002) *Att skriva en bra uppsats*, Liber, Wallin & Dalholm, Lund

### 2.1.3 Selection of Material and Sources

The legal material is compiled from different sources, being judicial libraries, official government homepages and databases. Laws are officially published, while preparatory work is to be found on the governments respective departments' homepages. Documents on preparatory work are often released in draft versions at every stage of the legislative process. Since the discussed regulative material is new, there is no previous material to work with on the specific focus areas of this paper. The same applies for the EU, where preparatory work, which is a major source of law in Sweden, hardly exists at EU level.

Comments on the legal material done by scholars, as well as other academic articles and doctrine is partly selected upon a availability basis. The same problem as already mentioned above also applies to this area, where the relative age, with a new legal proposal, with limited research on the area is holding back material supply. Published sources are so far scarce. However, regarding some of the areas that are covered in this paper, many publications are to be found. Legal and business related doctrine will be referred to on frequent basis throughout the paper. When conducting document studies personal, being scholars, and institutional sources are mostly available. To distinguish between the two and also between official and non-official sources makes sense since this can be used when evaluating the general quality of the source. Knowledge and competence are leading words when assessing the quality of a source. Jacobsen emphasize that parallel with this assessment relative correlations between the sources shall be made in order to reach a sufficient level of independence and through that, merit to arguments made.<sup>33</sup>

#### 2.1.3.1 Primary and Secondary Sources

Legal preparatory work must be considered semi-primary when codifications, regulations and laws are considered primary sources.<sup>34</sup> Secondary sources however, come into account both in describing the legal framework and its' development. Leading scholars and academic researchers often create such material. Secondary sources will also constitute the predominant point of influence for the overview of the relevant business principles.

In business research it is relatively common to include empirical data in academic work, however since this study aims to present potential

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<sup>33</sup> Jacobsen, D., I., (2002) *Vad, hur och varför? Om metodval i företagsekonomi och andra samhällsvetenskapliga ämnen*, Studentlitteratur, Lund

<sup>34</sup> See chapter 2.1.1 Legal Dogmatism and Hellner Jan, (2001) *Metodproblem i rättsvetenskapen – studier i förmögenhetsrätt*, Elanders Gotab, Stockholm, regarding rang and hierarchy in sources of the law.

consequences, primary sources would only give limited and probably arbitrary contribution, thus no significant value to the essay. Therefore, almost all theoretical references are secondary sources, being doctrine.

### 2.1.3.2 Criticism of Sources

As initially mentioned a clear definition of the corporate governance body is rather difficult to distinguish. The regulative and theoretical extent, to which the subject relates, is by nature wide, with no or vague lines that divides parts and subordinated material from each other. Validity in this context is to focus on relevant parts of the material in order to support and justify the eventually presented analysis. Validity is to study the right object.<sup>35</sup>

Reliability is about correctness; hence, in a qualitative deductive study the only way to enhance the level of reliability is to use as many primary sources as possible. In the case of secondary sources, which importance is crucial in giving academic and professional weight to discussions the best way must be to use several opinions in supporting argumentation. Especially in controversial circumstances or where a paradigm is challenged or unconventionally assessed.<sup>36</sup> To some extent, political or other personal thoughts will reflect doctrine produced by professors and thereby considered arbitrary. This is a fact that is unavoidable! Political agendas will possibly also reflect other initiatives, even though objectivity by nature is an issue i.e. in the Swedish Code Group, led by a former minister.<sup>37</sup>

Course of action; the study carried out for this paper is as mentioned primarily based on primary and secondary sources. The materials are compiled out of official and mainly publicly accessible sources of information. Hence, the study is replicable.<sup>38</sup>

## 2.2 Applicable Business Theories

This thesis will predominantly be based on a structure of institutional theory. This theory outlines three distinct parts: cognitive, regulative and normative. This is done in order to explain actions taken by the Swedish Government within an institutional context. I will examine whether there are any contra productive consequences connected with different governmental and EU initiatives to address issues that have aroused.

Corporate misbehaviour and scandals have affected all three pillars of the institutional theoretical body and therefore analysis will be made based on

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<sup>35</sup> Holme, I.M., Solvang, B.K.,(1997) *Forskningsmetodik* Studentlitteratur Lund

<sup>36</sup> Holme, I.M., Solvang, B.K., (1997)*Forskningsmetodik* Studentlitteratur Lund and Bell, E., Bryman, A., (2003) *Business research methods*, Oxford University Press, New York

<sup>37</sup> Report of the Code Group, SOU 2004:130

<sup>38</sup> Bell, E., Bryman, A., (2003) *Business research methods*, Oxford University Press, New York

the in later chapters outline contents of the three. The cognitive perspective is normally presented as the last of the three, but I have chosen to change the order when presenting the applied model. The reason for this is that I have made the basic assumption that the Swedish government recognized a change in the ethical, i.e. cognitive behaviours of corporate directors and managers and thereafter took action. The commission of Business Confidence is one example of such initiatives. Similar initiatives are, at this time, taking place on a parallel level in other countries in the European Union, and for this thesis, even more interestingly on the EU level.

In giving nuances to the legal, or regulative, part of this thesis, the basic problem with separating ownership from control will be further developed through presenting agency theory and in particular the therein found information asymmetry. This will highlight one of the problems in agent theory. Consequently, managers running the company, and the owners wanting return on their equity.<sup>39</sup> Information asymmetry constitutes one of the fundamental conceptions about fundamental imbalances between agents and principals. One of the aim with this thesis is to examine how new disclosure rules might have consequences for the company, its owners and even managers not considered when regulating on the area.

The relationship between managers / companies and society in general will also be highlighted through a short presentation of the classic stakeholder model. Herein will the relationship between managers on the one side and the from a constituency point of view largest actor in the stakeholder model, society, since the government has emphasized its' importance in their initiatives, presented.

## 2.3 Combined Approach

I will combine several methodological approaches. According to Jacobsen, based on the tentative nature of this problem an explorative methodological approach would be conceivable.<sup>40</sup> The explorative approach aims to lubricate the process of acquiring knowledge about the unknown. Partly this thesis aims to highlight tendencies and patterns that not yet have been comprehensively researched.

Based on both the legal material and the presented business aspects and principles I will vitalize the aim of an overall deductive methodological approach and analyze the issue at hand. Logical reasoning, analytical discussion and conclusions are drawn upon this approach, together with the applied legal dogmatism on the legal study of this paper. Thus, a somewhat explorative approach that has both inductive and deductive flavors to it, which according to Jacobsen is the “pragmatic” and best approach. This

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<sup>39</sup> Shleifer, A., Vishny, R., (June 1997) *A Survey of Corporate Governance*, The Journal of Finance, Vol. LII, No.2

<sup>40</sup> Jacobsen, D., I., (2002) *Vad, hur och varför? Om metodval i företagsekonomi och andra samhällsvetenskapliga ämnen*, Studentlitteratur, Lund

paper is to a large extent of descriptive character, which following the just mentioned reasoning on the methodological approach necessary to get a comprehensive and sufficient introduction to aspects of the studied material, which will lead to an integrated conclusive completion of the paper.<sup>41</sup>

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<sup>41</sup> Jacobsen, D., I., (2002) *Vad, hur och varför? Om metodval i företagsekonomi och andra samhällsvetenskapliga ämnen*, Studentlitteratur, Lund

## 3 Frame of Reference

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*This section will introduce the reader to the academic theories, i.e. business principle(s) / model(s) that I use to establish relevant theoretical references. Through institutional theory, a broad fundamental principle is ascertained, upon which I in latter chapters will base my analysis, and upon which I will draw my conclusions.*

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### 3.1 The Fundamentals of Corporate Governance

One of the more established definitions of Corporate Governance was made by Andrei Shleifner and Robert Vishny in the article “A Survey of Corporate Governance” in 1997, which eventually became an academic breakthrough and considered one of the most important texts on this relatively new area of research. The article pinpoints the obvious interests of investors to get their money back from managers who handle financial i.e. monetary means that do not belong to them.<sup>42</sup> Executive compensation issues have to be considered as an important part of the larger corporate governance body, and are often limited to involve constituencies like shareholders, managers and boards of directors. Nevertheless, as already mentioned, society in general is by definition a vague, but still, especially from a reputation point of view an important constituency in this context. Another important and fundamental aspect brought to light in the groundbreaking article “Law and Finance” by La Porta et al, is the disagreement on structure of compensation; managers on one side with a preference for as much fixed salary as possible and shareholders on the other with bias for performance driven compensation systems.<sup>43</sup>

For some time, Corporate Governance has gained increased attention; not the least through the mandatory educational part at most law faculties and business schools all over the world. Meanwhile, it has become a policy requirement in corporations, and it is said to be important for companies to have a well-defined corporate governance approach. Board meetings, press releases and corporate homepages are now being flooded with corporate governance declarations.

Shleifner and Vishny defined Corporate Governance as:

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<sup>42</sup> Shleifner, A., Vishny, R., (1997) *A Survey of Corporate Governance*, The Journal of Finance, Vol. LII, No.2

<sup>43</sup> La Porta, R. et al, (1998) *Law and Finance*, Journal of Political Economy, Vol. 106, No. 6



*“ The ways in which suppliers of finance to corporations assure themselves of getting a return on their investment ”<sup>44</sup>*

OECD, The Organisation for Economic Co-operation and Development has defined corporate governance and given its definition the credibility that emerges from such a diverse and numerous member base. OECD emphasizes the importance of both the internal as well as the external parties in the corporate governance relationship in its definition. Nonetheless, the organisation recognizes the consensus among all those in order to establish growth for companies in general, and further development of the markets on which they act.<sup>45</sup>

## **3.2 The Paradox of Disclosure**

Herein two different sides will be introduced, stated by two sides of leading American scholars that argue over the importance of disclosure standards on executive compensation. On the one side, Bebchuck and Fried arguing for total transparency. On the other side, Iaccobucci, who is raising his flag for problems that might arise when going too far with executive compensation disclosure standards. Articles from other, some of them less credential, scholars will be presented in conjunction with the just mentioned texts.

### **3.2.1 Disclosure and Transparency**

Bebchuck and Fried make a distinct difference between disclosure and transparency, where they emphasize that the more important of the two is transparency. They further argue that disclosure is just a means to reach a higher level of transparency. However, the importance of disclosure as such is stated by Thompson and Sale, still they agree on the overall aim of

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<sup>44</sup> Shleifner, A., Vishny, R., (1997) *A Survey of Corporate Governance*, The Journal of Finance, Vol. LII, No.2

<sup>45</sup> OECD (2004) Principles of Corporate Governance *“Increasingly, the OECD and its member governments have recognised the synergy between macroeconomic and structural policies in achieving fundamental policy goals. Corporate governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence. Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth.”*

<sup>45</sup> Bebchuck, L., Fried, J., (2004) *Pay without Performance – The unfulfilled Promise of Executive Compensation*, Harvard University Press, Cambridge, Massachusetts, and London, England

disclosure.<sup>46</sup> That aim is to not only inform a small number of market analysts, but to reach a broad group of people in order to provide a check on executives' compensation packages. Today's standards are of a more technical nature and might serve the purpose of pricing the companies' securities. In order to fulfil its aim, the information has to reach beyond Wall Street and a selected number of analysts and arbitrageurs. Transparency for the good of shareholders i.e. principals will be good for the company.<sup>47</sup>

Moreover, executives seem to be concerned about disapproval from different reference groups, such as institutional investors and other similar constituencies. More interestingly, they are afraid of the mass media and the impact of the popular press on their reputation through their like or dislike of the disclosed information.<sup>48</sup> This is probably the reason why compensation designers and consultants' attempt to make part of the compensation package that is least connected with any form of performance less transparent.<sup>49</sup>

### **3.2.1.1 Monetary Value**

In order to further enhance the transparency level of the remuneration system, a factual monetary value of all compensations should be disclosed together with the other information disclosed about compensation. Bebchuck and Fried argue that this should include every form of compensation, such as post retirement compensation, deferred balances and consulting arrangements or in some way concealed, so called "stealth" compensation.<sup>50</sup>

### **3.2.1.2 Full Disclosure of Contracts**

Another disclosure procedure that would enhance transparency of executive compensation is a development of disclosing contracts into a mandatory standard, where the company attaches the latest version of the most important executive contracts to their annual reports. However, disclosing even more information written in a cryptic way to a small number of people is pointless. Therefore, the new standards with the above discussed dollar value principle should be implemented in this context. This would supply

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<sup>46</sup> Thompson, R., B., (2003) *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 Vand. L. Rev. 859

<sup>48</sup> Dyck, A., Zingales, L., (2002) *The Corporate Governance Role of the Media*, Harvard Business School and University of Chicago

<sup>49</sup> Bebchuck, L., Fried, J., (2004) *Pay without Performance – The unfulfilled Promise of Executive Compensation*, Harvard University Press, Cambridge, Massachusetts, and London, England

<sup>50</sup> Bebchuck, L., Fried, J., (2004) *Pay without Performance – The unfulfilled Promise of Executive Compensation*, Harvard University Press, Cambridge, Massachusetts, and London, England

the outside world with a fair and understandable table of information about the actual compensation executives are given by the companies.<sup>51</sup>

Those measures should constrain companies from making camouflage arrangements, in order to refrain from public disgrace and costly mass media bad will, as well as increase the shareholder value. By adopting these means, companies would easily reach a higher level of transparency and therefore contribute to overall improved compensation arrangements.<sup>52</sup>

### 3.2.2 The Other Side

Iacobucci advocates that there is a difference in attitude towards different kinds of highly compensated groups. He emphasizes that only corporate executives, and to some extent politicians, are object to extreme scrutiny regarding their compensation schemes. He argues that there are surprising differences towards highly compensated groups in society. As mentioned executives are a target group for intense sceptical critique, while for example athletes and entertainers etc. seldom or never are shot at with the same rhetoric's as executives. He continues that very high executive compensation might have undesirable political effect i.e. render in explicit regulation and potentially such regulation, or rather the discussion might impose political cost to the company's relationship to interface parties, such as customers and other employees. Thus, non-involved in the relationship conflict that is target for regulation, i.e. principal agent.<sup>53</sup>

At the same time as disclosure of executive compensation is good when actively building a reputation for the company, even more important after conducted misbehaviours and the company has to restore reputation and demonstrate that shareholders are taking action against undesired patterns within the company. However, disclosure of information is only partly giving receivers complete information. Absolute numbers, will only give limited understanding of the level of compensation and mainly related to other absolute numbers. The lack of performance measures and absence of correlation between pay and performance is obvious. According to Iacobucci the debate on sensitivity of pay to performance that follows disclosure and enhanced standards is a positive externality. Critics of executive compensation want just this, enhanced correlation between pay and performance. They unfortunately do not fully complete the chain of thoughts, and argues that compensation shall be fair and set to an arbitrary figure that seems to belong in a fuzzy sense of what's fair. Hence, straight salary is the only compensation scheme that is ideal and implies enough

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<sup>51</sup> Bebchuck, L., Fried, J., (2004) *Pay without Performance – The unfulfilled Promise of Executive Compensation*, Harvard University Press, Cambridge, Massachusetts, and London, England

<sup>52</sup> Bebchuck, L., Fried, J., (2004) *Pay without Performance – The unfulfilled Promise of Executive Compensation*, Harvard University Press, Cambridge, Massachusetts, and London, England

<sup>53</sup> Iacobucci, E., (1998) *The effects of disclosure on executive compensation*, Vol. 48, No. 4, University of Toronto Law Journal

predictability, still the problem of performance remains but can be set through levels of set compensation.<sup>54</sup>

The main problem with making compensation transparent and public is the possibility of executives to benchmark their own compensation to others. According to Iacobucci, such information provides executives with ammunition to raise their pay further. Interestingly, the case is likely to go upwards since the following pattern is present: two executives with comparable jobs will lead to upon detection on the competitors salary the lower paid CEO will likely force his employer to adjust his compensation to that over the better paid instead of the other way around.<sup>55</sup>

Dotevall, advocates that as reason for ever increasing compensation levels the human interest in always be at the top is reason for being fully satisfied with 100, until information about that someone else is getting 125 comes to knowledge. At this point the person, who was satisfied with 100, suddenly wants 150 or at least 125 in order to restore his position. Consequently, humans seem to be more interested in their relative income instead of realising what they get in absolute numbers. Dotevall concludes with realising that accessibility to information on remuneration of others, i.e. disclosure on executive compensation might have just the above-mentioned undesired effect on general compensation levels.<sup>56</sup>

Interestingly, NBK (referred to in the next chapter) recognizes the problem of confidentiality and integrity in terms of publicly publishing compensation information of individuals. More importantly, business and competition problem aspects of individual disclosure standards might have negative impact on the business. Nevertheless, NBK thinks that the argument for making such information transparent should be exclusive for the company's top management and for no other group.<sup>57</sup>

The Swedish Code for Corporate Governance, with its' extensive rules that takes time away from board members and others, thus giving executives less time to focus on how to continue and develop business in the best way might be an argument for delisting. If this is the case Lennart Låftman, a credible name in the debate, argues that both parties for the stock market as well as those from the regulative side are urged to revise their positions.<sup>58</sup>

According to Westholm, the Swedish government has done everything wrong from an institutional theory point of view. First, the government, in a

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<sup>54</sup> Iacobucci, E., (1998) *The effects of disclosure on executive compensation*, Vol. 48, No. 4, University of Toronto Law Journal

<sup>55</sup> Iacobucci, E., (1998) *The effects of disclosure on executive compensation*, Vol. 48, No. 4, University of Toronto Law Journal

<sup>56</sup> Dotevall, R., (2005) *Kontrollen över ersättningsnivåerna i näringslivet ur ett internationellt perspektiv*. Intressekonflikter och finansiella marknader, Nord, G., (editor) and Thorell, P., Stockholm 2006

<sup>57</sup> The Swedish Industry and Commerce Stock Exchange Committee (NBK) on Rules Concerning Information about Benefits for Senior Executives (2002)

<sup>58</sup> Dagens Industri, April 13th 2006, "Gambroköpet en varning till börsen"

social democracy, chooses to intervene with regulation in the first place instead of letting the market powers, and actors self-regulate the market at any extent. Westholm advocates that government intervention is an outdated tool, and is supposed to be hurting more than helping the cause, which the intervention aims to address. Secondly, he emphasizes the problem of unreliability with the normative sectors self-regulating gatekeepers, from several reasons. Mainly due to the incompetence among journalists, together with the interest in publishing bad-will on corporate themes. Westholm argues that since journalists, mainly, are uneducated within business and economics there is a risk that they do not assess their sources and material properly and instead develops a bias towards the opinion of others. Thirdly he advocates that the initiative, cognitive or not, has immense negative impact on the business society in general. He argues that the establishment of a commission to investigate and enhance declining trust is contra productive in itself. The logic for the arguments is simplified through the example with the basket full of apples. If one apple proves to be rotten, this is no guarantee that all the other also are rotten. Consequently, Westholm is giving the Swedish government part of the responsibility of declining trust for corporations. The government, the institution has the privilege of formulating the issue, therefore they have been able to label the situation as “confidence-crisis” in society, with all affects that will have.<sup>59</sup>

Mats Qviberg, a respected commentator in Swedish financial press made a statement recently where he pointed out new legislation and the Swedish Corporate Governance Code and other transparency enhancing tools as dangerous to the development of the entire securities market in Sweden. In combination with a bull market for private equity companies and funds, partly due to the favourable interest rates, a large discontent with the problems that it means to be listed at the Stockholm Stock Exchange and elsewhere was gaining attendance and sympathy according to Qviberg. When the main reason to delist GambroAB, a Swedish pharmaceutical company is that the owners believe that the company will develop better outside a public marketplace at this time. According to Pontus Schultz, chief editor at the Swedish financial newspaper “Väckans Affärer”, in conjunction with reference to Qvibergs statement, he concludes that companies in general lack a strong and clear owner that is bringing the company forward. Gambro is a prime example of the opposite where weak owners, primarily institutions have less engagement and no sense of initiative and drive.<sup>60</sup>

This new phenomenon is mainly conducted by private equity companies and funds that are not only delisting companies from the worlds stock exchanges, but also bring along some of the most respected executives from publicity into a world released from disclosure standards and discussion on transparency, stealing focus from business. Several former CEOs express their relief in leaving public firms where public investors and their obsessed

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<sup>59</sup> Westholm, C-J. (2004) Ska näringslivet skämmas? Brev till företagare och anställda direktörer, Timbro förlag

<sup>60</sup> Veckans Affärer, Schultz, P., ”*Skyll er själva för börsflykten!*” No. 15-16, April 10th, 2006

focus on quarterly earnings in contrast to their new surrounding with long-term strategy of private equity actors. Attraction is said to be twofold for executives, money and freedom. The average fixed salaries are not spectacularly, but on the other hand executives in private equity often have a cut in the companies.<sup>61</sup>

### 3.3 Institutional Theory

The institutional theory is based upon the social structures that might affect our behaviour. Institutions in different kinds of forms constitute preconditions for our different activities and give us the structures and forms for our behaviour. The theory describes the correlation between parties in any given institution. In this thesis, I will refer to the Swedish government as the institution and refer to the structure and patterns it creates when giving the regulation for enhanced corporate governance, more specifically as already mentioned, new and enhanced disclosure standards on executive compensation. The structures and social behaviour that the “Institutions” create are not fixed and consequently they will change gradually in line with changes in society. According to this theory there are at least three different ways of how the institutional structures affects our behaviour;<sup>62</sup>

- *Cognitive structure*
- *Regulative structure*
- *Normative structure*

The cognitive structure describes how the institutions form the knowledge of individuals and groups. This structure focuses on knowledge. The institutions affect the behaviour in the sense that it provides for a common general picture which will influence rational choices to be made. This general picture will constitute a frame that will help individuals better understand the world. In the cognitive structure, the common idea on how to act, affects the behaviour more than deterrent rules or bad consciousness.<sup>63</sup>

The regulative perspective is the way to explain effects from regulations that form our behaviour. Rules can force people both directly and indirectly to act or refrain from acting in a certain way. Legislation and contracts are examples of regulative structures that can be considered regulative framework. Behaviour is controlled by the regulative rules, thus if they include a deterrent effect, it will make people act rationally.<sup>64</sup> However, it is

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<sup>61</sup> Business Week, by Emily Thornton, February 27, 2006 ”Going Private – Hotshot managers are fleeing public companies for the money, freedom and glamour of private equity”

<sup>62</sup>Nygaard, C. (Red.), Bengtsson, L., (2002) ”Strategizing – en kontextuell organisationsteori”, Studentlitteratur, Lund

<sup>63</sup> Nygaard, C. (Red.), Bengtsson, L., (2002) ”Strategizing – en kontextuell organisationsteori”, Studentlitteratur, Lund

<sup>64</sup> Nygaard, C. (Red.), Bengtsson, L., (2002) ”Strategizing – en kontextuell organisationsteori”, Studentlitteratur, Lund

important to recognise that fear and force alone is not an efficient way to implement rules, instead a belief in the legitimacy should be cultivated.<sup>65</sup>

From an economic perspective, regulation is connected with high costs. This becomes very clear in relation to agency theory and the costs associated with monitoring.<sup>66</sup>

The normative structure is based on the theory that institutions form the behaviour through common norms; what is right and what is wrong. Institutions provide a common moral standard which can guide individuals. The normative structure is more informal than the regulative structure and is often more internalized within small groups, associations or directly in different professions. In normative structures, exclusion from the group rather than deterrent rules is more frightening and therefore more efficient as deterrence.<sup>67</sup>

Breaking this down in more detail the normative pillar can be said to consist of values and norms. Values are perceptions of the preferred or desirable. These values also form a standard against which structures and institutions can be assessed and compared. Norms on the other side, gives instructions to how things should be done and stipulate legitimate means to do it.<sup>68</sup>

## **3.4 Relevant Corporate Theories**

The following sub-theories aims to lubricate understanding of the focus groups. Basic issues between society in general and companies as well as the already mentioned problem between managers and shareholders will be theoretically connected.

### **3.4.1 The Importance of Society as Stakeholder Constituency**

The societal interest in corporations, as to even consider society a stakeholder constituency, according to Nygaard, is primarily based on an ideological interest in the activities conducted by a corporation. Such interest is normally limited to environmental policy, corporate social responsibility and so on. In order to keep legitimacy in regards to all stakeholders, the company has to answer to all requirements put upon it. This is called stakeholder management.<sup>69</sup>

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<sup>65</sup> Scott, W., R., (2001) *"Institutions and Organisations"*, Sage Publications, London

<sup>66</sup> Scott, W., R., (2001) *"Institutions and Organisations"*, Sage Publications, London

<sup>67</sup> Nygaard, C. (Red.), Bengtsson, L., (2002) *"Strategizing – en kontextuell organisationsteori"*, Studentlitteratur, Lund

<sup>68</sup> Scott, W., R., (2001) *"Institutions and Organisations"*, Sage Publications, London

<sup>69</sup> Nygaard, C. (Red.), Bengtsson, L., (2002) *Strategizing – en kontextuell organisationsteori*, Studentlitteratur, Lund

Owners, employees, suppliers and customers are often considered internal stakeholders, while governments, mass media and society in general belong to the external. To distinguish between internal and external stakeholders is not a clear differentiation, since external can easily become internal. Vice versa is less common. Carroll introduces several requirements that arise due to the relationship between a company and its stakeholders:<sup>70</sup>

- Interests
- Rights
  - Legal rights
  - Moral and ethical rights
- Ownership

The company has responsibilities to react and maybe even respond to the mentioned requirements. Just like the demands from the counterpart, these will be oriented towards economic, legal, ethical and even philanthropically pretensions. Economic interest, might justify a transformation from being external until becoming internal.<sup>71</sup>

For example, companies have, through laws and other regulations, clearly stated antitrust and marketing directives. Employees, through their contracts as well as the corporate environmental policies, might also be subject to such protection, which most certainly puts restrains on companies in most countries. Aspects like this are likely to fall under the category of moral and ethical rights, i.e. requirements that stakeholders have on a company.<sup>72</sup>

### 3.4.2 Agency Theory

Many would probably argue that the early discussion by Berle and Means<sup>73</sup> regarding the dilemma of separating ownership from control, and later the principal-agent theory by Jensen and Meckling,<sup>74</sup> have laid foundation for many other academic disciplines, maybe even Corporate Governance. Despite many years of research and corporate evolution, it seems like the problem is still rather unsolved.

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<sup>70</sup> Carroll, A., B., (1996) "Business and Society. Ethics and Stakeholder management", South Western College Publishing. Cincinnati, OH

<sup>71</sup> Carroll, A., B., (1996) "Business and Society. Ethics and Stakeholder management", South Western College Publishing. Cincinnati, OH

<sup>72</sup> Nygaard, C. (Red.), Bengtsson, L., (2002) *Strategizing – en kontextuell organisationsteori*, Studentlitteratur, Lund

<sup>73</sup> Berle, A., Means, G., (1932) *The modern corporation and the private property*, Harcourt, Brace and World, New York

<sup>74</sup> Jensen, M., Meckling, W., (1976) *Theory of the firm: Managerial behaviour, agency costs and ownership structure.*, Journal of Financial Economics



The following overview outlines the basic assumptions in the relationship between the principal, in this case the owner, and the agent being manager in a corporation context<sup>75</sup>.

- Both the principal and the agent are wealth maximizing individuals
- Target conflict between principal and agent
- **Information asymmetry between the parties**
- The agent is opportunistic
- The agent is acting based on limited rationality
- The agent is risk avert

### 3.4.2.1 Information Asymmetry

Together with the above-mentioned problem with balance of monetary means, information asymmetry is one of the main problems within the agency theory. Basically, investors have put their funds in the hands of managers that are supposed to give them return on their invested equity. The obvious problem for principals is, of course, how to control managers and get them to return some of the profits. They also want to avoid that capital and assets are stolen from them or invested in bad projects.<sup>76</sup>

Information as such is a crucial asset in this context, especially since the theory assumes that decisions should be made based on perfect information, and that the fact that the principal lacks information about the agent's behaviour. The asymmetry is primarily unbeneficial for the principal since he is unable to assess the given compensation related to the contribution by the agent.<sup>77</sup> Furthermore, the agency theory states that if the principal based on his primary means of power cannot oblige the agent to contribute with a defined result, the principal should try to manipulate the agent's wealth or utility maximization. Such action is justified by the basic assumptions listed in the previous subchapter; the agent is supposed to be opportunistic and tries to minimize his contribution and maximize his compensation. Hence, the opportunistic behaviour of the agent is severely contributing to the target conflict that is present between the parties.<sup>78</sup>

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<sup>75</sup> Nygaard, C. (Red.), Bengtsson, L., (2002) *Strategizing – en kontextuell organisationsteori*, Studentlitteratur, Lund

<sup>76</sup> Shleifner, A., Vishny, R., (June 1997) *A Survey of Corporate Governance*, The Journal of Finance, Vol. LII, No.2

<sup>77</sup> Polinsky, A., M., (2003) *An Introduction to Law and Economics*, Aspen Publishers, New York

<sup>78</sup> Nygaard, C. (Red.), Bengtsson, L., (2002) *Strategizing – en kontextuell organisationsteori*, Studentlitteratur, Lund

### 3.4.3 Business Ethics and Trust

A contradiction emerges already in the terminology “business ethics” that insinuates that the discussion about business people having an ethical awareness is superfluous. In contrast to this, changes in our society seem to take place in the opposite direction than the assumed after reading the capture of this paper. Scholars mean that the trend is movement from a materialistic to a post materialistic value base. Hence, this would mean that we are approaching a general change in the ethical trend.<sup>79, 80</sup>

Research repeatedly present articles and materials stating that Sweden is a society of trust. They say: Sweden has close to zero level of corruption and a hand shake should be enough to make business.<sup>81</sup> The fact that over half of the Swedish population directly or indirectly owns shares is proof of a high level of belief in corporations to thrive sound businesses. However, ownership remains concentrated, which might indicate that other factors than those based on trust are predominant, in developing a more disbursed ownership structure.<sup>82</sup>

When adopting a legal rule that owns origin from a normative context, the legislator is signaling that the regulation is especially important. Even more if the rule is based on a social norm, such as loyalty duties in the corporate context, deriving from behavioural patterns.<sup>83</sup> This is important when considering the importance of trust, which is argued by Blair and Stout to be determined by the social context, i.e. subject’s perceptions of other’s beliefs, expectations, actions and relationship to themselves. They advocate that social framing is the key when cooperative personalities are born. Hence, social norms and context behaviours and trust are all correlating with each other in creating trust.<sup>84</sup>

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<sup>79</sup> Brytting, T., (1998) *Företagsetik*, Liber Ekonomi, Malmö

<sup>80</sup> An interesting concept within ethical theory regarding information asymmetry is the one about the communicative human that is solving all ethical problems with communicative consensus ala Habermas (Father to the rational discourse)

<sup>81</sup> Transparency International corruption index

<sup>82</sup> Roe, M. J., (2000) Political Preconditions to Separating Ownership from Corporate Control, 53 Stan. L. Rev. 539

<sup>83</sup> Eisenberg, M., A., (1999) *Symposium: Corporate Law and Social Norms*, 99 Colum. L. Rev. 1253

<sup>84</sup> Blair, M., M., Stout, L., A., (2000-2001) Trust, trustworthiness, and the behavioral foundations of corporate law, 149 U. Pa. L. Rev. 1735

# 4 Application of the Institutional Theory

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*This chapter aims to describe the initiatives that have been made by the Swedish government in order to address the issue of declining trust for the actors on the business arena. The situation in Sweden will be presented from a institutional theory i.e. threefold perspective: cognitive, regulative and normative. This framework will later constitute the fundamental basis for analysis and conclusions to follow upon that. Furthermore, the development of initiatives at the European Union level will be presented, with a comprehensive background in order to allow understanding of the purpose of the recommendation. Aim and reasoning regarding the problem of implementation i.e. harmonizing regulation in the different Member States will be discussed.*

*“The world’s first democratically elected socialist government took power in Sweden in 1920. It has been for quite some time the paradigm of the welfare state, with cradle-to-grave social coverage.”* Mark J. Roe<sup>85</sup>

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## 4.1 General Introduction

Sweden, like many other European countries, has a less dispersed ownership structure than in England and the US. Like Germany and other parts of continental Europe, Swedish companies often have one or more large block holders among their owners. The reasons therefore are several. Frequently a family, individual, or any other structure involving owner constituencies has a certain attachment historically or based on other relationships, such as foundations, that has made them block holders by definition.<sup>86</sup>

The fact that these structures persist in many European countries, despite some organisations being as large as their American equivalents, is something that first and foremost holds the development of a deep securities market back.<sup>87</sup> Hardly any corporate scandalous behaviour is to be found

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<sup>85</sup> Roe, M. J., (2000) Political Preconditions to Separating Ownership from Corporate Control, 53 Stan. L. Rev. 539

<sup>86</sup> Roe, M. J., (2000) Political Preconditions to Separating Ownership from Corporate Control, 53 Stan. L. Rev. 539

<sup>87</sup> The US is the classic example of a deep securities market where, compared to Europe, few companies are controlled by one or a small number of individuals or families. Due to many reasons, one of them being strict regulations for banks, as financial institutions, to invest. Widely dispersed owner system has developed, with a scattered market of financial actors and a well-developed fund market for individuals and companies to use. The US would by definition have a market-controlled system. While most countries in Europe, except England, has systems that largely are control systems, aiming at the already mentioned characteristics of European owner structure.

among companies with a strong family owner structure. Rather, among those companies in Europe and Sweden that are to be considered widely dispersed, or more frequently where the block holder is a “weak” owner. Pension funds, insurance companies and others with only a secondary interest level for the companies’ development are considered weak owners.<sup>88</sup>

The gap in CEO compensation between the US and Europe has been a fact for a long time. It is not only that American executives receive more base salary, but they also receive larger bonuses, stock options, and other financially based incentive packages. Financial press and media have argued that American CEOs are taking advantage of weak owners in companies with widely dispersed shareholders.<sup>89</sup>

It is argued that the different types of ownership structures are holding back CEO compensation in Europe. It is unlikely that a family owner or other block holders would give management excessive compensation since many are entrepreneurs who started the company or have inherited the majority of stocks and consider the company as theirs. It is argued that American CEOs, generally speaking, have a larger responsibility for mostly larger firms, which also have greater growth opportunities. Another aspect is a cultural impact of competition already from business schools that contributes to a more tournament-like pattern, which also might be a reason for increasing compensation levels. Many of these fragments from a more complex theory are based on the benchmarking possibilities of a CEO, especially the tournament or the “winner takes all” parts of this theory, which are based on the actual knowledge of compensation levels of others.<sup>90</sup>

## 4.2 The Cognitive Perspective

If corporate governance laws and regulations should reflect the culture of a country, more specifically applicable to Sweden, an extreme point in the culture of trust, a code of corporate governance and other regulative frameworks would be superfluous. This is a utopia; but a further step in the chain of thoughts based on culture and trust is the problem of harmonizing corporate governance rules, if not globally so, at least within the European Union.<sup>91</sup>

Another aspect of corporate trust in Sweden is again the owning structures that are significantly present, such as primarily the family of Wallenberg,

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<sup>88</sup> Roe, M. J., (2000) Political Preconditions to Separating Ownership from Corporate Control

<sup>89</sup> Randall, T., S., (2004) *Explaining The International CEO Pay Gap: Board Capture or Market Driven?*, 57 Vand. L. Rev. 1171

<sup>90</sup> Randall, T., S., (2004) *Explaining The International CEO Pay Gap: Board Capture or Market Driven?*, 57 Vand. L. Rev. 1171

<sup>91</sup> Licht, A., N., (2003) *Legal Plug-Ins: Cultural Distance, Cross Listing and Corporate Governance Reform* (Working Paper Series [www.ssrn.com](http://www.ssrn.com))

followed by Lundberg, Douglas and many others. Most of these owning families or conglomerates of family constellations have a particular attribute in common: they own companies through a number of stocks with strong votes. There is a lack of correlation between cash flow rights and control rights.<sup>92</sup>

Trust for the market actors is only the head sign of a coin, tail is trust for the markets as such. Legislations and regulations have historically in Sweden, and elsewhere been used as tools in order to create trust for financial and securities markets. However, it would be an exaggeration to say that Swedish general disclosure standards have had the same important position as in other countries.<sup>93</sup>

Trust is about individuals perceptions about relationships and behaviours that somewhat relates to them, in this case based out of corporate institutions and thereto connected constituencies.

## 4.2.1 Commission of Business Confidence

The Swedish government initiated a committee<sup>94</sup> in order to meet new corporate governance standards and to address issues such as widely dispersed lack of confidence for the institution of “corporation” raised after US as well as Swedish corporate scandals. The aim of the commission was to re-establish trust and confidence for companies.

The two following chapters will introduce the tangible regulative and normative structures deriving from the committee’s work. However, the government aimed to address an issue that is rather intangible, or cognitive if you will, i.e. unethical behaviour that has contributed to aggravate the main issue of declining confidence for businesses. The presence of such behaviour has been confirmed through numerous corporate scandals; however, unethical behaviour and non-compliance seem to have been widely dispersed and rather state of mind before the misbehaviours became public. The initiative indicated that the government is taking the issue seriously and wants to affect general behaviour, and increase ethical awareness in the business community.<sup>95</sup>

The Commission of Business Confidence was insufficient in meeting the extensive demand of addressing all issues within the context, and soon the Code Group was established in order to focus on and develop a proposal for

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<sup>92</sup> Roe, M. J., (2000) *Political Preconditions to Separating Ownership from Corporate Control*, 53 Stan. L. Rev. 539

<sup>93</sup> Samuelsson, P., (1991) *Information and Remedies – Listed companies and their Responsibility for False and Misleading Information in the Stock Market*, Norstedts Juridikförlag, Stockholm

<sup>94</sup> The Commission on Business Confidence, SOU 2004:47

<sup>95</sup> The Commission on Business Confidence, SOU 2004:47

a new self-regulating Swedish corporate governance code. The Swedish Code of Corporate Governance will be presented under the normative part of this section of the thesis.<sup>96</sup>

The former finance minister Erik Åsbrink led both committees. However, the Commission of Business Confidence consisted of a majority of scholars from law schools and academia together with representatives from law advisory committees and audit expertise. In contrast, the Code Group consisted of a majority from private business representatives from several lines of business such as banks, manufacturing companies, and other larger corporate and industrial groups. Several other constituencies were represented, importantly, as a large owner group representatives from the large pension funds.<sup>97</sup>

The work of the commission resulted in the report: *Swedish Business Society and Trust*,<sup>98</sup> from which the proposal to new legislation is derived. This proposal will be further described and analyzed in the next chapter, focusing on the regulative perspective.

## 4.3 Regulative Initiatives

In order to address the issues that arose and seem to have established themselves in the cognitive sphere, the Swedish government decided to intervene and regulate on certain areas, which are not considered to be efficiently taken care of in any other form.

### 4.3.1 Relevant Legislations Regarding Disclosure on Executive Compensation and amendments to the Swedish Company Act, Deriving from the Report: Swedish Business Society and Trust

The Swedish legislative preparatory work, (Prop. 2005/06:186), has two main purposes; I will focus on the one addressing enhanced transparency and disclosure standards on executive compensation, which chiefly consists of an amendment to the Swedish Annual Accounts Act (1995:1554). I will also introduce legislative proposals regarding adjusted competence-balance between the corporate decision-making bodies, parallel to an examination of a proposal regarding compensation policies that are to become a mandatory part of the shareholder meeting agenda.

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<sup>96</sup> The Commission on Business Confidence, SOU 2004:47 and <http://www.sou.gov.se/fortroende>

<sup>97</sup> The Commission on Business Confidence, SOU 2004:47

<sup>98</sup> The Commission on Business Confidence, SOU 2004:47

In order to create a comprehensive picture I will, as mentioned introduce the other borderline purpose targeting increased shareholder influence in the process of determining executive compensation packages. This other purpose is suggested to be fulfilled through several amendments and changes to the legislative framework. Focus for this thesis is the amendments to the Swedish Company Act, that is directly attached to the process of determining compensation to executives. As mentioned this proposal states that the shareholder meeting shall strengthen its competence through an exclusive deciding mandate on compensation to board members. Moreover, the shareholder meeting should adopt guidelines on executive remuneration, including all types of compensation, with exemption for compensations considered in the Leo regulation<sup>99</sup> and compensation based on board of director membership. The auditor should guarantee that the company adheres and complies with the guidelines.<sup>100</sup>

Mandatory disclosure standards on executive compensation shall be extended according to the proposal.

#### **4.3.1.1 Amendment to the The Swedish Annual Accounts Act (1995:1554)**

New legislation is proposed as an amendment to the Swedish Annual Accounts Act chapter 5, §20, which outlines the following *current (de lege lata)* regulation on disclosure on executive compensation.

“The total value of executive compensations and other benefits for the fiscal year should be disclosed for the following groups:

1. board members, the CEO, other equivalent executives, and
2. employees that are not comprised under 1.

Profit sharing instruments and other comparable compensation to board members, the CEO or other equivalent executives should be specified.”

In the proposal for *new (de lege ferrenda)* legislation (Prop. 2005/06:186) the government suggests that the following amendments are done:

*“Public companies should when applying the first and second passages include all executive directors under 1...<sup>101</sup>*

The reasons are thoroughly discussed in the preparatory work to the suggested amendment. Executive positions in a company, targeted for this legislation, are listed in conjunction with the proposal containing guidelines on compensation.<sup>102</sup> They are members of executive committees and

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<sup>99</sup> Leo (1987:464)

<sup>100</sup> Prop. 2005/6:186

<sup>101</sup> Prop. 2005/06:186

<sup>102</sup> Prop. 2005/6:186 amendment to Swedish Company Act (2005:551) Chapter 8, 51§

equivalent senior executives, as well as executive director positions and managers that are, from a hierarchical point of view, directly subordinate to the CEO. Specific examples of positions referred to are<sup>103</sup>: director of finance, directors of main business areas, CFO and director of human resources. Furthermore, executives hired by the mother company or subsidiary and appointed to the board of directors of the mother company, should be included.<sup>104</sup>

The issue of defining the roles for those who are to be considered senior executives has been targeted for intensive discussions along the legislative process. The Swedish Companies Registration Office<sup>105</sup>, acting as a consultee during the comment period for the legislation proposal, made reservations about the definitions of senior executive. They pointed out the problem with terminology uncertainty regarding: senior executive, executive director and company management, as well as the definition of group management. Such differentiation is crucial in a new legislative text where distinguishing one group and one role from another is a basic precondition in creating regulative framework.<sup>106</sup>

The initial proposals<sup>107</sup> explicitly included a regulation on disclosing information regarding obligations to former executives and other former senior managers who are still compensated in different forms based on their past position in the company. A key reference group, involved in important projects for the company, is made up of just former executives who are working on a consultancy basis.<sup>108</sup> Such a regulation is already to be found in The Swedish Annual Accounts Act (1995:1554)

During the comment period of the preparatory work, several consultees raised concerns regarding the definition of “director.” Hence, they argued that the influence coming from the EU recommendation was just targeting the systems where director and executive director is the same person. Such a problem would not be applicable to Swedish standards, thus the recommendation would not apply. The Swedish government acknowledges the issue, but reasons that the conditions are more than ever applicable to Swedish standards, especially since we have to address the issue of declining trust and confidence for businesses in society in general, where enhanced transparency can only do good.

*...The number of executives referred to in the first part should be specified...<sup>109</sup>*

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<sup>103</sup> The circle of executives that are target for this legislative change are outlined in the former Swedish Company Act (1975:1385, chapter 4, 22§

<sup>104</sup> Prop. 2005/6:186

<sup>105</sup> Swedish Companies Registration Office (Bolagsverket)

<sup>106</sup> Bolagsverket ärende nummer 41-17/2005

<sup>107</sup> See Preparatory work Promemoria JU2005/39/L1 from April 1<sup>st</sup> 2005 or draft to Lagrådet February 16<sup>th</sup> 2006

<sup>108</sup> Prop. 2005/06:186

<sup>109</sup> Prop. 2005/06:186



The first proposal implied a specified catalogue covering compensation on a per person basis for all senior executives. This was met with scepticism from several of the consultee parties that commented on the legislation proposal. They argued, based on examples with Ericsson, having more than 100 subsidiaries all over the world, or Volvo with some 2300 senior executives, that would constitute an outrageous number of individuals to be target for such regulation. Thus, a detailed catalogue would probably imply significant costs for the enlarged audit and documentation process.<sup>110</sup>

This is also supported by the Swedish Association of Listed Companies<sup>111</sup>, in their comment where they reject the proposal and indicate that it is too far reaching. They also emphasize the risk of decreased integrity, in the sense that too much transparency might reveal corporate secrets, i.e. pricing of competence and so on, which eventually might lead to larger problems in keeping talented people in the organisation.<sup>112</sup>

*...Compensation for the fiscal year should be disclosed on an individual basis for the CEO and the members of the board...*<sup>113</sup>

Following the above outlined argumentation, compensation regarding the CEO as the most senior executive in the company, and most often the individual whose compensation is the target for discussion as well as for speculation, should together with compensation of board members be disclosed on an individual basis.

*...Information regarding the board representation of employees according to the law (1987:1245).*<sup>114</sup>

Information on the compensation to the workforce and other employee representation on the board is argued to have a non-significant impact. Thus, there is no need to extend the disclosure standard to comprise this group.

The above discussed changes and amendments to The Swedish Annual Accounts Act (1995:1554), also affect companies that, based on the EC regulation /1606/2002/EC, are applying international accounting standards, according to the new rules in chapter 7, 32§. Moreover, the proposal also affects so-called SE companies under articles 39-42 the SE Act.

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<sup>110</sup> The Swedish Association of Listed Companies (Aktiemarknadsbolagens Förening) and Law firm Setterwalls, Newsletter February 2005 “Deg för kneg”

<sup>111</sup> The Swedish Association of Listed Companies (Aktiemarknadsbolagens Förening)

<sup>112</sup> Remissyttrande February 28<sup>th</sup> 2005, Aktiemarknadsbolagens Förening

<sup>113</sup> Prop. 2005/06:186

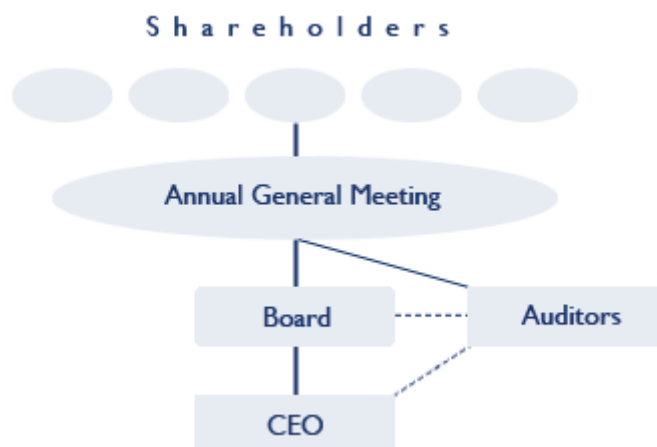
<sup>114</sup> Prop. 2005/06:186

### 4.3.1.2 Amendment to the The Swedish Company Act (2005:551)

In order to create understanding of the entire process of how to determine compensations to a company's executives, the following chapter present proposals, Prop 2005/6:186 to legislations amendments and changes to the Swedish Company Act (2005:551) chapter 7 and chapter 8. These proposals are part of the result of the work of the Committee on Business Confidence, and derive from their Report: Swedish Business Society and Trust.

In this chapter I will introduce two parts of the proposed amendment to the Swedish Company Act. First, new rules regarding exclusive decision competences between the different corporate body organs are examined. Secondly, proposed rules regarding a new mandatory item on the shareholders agenda, compensation policies for the remuneration to the executives.

The corporate body is normally divided into four distinct parts: <sup>115</sup>



For a limited liability company in Sweden, the company act is the major framework of regulations on decision making and the corporate organs that constitutes the corporate body. The annual general shareholder meeting is the superior deciding organ, since this is the forum where the companies' owners i.e. the shareholders, can exercise their decision right. Furthermore, a company has to have a board of directors, appointed by the annual general shareholder meeting, that is responsible for the organisation of the company, as well as for several other administrative powers. In a company that is listed on a commercial stock exchange, a chief executive officer, CEO, who is appointed by the board of directors, is supposed to have the responsibility

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<sup>115</sup> [www.bolagsstyrning.se](http://www.bolagsstyrning.se) (Auditors are not target for this thesis, and therefore not further mentioned in this outline.)

for the operating business on a day-to-day basis, in congruence with the instructions he is given by the board of directors.<sup>116</sup>

All compensation to the board is determined by the annual general shareholder meeting. Until now a lump sum has been determined by the shareholder meeting and later distributed within the board, in contrast to incentive programs that have to be decided by the general meeting, as well as the program, which has to be separated between directors and management. As mentioned the general meeting of shareholders is the sovereign deciding institution in the corporate body. The idea is that senior governing bodies can take over the lower bodies' decision making authority. The rule gives the right to issue express orders to be carried out at lower hierarchical levels in the organization. However, this is rarely done.<sup>117</sup>

The board structure differs somewhat from the Anglo-American model in the sense that there must be a certain distinction between executive and management authorities. Hence, in public companies one person cannot sit on both chairs: CEO and chair of the board. Normally no member other than the CEO from senior management represents at the board, except from employee representatives, who like in Germany have a legal right based on the number of employees. The Swedish model is somewhat a mixture between the American model and the two tier German structure. It is, as initially discussed, required by the law that a Swedish limited liability company has a board and a managing director. The board is responsible for the company's organization and the management of its affairs.<sup>118</sup>

#### **4.3.1.2.1 Legislative Proposals and Reasoning**

The purpose of the proposed rules is targeting a strong belief by the legislator that the annual general meetings' deciding power on executive compensation should be strengthened through legislation. The discussion in the preparatory work includes concerns on, not, making it harder for shareholders to decide on compensation; neither should the decision process regarding the extent of the remuneration be affected. An important aspect, the ability to recruit competent people, is another important factor to consider when proposing regulation on the area.<sup>119</sup>

Consequently, the main aim of the proposal is to create constructive conditions for a well prepared and reasonable compensation policy in the long-term perspective. Subsequently, this will enhance transparency and a higher level of influence for shareholders on executive compensation. Moreover, the legislator believes that this will have a positive effect and enhance societal trust for the entire business society.<sup>120</sup>

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<sup>116</sup> Prop. 2005/6:186

<sup>117</sup> Rodhe, K., Skog, R., (2002) Aktiebolagsrätt, 20th edition, Norstedts Juridik, Stockholm

<sup>118</sup> Rodhe, K., Skog, R., (2002) Aktiebolagsrätt, 20th edition, Norstedts Juridik, Stockholm

<sup>119</sup> Prop. 2005/6:186

<sup>120</sup> Prop. 2005/6:186

*New legislation is proposed as amendments to the Swedish Company Act chapter 7 and 8.*

The preparatory work of the legislative proposal contains an extensive discussion on whether compensation should be put up as a mandatory item on the general shareholder meeting. The reasoning for not deciding in this direction is based on the argument that this is not a sufficient tool to address the issues that the proposal aims to find a plausible solution to. The main argument for abolishing such a regulation is as, the consultee the Stockholm Stock Exchange, emphasized an obvious risk that compensations will be considered a technicality on the annual general shareholder meeting. In order to avoid such a regulation it is instead proposed that the annual general meeting shall decide on compensation to the directors of the board, on a per person basis, as well as introducing another tool; compensation guidelines regarding other executives. This way; directors of the board and executives such as: CEO, CFO etc. are distinguished into two groups.<sup>121</sup>

In the proposal for *new (de lege ferenda)* legislation (Prop. 2005/06:186) the government suggests that the following amendments are done:

To be decided at the annual general shareholder meeting

*Chapter 8, §23a*

*“The annual general meeting shall decide on compensation as well as any other remuneration for services at boards for the directors of the board....”<sup>122</sup>*

As mentioned, the annual general meeting shall decide on the compensation to the directors of the board. Exclusive deciding rights and competences on specific areas by the different corporate body organs is a well established principle within Swedish corporate legal tradition. However, there is today no explicit regulation stating that the annual general meeting possess the exclusive right on deciding compensation to the members of the board. Instead, this has based on rules regarding challenge become code of conduct. Hence, this conduct will hereinafter be explicitly demonstrated in the law, with the only amendment that compensation shall be decided for the directors of the board on a per person basis.<sup>123</sup>

Regarding decision-exclusivity on compensation to other executives, management of the firm, which is focus of this essay, the proposal includes arguments against such a legislation based on several interesting points. One of them already mentioned is the risk of making the decision process a

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<sup>121</sup> Prop. 2005/6:186

<sup>122</sup> Prop. 2005/6:186

<sup>123</sup> Prop. 2005/6:186

technicality on the annual general meeting without any, understandable, contribution to the transparency towards shareholders. Even stronger is the argument regarding the obvious inflexibility such a regulation will create put forward in the preparatory work. If the annual general meeting is given the exclusive right to decide over compensation to executives, extra annual meetings has to be held every time changes, amendments or other rather technical or minor changes shall be done. Hence, to give the shareholders exclusive right to decide over guidelines and policies as a mandatory item on the annual general meeting agenda will minimize costs and practical issues that the opposite would mean.<sup>124</sup>

Introducing guidelines for executive compensation as a mandatory item on the annual general meeting will implicitly reorganise exclusive decision rights within the company. Compared to the above stated regarding directors of the board, where a legislation is just making a conduct legible, here exclusive decision powers is moved from the board of directors to the shareholders and the forum for their deciding power: the annual general meeting. This is also a sign of importance and significance the issue of executive compensation is given, when made a mandatory item, through the guidelines, at the superior deciding level of a company.<sup>125</sup>

In the proposal for *new (de lege ferrenda)* legislation (Prop. 2005/06:186) the government suggests that the following amendments are done:

To be decided at the annual general shareholder meeting

*Chapter 7, §61*

*“In a limited liability company, whos’ stocks are listed at a stock exchange or at any other authorized market, the annual general meeting shall decide on compensation guidelines for the senior executives...”<sup>126</sup>*

*and*

In the proposal for *new (de lege ferrenda)* legislation (Prop. 2005/06:186) the government suggests that the following amendments are done:

Guidelines on compensation to senior executives in listed companies

*Chapter 8, §51*

*“In a limited liability company, whos’ stocks are listed at a stock exchange or at any other authorized market, the board of directors shall establish a proposal for guidelines on compensation to the CEO and other senior*

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<sup>124</sup> Prop. 2005/6:186

<sup>125</sup> Prop. 2005/6:186

<sup>126</sup> Prop. 2005/6:186

*executives. Compensation also includes transfers of securities and, warrants with the right to acquire securities from the company in the future. The guidelines are valid from the next annual meeting.*

*Information regarding compensation that have been subject for decision on a previous point of time, but have not yet been paid out is subject of disclosure to the proposal for guidelines.*

*If non-compliance to, according to §53, the guidelines, decided at the annual general meeting exists, shall information of this and the reason for non-compliance be disclosed with the proposal for guidelines... ”<sup>127</sup>*

There is a requirement that the guidelines contains exact monetary figures, however as set out in the paragraph below it is important for the shareholders to understand the cost for the contract with the managers. Target for the guidelines is the executive manager and other senior executives. (CEO, CFO, HR senior executive, business area senior executives) Subsidiary executives, if appointed to the board of the mother company, is also target for the regulation.<sup>128</sup>

If a company does not decide on new guidelines, the latest version of guidelines will continue to be valid until new guidelines are adopted by the annual general meeting. The board of directors and the CEO are responsible for the guidelines, and have to make sure that the company comply with the rules. Following the text in the paragraph, there is no possibility for the annual general meeting to adopt advising guidelines for the board of directors.<sup>129</sup>

The guidelines, or compensation policies will not totally tie the hands of the directors of the board, which is one of the main arguments for not introducing this rule. I will later return to what room and flexibility that remains for the directors of the board after a regulation as the just described.<sup>130</sup>

In the proposal for *new (de lege ferenda)* legislation (Prop. 2005/06:186) the government suggests that the following amendments are done:

Guidelines on compensation to senior executives in listed companies

*Chapter 8, §52*

*“If the proposal for guidelines as stated in §51 allows room for compensation that is not specified in advance, information regarding the*

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<sup>127</sup> Prop. 2005/6:186

<sup>128</sup> Prop. 2005/6:186

<sup>129</sup> Prop. 2005/6:186

<sup>130</sup> Prop. 2005/6:186

*nature of the compensation and how and under what conditions it can be given, or claimed to be valid, shall be disclosed.*

*If the first section of this paragraph occurs, information regarding the companies' undertaking, and the financial impact of such undertaking to such individuals potentially could cost the company i.e. possible results.*<sup>131</sup>

The guidelines can prohibit certain compensation instruments, if they for example can not be accompanied with an estimation of the cost for the company. However, the guidelines have to include such a statement in order to validate such an argument.

The cost of the compensation shall according to § 52 be disclosed, which is targeting the possibly maximal cost of compensation in the particular case. The aim is to give shareholders insight into the range in which the total cost of compensation could possibly land.

*and*

In the proposal for *new (de lege ferenda)* legislation (Prop. 2005/06:186) the government suggests that the following amendments are done:

Guidelines on compensation to senior executives in listed companies

*Chapter 8, §53*

*"In the guidelines, stated in §51, the board of directors can decide to depart from the guidelines, in particular cases if particular reasons exists."*<sup>132</sup>

The board and the CEO, are still given some room for flexibility. There is no restriction regarding not fully distribute the compensation levels given in the guidelines. The guidelines are supposed to constitute a framework to executive compensation within the company. The board, and the CEO, will still be given a certain deciding power on minor items such as allowances for expenses and per diem not exceeding what is considered to be normal values.

In particular cases the board of directors or the CEO, can depart from the guidelines and decide to enter into contract binding the company to compensation that exceeds the limit in the guidelines. However, this has to be motivated and it has to be explicitly expressed by the shareholders at the annual general meeting when adopting the guidelines that in certain cases is not in compliance with guidelines accepted. In the preparatory work, the example of acquiring a new CEO is put forward to illustrate issues that

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<sup>131</sup> Prop. 2005/6:186

<sup>132</sup> Prop. 2005/6:186

might arise if the individual is offered a similar position at another company for instance, and an auction-like bidding contest is necessary to acquire the expertise and competence needed for the company. If the guidelines would constrain such situations, a large portion of the room where a company's day-to-day management is supposed to be able to make decisions is taken away from them, and thereby maybe even the spirit of doing business.<sup>133</sup>

Particular reasons, in §53, requires a certain level of quality. It is not allowed for the board of directors to systematically depart from the rules motivated by "particular reasons". The CEO can not alone refer to these rules, and the board of directors can not refer to reasons known to them when adopting the guidelines.

If the annual general meeting does not accept the guidelines, the board or a shareholder can propose revised versions.

A recent investigation by a Swedish team of TV journalists for a popular show, presented information on how the board of directors and representatives for large, mainly institutional, owners had preparatory communication in order to facilitate acceptance of compensation programs to be accepted at the shareholder meeting.<sup>134</sup>

#### **4.3.1.2.2 Benchmark**

Interestingly, the Swedish Company Act from 1955, §139 contained restrictions on executive compensations. It was stated that a shareholder, with a 10 percent share of the company, within three months from the decision could appeal and base his issue on the fact that he believed that the compensation was exceeding reasonability. The compensation could be adjusted by the court if it was found to be obviously unreasonable.<sup>135</sup>

Under the German Aktiengesetz §87<sup>136</sup>, one of the few explicit provisions in western countries that states any form of legal rule that contains a wording, synonymous to performance in conjunction with compensation. Paragraph 87, is designed to indicate a framework or cap for compensation through its wording: compensation is supposed to be proportional with the contribution to the company by the manager. The regulation does not seem to have been largely accepted, and has not been used or referred to in any significant way until very recently. The rule was established in 1937.<sup>137</sup>

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<sup>133</sup> Prop. 2005/6:186

<sup>134</sup> [www.svt.se](http://www.svt.se) – Uppdrag Granskning – Granskning av direktörlönerna III, "Folkets miljarder utnyttjar inte makten" – 2006-05-26

<sup>135</sup> The Swedish Company Act 1955, §139

<sup>136</sup> BGB Aktiengesetz §87

<sup>137</sup> Dotevall, R., (2005) *Kontrollen över ersättningsnivåerna i näringslivet ur ett internationellt perspektiv*. Intressekonflikter och finansiella marknader, Nord, G., (editor) and Thorell, P., Stockholm 2006



## 4.4 Normative Initiatives

The result of the Commission on Business Confidence work can be distinguished parts. The first is the legislative part, from which in the previous chapter selected aspects just have been presented. The normative, i.e. the Swedish Code of Corporate Governance has through its incorporation into the Stockholm Stock Exchange Listing Agreement become part of, and thereby constitutes, the most important self-regulating soft-law on the area. Together with the rules from The Swedish Industry and Commerce Stock Exchange Committee (NBK), the Listing Agreement are the dominant self regulating frameworks on this area in Sweden. The for this thesis focus part of the Listing Agreement i.e. the Swedish Code of Corporate Governance, will as well as the NBK regulations be introduced in the following chapter.<sup>138</sup>

### 4.4.1 The Swedish Code of Corporate Governance

Until the establishment of the code, corporate governance standards were incorporated in a number of self-regulating bodies in the business community. Therefore, the Swedish Code for Corporate Governance is not introduced due to lack of standards but rather as a comprehensive catalogue and basis for what constitutes good Swedish Corporate Governance.<sup>139</sup>

Improving corporate governance standards in Sweden is the general aim for the code, which due to the code group is likely to strengthen business efficiency and competitiveness. The code is supposed to address the issue of declining trust and confidence in the market in general, as well as in the society's confidence in business functions in particular.<sup>140</sup>

A second aim of the code is to actively promote Sweden as target for foreign investments. Establishment and implementation will help investors understand the specifics of Swedish corporate governance standards, through which confidence in the Swedish securities market will be created.<sup>141</sup> Sweden has compared with for example the US an undeveloped securities market, which also will be referred to in later chapters.<sup>142</sup>

The following key principles outline the main purposes and aims of the Swedish Corporate Governance Code:

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<sup>138</sup> Stockholm Stock Exchange listing Agreement (Noteringsavtalet) as of January 1<sup>st</sup>, 2006

<sup>139</sup> Swedish Code of Corporate Governance, SOU 2004:130

<sup>140</sup> Skog, R., (Red.), (2005) *En svensk kod för bolagsstyrning – vad är det för något och vad innebär den?*, Iustus Förlag, Uppsala

<sup>141</sup> Swedish Code of Corporate Governance, SOU 2004:130

<sup>142</sup> Skog, R., (Red.), (2005) *En svensk kod för bolagsstyrning – vad är det för något och vad innebär den?*, Iustus Förlag, Uppsala

- Create good conditions for shareholders to exercise the ownership role actively and responsibly
- Create sound balance of power between the owners, the board of directors and the executive management to enable shareholders to assert their interests vis-à-vis company management
- Create a clear division of roles and responsibilities between the various governing and supervisory bodies
- Uphold in practice the principle of equal treatment of shareholders as found in the Swedish Company Act
- **Create as much transparency as possible towards shareholders, the capital markets, and society in general**<sup>143</sup>

The code is to be considered soft law; through its incorporation in the Stockholm Stock Exchange listing agreement<sup>144</sup> it is mandatory for all listed companies with a market value exceeding 3 billion SEK to comply with the rules.

Non-compliance is regulated through the self-regulating principle of comply or explain. The concept of comply or explain will be introduced later in this chapter.

*The Swedish Code of Corporate Governance recommends the following additional general standards to enhance transparency: compensation committees, annual report on Corporate Governance and Corporate Homepage Information.*

The board should establish a remuneration committee, which should prepare proposals on remuneration and other terms of employment of senior executives. The person who is chairman of the board may also chair the remuneration committee, while the rest of the members should be independent directors. Furthermore, most of the compensation issues are to be dealt with at the shareholders meeting. The new terms imply an obligation to examine all incentive programs through deciding on maximum number of financial instruments to be issued or transferred to senior management.<sup>145</sup> Parallel to this, a special corporate governance report is to be established and attached to the annual report. If the company departs from some rule, this has to be explained in the corporate governance report. This should all be according to the self-regulating principle.<sup>146</sup> The report shall contain extensive information about the remuneration that is given to the CEO. This is supposed to be informational enriching by providing an extensive compensation profile of the CEO and of other important individuals within the company. The corporate homepage is supposed to contain an informative section addressing issues connected to the code. This

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<sup>143</sup> Swedish Code of Corporate Governance, SOU 2004:130

<sup>144</sup> Stockholm Stock Exchange Listing Agreement (Noteringsavtalet)

<sup>145</sup> Swedish Code of Corporate Governance, SOU 2004:130

<sup>146</sup> Swedish Code of Corporate Governance, Report of the Code Group, SOU 2004:130

section shall provide updates and current information that is required under the code.

#### **4.4.1.1 Comply or Explain**

The concept of “comply or explain” is a standard that was introduced through the Cadbury Committee in 1992 in the United Kingdom. A self-regulating instrument such as “comply or explain” has come to be the most frequently used system in the corporate governance codes throughout the Member States in the EU. The Commission has expressed their belief in such systems aiming to regulate corporate governance codes.<sup>147</sup>

The basic idea of the system lies in the legible meaning of the wording; either companies comply with the rules or they have to explain why they depart. Specific examples of what are to be considered as acceptable explanations are not stated in the preparatory work, but the phenomenon of cross listing, would be brought up as a valid reason for departing on the compliance to the code.

##### **4.4.1.1.1 Deterrence**

The self-regulating code is supposed to use media as its’ only deterrence for non-compliance. Medias’ importance in a country can be measured by the circulation of newspapers normalized by population. Sweden ends up among the five countries in the world with the highest readership. However, even in countries with a lower readership rate media might be one of the best available mechanisms against mis-governance. In those countries foreign media such as New York Times, or Wall Street Journal might have higher credibility than the local press.<sup>148</sup>

Issues concerning corporate behavior have been intensively exposed after the corporate scandals. Mass media has the ability to affect reputation of companies and individuals in many ways. Attention can get politicians to get engaged in corporate law reforms or make sure that the laws are enforced in order to keep their political good standing, with the belief that inaction would hurt their reputation. Furthermore, media attention can help refrain managers to take self dealing action for the same reasons: bad-will and discounted reputation. What we tend to see is a game with the smallest common denominator, being attention and bad-will. Based on a perception of self protective behavior from individuals that do not want to get their photo on the front page of the morning paper. Hopefully this leads to shareholders wealth maximization. Even “bad” managers might take the

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<sup>147</sup> Swedish Code of Corporate Governance, Report of the Code Group, SOU 2004:130

<sup>148</sup> Dyck, A., Zingales, L., (2002) The Corporate Governance Role of the Media, Harvard Business School and University of Chicago

right action just to relate to the opposite type and gain media coverage and leverage their own person or beliefs.<sup>149</sup>

#### **4.4.2 The Swedish Industry and Commerce Stock Exchange Committee (NBK) on Rules Concerning Information about Benefits for Senior Executives (2002).**

Since 1993, NBK has published transparency rules on executive remuneration. Such information is believed by NBK to be crucial in the discussion regarding overall confidence for corporations. NBK states under No. 3, Information Regarding Benefits for Top Management, that such information should be disclosed in detail for the group's chief executive as well as for the managing director. The information that is supposed to be disclosed shall contain the total monetary amount of all remuneration and other benefits as well as other items that are not of minor importance.<sup>150</sup>

Under rule No. 4, other executives are targeted for regulation. The total amount of remuneration and benefits for the category of other executives, persons in the management other than those on the board, is to be specified for the group as such. Companies have to determine what company functions, i.e. what individuals are included and therefore constitute "other executives." The total amount for this group shall be disclosed together with information on the number of executives included. There are no requirements for disclosing information on a per person basis, however, terms concerning future benefits and pension arrangements are to be disclosed.<sup>151</sup>

According to No. 2, the information is to be disclosed in the annual report. Significant changes to what has been earlier disclosed shall be announced publicly in the forthcoming interim report. Such information, as just mentioned, has to be disclosed in a manner that is conveniently accessible to all shareholders.

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<sup>149</sup> Dyck, A., Zingales, L., (2002) The Corporate Governance Role of the Media, Harvard Business School and University of Chicago

<sup>150</sup> The Swedish Industry and Commerce Stock Exchange Committee (NBK) on Rules Concerning Information about Benefits for Senior Executives (2002)

<sup>151</sup> The Swedish Industry and Commerce Stock Exchange Committee (NBK) on Rules Concerning Information about Benefits for Senior Executives (2002)

## 4.5 Corporate Governance at the EU Level

### 4.5.1 General Background

Even though there have been a lot of measures taken in the field of corporate governance at various national levels, there has been a lack of involvement at the Community level. One of the objectives, as set out in Article 2 and 3 EC, the European Community, is to establish and sustain an internal market without any internal boundaries. Nonetheless, the EU has taken very few measures concerning corporate governance. In the following subchapters, I will describe the measures taken at EU level in order to introduce the EU approach to corporate governance issues in general, and disclosure in particular.

### 4.5.2 Characteristics: EU vs. Sweden

There are not any major differences in fundamental Swedish corporate governance standards compared to those in other industrialized and developed countries in Western Europe. However, in comparison with the Anglo-American standard, which is predominant within this field, there are a couple of discrepancies.<sup>152</sup>

One of the most outstanding differences within the EU is the one and two-tier board systems that are present in the different Member States. The clearest example is the UK, with a one-tier structure where management and board members practically are the same people. Germany on the other hand has a two-tier system, with the first tier being responsible for operational business and strategy, and the second tier board that is supposed to evaluate the first tier board and its performance. The German system consists of “*Vorstand*” and “*Aufsichtsrat*”. However, recent studies indicate that one is not supposed to be better than the other. The classic argument favouring a one-tier system is the close relationship between shareholders and managers, thus leading to a better and more intense exchange of information between the parties. On the other hand, the two-tier system is supposed to divide principals and agents into a distinct relationship. Instead, mandatory employee representation in certain decision-making bodies of the company is believed to ascertain transparency. Employee representation at top tier level in companies is considered, argued by some scholars, as a sufficient system for keeping checks and balances in place.<sup>153</sup>

#### 4.5.2.1 Cultural Characteristics of the European Union

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<sup>152</sup> Swedish Code of Corporate Governance, Report of the Code Group, SOU 2004:130

<sup>153</sup> Davies, P., (2006) On board of Directors: The European Perspective: Where are we now?, Macmillan, Palgrave

Sweden, together with many other European Union countries, has a long tradition of social democracy, doubtlessly something that had and still has immense impact on not only society's climate in general, but on the corporate climate as well. By classic theory, a social democracy has a large portion of direct or more recently indirect, governmental involvement in the corporate environment.<sup>154</sup>

In some of the countries referred to, the goal of a corporation is rarely explicitly articulated to be shareholder wealth maximization. In social democracies, such a statement is due to Roe, not an accepted goal for a company where many employees dedicate their lives, sometimes even more than one generation, and give up their total working asset allocation. If a social democracy would leave some of the most important constituencies, as in this case the employees, without any further importance in the context of the company goal, it is likely that they would be beaten up by media and union representatives.<sup>155</sup>

A strong social democracy is argued to raise managerial agency costs, and promote a wedge between managers and shareholders where managers are likely to line up with their employees against shareholders. They are able to do this based on governmental involvement, in codifications and also through policy making. Now they can do what they always wanted to do; be risk averse about their own jobs, expand and refrain from any change that would cause them or their peers the risk of losing jobs, status and compensation. This is certainly also a protective behaviour from managers, at least towards society, that they line up side by side with their employees, which then would give them acceptance and maybe even forgiveness in the cause of bad-will publicity.<sup>156</sup> However, salaries in Sweden according to NBK has increased with 70% for executives, whereas employees has just had a 16% rise in the same period of time.<sup>157</sup>

### **4.5.3 The High Level Group Report II**

The first actual measure taken at the EU level was a report from a group of legal experts on the regulatory framework for company law in Europe which included corporate governance. This was the second report which now had extended its mandate to also include corporate governance. The extended mandate was a reflection of the Enron scandal in the US. The discussions in the US concerning corporate collapse had now reached the EU and there was an emerging need to discuss the future strategy to address these issues at Community level. In the High Level Group Report II, questions

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<sup>154</sup> Roe, M. J., (2000) Political Preconditions to Separating Ownership from Corporate Control, 53 Stan. L. Rev. 539

<sup>155</sup> Roe, M. J., (2000) Political Preconditions to Separating Ownership from Corporate Control, 53 Stan. L. Rev. 539

<sup>156</sup> Roe, M. J., (2000) Political Preconditions to Separating Ownership from Corporate Control, 53 Stan. L. Rev. 539

<sup>157</sup> <http://www.naringslivetsborskommitte.se/default.htm>

concerning how the Union should proceed with regulation concerning corporate governance and whether a European Code on Corporate Governance should be established was discussed.<sup>158</sup>

In this report it was concluded that a unified European corporate governance code must be rejected. Since the national corporate governance rules are still widely different due to the differences in the national legislative backgrounds, such a code would fail to give full information about the applicable corporate governance rules to investors about companies in Europe. The report emphasized that it is instead the market and its participants that should enhance corporate governance rules through self-regulating systems.

The Community and the Member States shall merely monitor the situation.<sup>159</sup> According to the report, each Member State should designate its own corporate governance code, under which the companies, in that specific jurisdiction will be subject to scrutiny. The report also covers general ideas on the developments of the European Company Law, particularly on the role of disclosure as regulatory rules for which the EU can take initiatives.<sup>160</sup>

The group of experts gave several recommendations on how the EU should proceed.<sup>161</sup>

- The EU should develop mechanisms for an efficient and competitive business in Europe
- The EU should make modern company law and consider other sources than primary law, but also secondary legislation
- **The EU should consider disclosure of information as a regulatory tool more efficient than substantive rules**

Since the report contained many recommendations, the Expert Group also recommended the Commission to make an Action Plan and to set the EU Agenda for the regulatory initiatives in the area of company law and to enhance the corporate governance in the EU.<sup>162</sup>

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<sup>158</sup> Press release on the Final Report from the High Level Group of Company Law Experts; [http://europa.eu/rapid/pressReleasesAction.do?reference=IP/02/1600&format=HTML&age\\_d=0&language=EN&guiLanguage=en](http://europa.eu/rapid/pressReleasesAction.do?reference=IP/02/1600&format=HTML&age_d=0&language=EN&guiLanguage=en).

<sup>159</sup> Final Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, Brussels, November 4, 2002

<sup>160</sup> Final Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, Brussels, November 4, 2002

<sup>161</sup> Final Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, Brussels, November 4, 2002

<sup>162</sup> Final Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, Brussels, November 4, 2002

## 4.5.4 The Action Plan

The Action Plan was presented by the Commission in May 2003. The Action Plan on “Modernising Company Law and Enhancing Corporate Governance in the EU” gives several proposals for action in these areas and constitutes a European regulatory framework for company law and corporate governance.<sup>163</sup>

The main objectives for corporate governance of the Community outlined in the Action Plan are:

- Strengthen shareholders rights and reinforcing protection for employees and creditors;
- Increase the efficiency and competitiveness of business.

The Action Plan is necessary due to the cross-border operations that exist at the internal market today, especially considering the integration process between the European capital markets, and the IT-development that has brought completely new technology and communication possibilities. Among other fields, the Action Plan gives proposals for legislative and non-legislative measures to be addressed in the field of corporate governance.

It further expresses the statement from the Legal Expert Group that a unified European Corporate Governance Code would not solve the situation. Instead the Action Plan emphasizes that a self-regulatory market, based on merely non-binding recommendations, would be insufficient in order to guarantee sound corporate governance. The Commission proposes instead a common approach that should be adopted at the Union level, which would constitute a few but still necessary rules, which would ensure a good co-ordination of the different corporate governance codes in the various Member States. The proposals for the legislative and non-legislative measures concern:

- The introduction of an Annual Corporate Governance Statement
- Development of a legislative framework that aims to protect the shareholders
- Adoption of a Recommendation aiming at promoting the role of independent directors
- **Adoption of a Recommendation on directors’ remuneration**
- The establishment of a European Corporate Governance Forum which would help to co-ordinate the different national codes.<sup>164</sup>

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<sup>163</sup> Communication from the Commission to the Council and the European Parliament - Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward, COM/2003/0284 final.

<sup>164</sup> Communication from the Commission to the Council and the European Parliament - Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward, COM/2003/0284 final.



The Recommendation on directors' remuneration was adopted in December 2004.<sup>165</sup>

#### **4.5.5 EU Recommendation on Fostering an Appropriate Regime for the Remuneration of Directors of Listed Companies**

The Recommendation on Fostering an Appropriate Regime for the Remuneration of Directors of Listed Companies constitutes an efficient tool in the control of the structure and level of the payment to directors within listed companies. The non-binding instrument recommends Member States to ensure that listed companies disclose their policy on directors' payment. Moreover, it recommends that shareholders shall be informed about how much individual directors are earning and in what form they are compensated. Shareholders shall be given adequate control over these issues, but also control over share-based remuneration schemes.

In the preamble of the Recommendation it is stated that directors' payment is one of the "key areas" where potential conflict of interest for the executive director concerning the own profit and to what account the interest of the shareholders shall be protected, i.e. the agency theory. The Recommendation therefore states that remuneration systems shall be subject to "appropriate governance controls." These systems will be based on adequate information rights. At the same time, the preamble stresses that it is crucial to respect the different systems of corporate governance in the various Member States. The differences reflect the various approaches that have been taken in the Member States concerning the responsibility for the corporations to the policy on remuneration of directors.<sup>166</sup>

##### **4.5.5.1 Enhanced Transparency**

Furthermore, the Preamble to the Recommendation states that disclosure of accurate information will lead to enhanced confidence among investors, and will promote a sound corporate governance in the EU. In this sense it is crucial that listed companies opens up for transparency and disclosure in order to let investors express their points of view. However, the Recommendation recognizes that the aim is not to interfere in a specific decision on executive compensation, instead the Recommendation is

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<sup>165</sup> Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companiesText with EEA relevance, OJ L 385 , 29/12/2004

<sup>166</sup> Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companiesText with EEA relevance, OJ L 385 , 29/12/2004

supposed to provide guidance for shareholders in order to let them stay à jour with current policies and how they can influence them if disliked.<sup>167</sup>

Four cornerstones of the recommendation are outlined as follows:

- Remuneration policy- *all listed companies are obliged to disclose a statement of their compensation policy for the year to come*
- Shareholders meeting- *the mentioned policy should be a mandatory discussion point on the meetings agenda*
- **Disclosure of the remuneration of individual directors- detailed information on all remuneration schemes of the individual director**
- Approval of share and share option schemes to directors- *such compensation systems should be objective to shareholder meeting approval.*

#### 4.5.5.2 EU Progress

The Action Plan points out that the European Union should establish and develop rules that shall be convergent to the Member States. However, the specific culture, traditions and legal heritage should be taken into account, thus new rules must be established.

One obvious problem with the EU is the diversity of different legislative rules, codifications and codes in the different Member States. The EC Treaty Article 5 states that the Community shall take action...*in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States...* Therefore, the harmonisation with the recommendation is of severe importance, something that also is stated in the proposal for the new legislation standard in Sweden.<sup>168</sup> Based on this, one can assume that the intention from the Community is to let each Member State, at least initially, decide how to, and to what extent, compliance to the recommendation shall be made. The EU has invited Member States that by mid-2006 to report the status of the work with the recommendation to the Commission. This will then give the Commission an overview and basis for assessment whether further measures and initiatives are needed on the EU level.<sup>169</sup>

The phenomenon of global business has also contributed to the increasing number of so-called cross-listings. Parallel to broadened customer bases, companies are broadening their investor bases in order to attract more capital to their firms. Companies that are listed in one country, and then also in the US, are, despite their status as foreign with headquarters outside the country, obliged to obey SEC filing standards and several other US

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<sup>167</sup>Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companiesText with EEA relevance, OJ L 385 , 29/12/2004

<sup>168</sup> Prop. 2005/06:186

<sup>169</sup> EC MEMO/04/231

regulative frameworks. Hence, many large corporations in Europe already follow US standards that could be a merit in the frequent argumentation that the EU should partly “adopt” the Sarbanes-Oxley Act. Cross-listing might be of interest to managers and agents where compensation schemes, for example, are based on liquidity.<sup>170</sup>

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<sup>170</sup> Licht, A., N., (2003) *Legal Plug-Ins: Cultural Distance, Cross Listing and Corporate Governance Reform* (Working Paper Series [www.ssrn.com](http://www.ssrn.com))

## 5 Analysis

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*Sweden is about to implement new legislation on disclosure and procedures regarding decisions on executive compensation. The aim of this is to address policy issues, lack of ethics and a part of the recipe hereto is disclosure and somewhat reorganized decision-making competences. Information on executive compensation will be disclosed to a larger part in order to create enhanced transparency towards shareholders, society and all other constituencies. It will also, at least partly, be restricted to a framework set by the shareholders at the annual general meeting.*

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*The institutional framework of this thesis will serve as structure for the first part of this analysis. The second part will introduce potential contra-productive consequences due to the initiative by the Swedish government but also due to the basic conflict between legal and business purposes and aims.*

As initially discussed, a classic business theory concept i.e. agency theory is once again addressed with legislative and normative initiatives. The basic issue is pinpointed by La Porta et al., who argue that managers want as much money as possible based on compensation schemes with limited or, even better, no connection with any means of performance. Following the basic assumptions in agency theory, previously outlined, the agent is opportunistic and tries to minimize his contribution and maximize his compensation.

The problem is however, for the government to carry out action according to the basic aim: addressing unethical behaviour that definitely belongs in a cognitive sphere since ultimately the mismanagement and corporate crimes that have occurred are conducted by human beings. These individuals have obviously pinched on their moral, ethical but more than anything else abused their responsibilities as leading representatives for corporations with thousands of peoples employments, indirect their primary source of financial supply, in their hands. Another abused responsibility is that, stated by Shleifner and Vishny, as agents managing monetary means not belonging to them, but rather to their counterparts in the agency relationship: principals. Also OECD, is emphasizing the need of keeping balance between the parties, which together with other factors will lubricate the development of a deeper securities market. This is another explicit aim of the initiative by the government i.e. creating trust for investors in the Swedish securities market.

Now the government addresses these issues with different means of intervening power, one of them being an attempt to restore the information asymmetry i.e. imbalance between agents and principals through enhanced

disclosure standards on executive compensation. One problem that frequently occurs in this kind of context is the target conflict between legal and business aims. Some of these issues will later, under the section of contra-productive consequences, be further presented.

As outlined in the paper scholars have different opinions on the efficiency of disclosure on executive compensation, however transparency as such is rarely questioned. Since disclosure according to Bebchuck and Fried is only the means to reach the higher goal of transparency, they seldom reflect over potential contra productive consequences that might arise when disclosure has passed the limit for what is conceivable and valuable, in terms of enhanced transparency. Disclosed information on executive compensation as such might imply contra productive consequences, even worse would the case of disclosing information beyond transparency be. This is of course impossible to measure and only, until confirmed through some form of measurement, a play with thoughts. The discussion is rather bias for principals, i.e. shareholders, but is it sure that the same level of transparency is good also for society, and not the least for the company itself.

Meanwhile businesses are growing from national, to international, pan-European and even to truly global. This brings enormous business opportunities and thereby growth potential. But it also brings problems to the table. The US, being the largest economy in the world with a geographically dispersed presence of corporations is doubtlessly also the largest source of influence on this subject. From the mentioned US companies many truly global are to be found. Companies, just like families and individuals are carrying traditions and behavioural patterns along, when away from home. The companies have contributed to spread American corporate governance standards over the world. Cross border business with corporate headquarters and subsidiaries in several different countries and markets implies the need of homogenous corporate governance standards. Europe is moving towards the US in terms of company expansion and patterns, but the EU is not necessarily moving toward the US corporate governance standards as such. In the meantime, the EU has established a pan-European company form (SE-companies) that might lubricate, prepare and simplify the harmonisation process on the EU level at least over time.

## **Cognitive**

The situation was close to identical when the Sarbanes Oxley Act was implemented in the US in 2002, and thereafter many countries have followed. The Swedish government, as a primary example of institution, initiated a committee to address issues of declining trust for the business society. It is rather obvious that the government wanted to address issues in the cognitive sphere i.e. attitudes, tendencies and trends among executives that repeatedly were caught with their hands in the cookie jar. The government can not intervene in any other way than through the regulative, which means with legislation and to a certain extent through e.g. self-

regulating frameworks for regulation in the normative pillar of the institutional framework.

Following the institutional theory, I believe that the Swedish government, other states and the EU, has tried to change a behavioural pattern i.e. cognitive behaviour through usage of their means of intervention. This means that the aim of the initiatives is to affect the cognitive pillar through intervening with new legislation in the regulative and a corporate governance code in the normative.

The pendulum swings back to complete the oscillation!

According to stakeholder theory, society in general has a strong interest in for example environmental policies and other corporate ethical and moral oriented issues. Information on executive compensation does not, as obvious, as some of the other types of information fall within this category, especially since nobody outside the internal stakeholders should have any direct interest in such specific business oriented issues of a company. However, most people in Sweden for example are direct or rather indirect shareholders through pension funds or other discretionary investments. This means that, Joe Blow, suddenly transforms from being an external stakeholder, considered “society” until becoming internal and shareholder. This implies that most people have reasons to access numbers and figures on executive compensation. Subsequently, if this transformation takes place without notice, or if the owner is distressed and uninterested, the distinction between internal or external is pointless. However, having a vague but still noticeable notion about being owner, ethical behaviour towards society in general by corporations becomes even more important. The obvious risk is of course that the shareholder makes an active choice to leave a misbehaving company with his or her direct or indirect investments, which in turn affects both the company and if the person chooses to stay liquid even the securities market as a whole.

I find it questionable if it at all is possible to affect cognitive behaviour through intervention in two other structures; the regulative and the normative?

### **Normative**

The Code of Corporate Governance in Sweden constitutes a good complement to the initiated regulative standards. The Listing agreement, in which the code is part together with the rules from NBK are two clearly self-regulating norms. The more legislation that emerges out of the same basis as soft-law, as the case to some extent were regarding the issues at hand in this theses, thus close to or overlapping existing soft-law regulations, soft-law is losing its dignity. Law source hierarchy is clear, and the question is how non-compliance with the code would be considered in for example a trial. There are no such cases, due to the relative age of the entire legal area. It will be interesting to follow, whether non-compliance

with the company code would constitute evidence value in for example a criminal trial.

The actual impact of media is dependent on the strength and nature of social norms. Since Sweden is a country with a proven high level of trust as social norm, the assessment is not easy. Given that there is trust to the media actors, people expect to believe what is presented to them at the breakfast table. On the other hand, if there were misinterpreted or fraudulent information the same logic would be fatal. Therefore, it is extremely hard to assess whether media in one country or another has only some or extensive impact on peoples values and shaping corporate policy. Mass media can obviously both help and hurt shareholders. Since not only stakeholders or other constituencies that are connected to the company are taking notice about the buzz, society as a whole also has to be considered as the receiver of any information about the company: good or bad.

Interestingly, there are not yet any measurable effects of the Swedish Corporate Governance code, and still the government chooses to intervene with legislative power. Why did not the normative, well developed code of corporate governance get a chance before new legislation becomes effective. This must somewhat diminish the magnitude of soft-law as such, since there is no point in developing a framework that aims to constitute the primary tool for transparency and there through guarantee sound business manors in Sweden and elsewhere, when severe disbelief for the overall normative function of a corporate governance code and its extent is explicitly stated by the legislator in the preparatory work to the proposed legislation.

### **Regulative**

Bebchuck and Fried are arguing that extensive or even total disclosure on executive compensation standards is the solution to executive compensation misbehaviour. Their pragmatic idea of attaching a dollar value to all compensation paid by the corporation appears to be applicable. This framework is certainly also applicable in Sweden, where the outlined proposals to new disclosure standards will force companies to disclose extended information about executive compensation, maybe even in the near future on a per person basis not only for the CEO but also for other leading executives. The EU is clearly moving in the same direction.

Exact formulations for charts, which is a proposal by Bebchuck and Fried for generally enhanced transparency should be provided wherein management has to present their different types of compensation. If this is to be done on a regular basis scholars argue that this is a step towards corporate governance federalism, and indicates that such disclosure standards might be forcing substance in contexts where issues on conflicted loyalty may arise.

Such patterns have not won acceptance in Swedish standards. But extensive disclosure levels were discussed in the preparatory work to the new

legislation. The discussion touched upon the number of executives, and exactly who that was to be included in the mandatory per-person standards of compensation disclosure. This discussion rendered some attention at an early stage from both consultees and by practising lawyers, during the comment period, who were interested in the progression of the coming legislation. They all had the same essence in their consensus opinions regarding the proposal. – It is too far reaching and it will only create excessive administrative work and contribute with very little value. This was first and foremost an argument on the proposed disclosure of per-person disclosure on all executives in both mother company and subsidiaries. Such a regulation would create extremely excessive appendices to annual reports.

One of the main problems throughout the process was to determine distinction between the different corporate functions that are target for legislation. Since the EU Recommendation partly constitutes basis for the proposal, obvious problems occurred on whom to be targeted. The important aspect of this discussion has to be put in the light of the owner structures that persist in Sweden. Later, it was determined that the rules on per person basis should only include the CEO, and a lump sum for the rest of the senior executives including CEO, CFO and so on. Also executives in subsidiaries that are appointed to the board of the mother company, a relatively common organisational solution, is subject to the rules on enhanced disclosure. The proposed legislation to include all executives in both mother company and subsidiaries, seem to have been an outrageous idea. Implying that big companies like Ericsson and Volvo etc., would have to had list up to numbers exceeding 1000 individuals. That would have caused any company severe administrative costs and time-consuming routines. In addition, members of the board are target to per person information on compensation disclosure.

In terms of compensation policies and guidelines an interesting question arises, how much can the given compensation depart from the guidelines? The wording in the preparatory work is rather vague regarding this particular aspect. If the annual general meeting has adopted, guidelines that can be departed from, then the directors of the board and the CEO can depart from the rules without any notice. The example brought forward, of hiring a new executive in competition with others seem realistic but not as single reason why the company should be able to depart from the guidelines. Instead, there is a risk that this vague wording might open up for potential conflicts between the shareholders and the board of directors and CEO. The question is who is responsible for such action? The board as of today, but they can not be in the future since they have given up exclusive deciding rights to the annual general meeting and the shareholders.

Particular reasons, is a key word in the proposed legislation since this has to be approved by the annual general meeting in order to open up for the board of directors or the CEO to depart from the guidelines. What constitutes particular reasons? The only guidance that is to be found in the preparatory



work is that this is an exception rule and is not supposed to be used systematically. However, this does not help much when determining the legible meaning of this, potential, loop-hole.

The only actual difference in deciding power lies in the shareholder competence, through the new legislation, to decide on compensation guidelines to executives. The annual general meeting have already been the deciding corporate body for compensation to the directors of the board. Since, this always has been the only solution based on the principle of challenge. Therefore, this change of power is only a formality.

The set of problems that occur in the world are somewhat universal. Integrity i.e. decision-making competences are being reorganized within company functions, and shareholders are given exclusive means of power to make decisions on certain areas. Executive compensation is such an area. Means of power, mandate and competence, are moved from the board room to the shareholders, which might result in inflexibility through intervening in company integrity.

On a regulative basis, the initiatives in Sweden and in the EU are rather similar when it comes to the aim of enhancing corporate transparency through disclosure. As well as with the aim of addressing the issues of lacking confidence and trust for corporations among people in general and at the same time helping shareholders to regulate the imbalance even more between them and management, through new disclosure standards, in particular on an individual basis for the directors of the board and the CEO. This is explicitly stated and cornerstones in both frameworks, and most importantly, attempts to make changes in the cognitive area.

The development of the initiative, the recommendation, was preceded by a thorough analysis in the reports, the High Level Group report II and the Action Plan as outlined in the chapter regarding the development on the EU level. Therein is to find an interesting discussion on how to address the problems, referring to the big corporate scandals in Europe and in the US, in order to avoid such manor within the Union in the time to come. Both reports determines that the EU, and the Member States are still too legally, and partly culturally diverse, hence a unified code was abolished. They concluded that corporate governance codes are to be developed at the national arena where companies will be target to scrutiny for such regulation. They recommend usage of self-regulating deterrence systems. The Action Plan's work resulted in a list of key points that will ensure that good coordination in the respective corporate governance initiatives in the different Member States are guaranteed. Interestingly, EU de facto discusses the implementation of a uniform corporate governance code, which seems like a plausible solution in times of globalization. However, the constantly present problem regarding EU initiatives is, at the same time the strength and core of the Union, its diversity. The different Member States are having their current respective legal tradition and heritage of legal rules and traditions. This means that although initiatives have been taken at the EU

level, there is still a long way to go in terms of approaching each other. As seen in the outline of the progress of discussions at EU level, a turnaround, or rather a discussion that have grown mature and made its way pass many of the boundaries of a tempting the idea of an European federal codification.

The recommendation outlines four cornerstones, from which two are of certain interest. They are both covering the focus of this essay and are in conformity with the proposed Swedish regulations and amendments to the Swedish Annual Accounts Act and to the Swedish Company Code. The EU has invited the Member States to report the progress of the implementation of the recommendation mid-2006. Sweden seems to be well on time, the question is how many of the other 24 states that will also have implemented the recommendation. Another, rather simple argument of giving the Union legislative power over other areas than the current ones, such as corporate law would doubtlessly speed up the integration process of the entire Union.

### **Contra Productive Consequences: Information, Integrity and Inflexibility**

Sweden has with its structure of block-shareholders been relatively spared from corporate scandals. However, a question that arises is the reason for the general increase in executive compensation, which ultimately has grown to the extent of Enron and other corporate scandals. Is it just a opportunistic hunger for financial and monetary means, or a need to safeguard family financial supply for centuries to come? Another reason would be as both Dotevall and Randall is mentioning in their reasoning on general executive compensation levels; a chase for the top. The human being is a predator and maybe this basic need has transformed and evolved into a hunt for financial means instead of that for meat. Randall, reasons on a competitive culture that is already present at MBA schools that later is brought to, and implemented in the corporate society. The idea about “the winner gtakes it all”, is obviously spreading to other geographical areas of the world. This mentality is utterly based out of a benchmarking attitude with others, where it is given that you know the figures of others. I believe, as Dotevall, that rather the human basic, constant mode of comparison is the source of problem in this context. However, I fully agree that it is the knowledge of other parties’ compensation level that constitutes the contra-productive effect in this sense the information i.e. disclosed information on executive compensation.

### **Information**

If total transparency is the solution of corporate misbehaviour in the compensation context, how can it be that enhanced information has showed to be contra productive, as argued by Iaccobucci, Randall and Dotevall and instead contributed to the fact that average compensation to managers have increased over the last couple of years? Not until managers were able to benchmark their own remuneration, did the salaries start to get homogenously at a higher level than before. Today the effect of

benchmarking is probably negligible in the US in accordance with that it is probably not as applicable to the largest Swedish corporations either, but still to many others. If transparency has not been the leading word before, it will definitely contribute to managers' awareness about their respective compensation solutions: hence, something that can be used as leverage in the next round of negotiations about remuneration.

### **Integrity**

In Europe in general, counting for Sweden and maybe even more Germany, discretion is still an issue. Salary levels are not something that is widely discussed; instead people speculate about them. There are policies that are fundamental in a social democracy, where no one is supposed to express certain social norms such as disregarding employees like in the US. The highest paid CEO in Sweden will get exposed in media against a wall of workers illustrating his yearly salary in comparison with the people working for him. Interestingly the average number in the US is tenfold.

Ultimately, still partly, through new legislation-competence is moved to the courts. This implies certain complications, especially in terms of issues that are connected with determining what is reasonable. A court in Sweden can just as much as any other court elsewhere examine potential crimes committed, but never assess whether a company has made any bad business decisions. However, there might be an overall smaller number of companies in Sweden with excessive compensation packages due to a strong family ownership structure, but instead maybe with an opportunistic block holder. One could easily imagine other misbehaviour that might occur, such as self interest by block holder in conjunction with acquisitions or transfer pricing issues between companies owned or partly owned by block holder.

### **Inflexibility**

Another aspect to consider with extensive disclosure standards is the potential inflexibility that occurs for shareholders in negotiations about compensation with their executives. Imagine the following hypothesis: a CEO of a company is underperforming while the CFO is doing extremely well. How will the discussions about performance based compensation go if the CEO, due to for example compensation guidelines already knows exactly how much he is going to be paid? This is an efficient way to tie the hands of directors and shareholders, and take away their leverage or ability to assess a manager based on performance, and instead create leverage for the personal position of the manager in the negotiation situation concerning his own compensation. If the above is a reason as to why there is a pay gap between American and European CEO's, where the latter has a significant lower average compensation than the former, we should reassess the necessity of "total transparency" as the optimal goal.

The Swedish Company Act from 1955, pinpointed an interesting aspect that seems to have left the arena of legal discussion in Sweden. This rule opened

up for shareholders, certain size, to “appeal” executive compensation that he did not agree on. Thereafter, it was up to the court to adjust the compensation if it was obviously unreasonable. This means that the respective shareholder, if he did not agree on the decision, that the manager delivered at the level that was expected, he could make his voice heard and push the remuneration towards a level that he thought, and obviously also the court if approved, was corresponding with the performance of the executive. Pay for performance is rarely stated in legal texts, neither in Sweden and nor somewhere else. Except Germany, the German company act facilitates a rule that surprisingly have gained increased attention and importance lately. The usage of such a rule after several decades without hardly any use at all, is a sign that the German business society has just as every other become victim of mismanagement and corporate scandals through executive opportunism.

### **Private Equity, Competence Issues and Change of Ownership – Creation of New Structures and Patterns.**

The recent trend of delisting companies from commercial stock exchanges might seem surprising since the firms lose the ability to easily acquire capital through the delist. Many times the main reason for conducting an IPO in the first place was just the access to capital. There must be strong incentives as shareholder to take such action. The explosively growing private equity business trend confirms reasons enough for conducting systematic delisting of small, mid-size and large corporations around the globe. It is tempting to speculate about the reasons for this kind of business manor. News articles, such as the one presented earlier, pinpoints some of the arguments for delisting. The, often new, owners want to avoid the short sighted analysts quarterly headache and make long term strategic reorganisations and investments that might not satisfy the exact timely calculation on pay-off or return. But the owners, who often are having senior executive positions or at least have been appointed some form of consulting position accompanied with an equity-compensation-solution not to be found in any listed company in the world, wants to act long-term. Private equity owners often work “old style” for a couple of years before the company is again ready for the market and a renewed IPO with attractive exits for owners and management.

This trend has significantly contributed to the tendency with more possibly high potentials, i.e. human capital is seeking a future career within this segment. Consequently, it has on a parallel basis created a side effect with a stream of human- as well as actual capital that are leaving publicity and continue their journey in companies that are less transparent in most means. One can assume that there is probably much merit to the argument of avoiding public companies with enhanced transparency standards through disclosure and revised deciding competences between company entities. Management does not have to argue with boards, and shareholders in a public environment. To some extent and particularly in some countries there might be a risk that some of the, earlier mentioned societal oriented points

of interest becomes harder to acquire for the environmentally interested citizen, when the strains on information disclosure in general loosens on the company.

Delisting also has direct negative effect on the possibility to diversify asset portfolios for interested parties. Thus, this is a direct contra productive effect to one of the clear and explicitly stated aims of the new regulation; to create a deeper securities market.

### **The Wallenberg Case x 2**

A vast majority of Swedes probably have a high level of trust for the Wallenberg family. Especially; for its continuous presence at the Swedish business arena and its consistency in engaging in certain important national corporate icons such as Ericsson AB, Skandinaviska Enskilda Banken and other well known manufacturing and financial actors. Trust from society instead of bad-will in the newspapers has always been the device of the Wallenberg conglomerate. It is tempting to assume that there has been a mutual understanding between the Wallenberg family and the social democracy government that has only with few conservative political terms been interrupted since 1920. On a speculative level, this might then be the reason for the Swedish government not to intervene with the dual stock owning structures that are heavily criticized by foreign investors, but on the other hand, totally crucial for the Wallenbergs, and most other family dynasties in order to maintain their superior position. Since some scholars argue that a widely diverted structure of shareholders would contribute to higher corporate governance structures, one wonders why the Swedish state has kept the privileges of stocks unknown and considered middle-aged to some. This is especially interesting based on the fact that, one of the explicit goals with the new regulation has been to deepen the securities market through a clear corporate governance regulation.

### **The Gambro case**

It seems easier to accomplish development and further fostering of a creative culture that result in gains for the company and its' owners in a private company is significantly better and more fruitful, compared to one that is listed? The Wallenberg family, has via its private equity fund EQT bought Gambro AB and are about to finalize the process of delisting from the Stockholm Stock Exchange. Interestingly, the main argument for delisting the company, publicly stated by representatives for EQT, is the belief that Gambro AB has greater potential to grow and develop as a privately held company.

Lennart Låftman, former CEO of one of the largest pension funds in Sweden, Femte AP-Fonden, raises criticism saying that such behaviour is direct contrary to that of a capitalist system and a free market. Lennart Låftman, a senior Swedish former pension fund executive, argues that both parties for the stock market as well as those from the regulative side have to

revise positions if The Swedish Code for Corporate Governance and the rules found therein as such is argument for delisting.

Equity based compensation was probably introduced in order to create incentives for management to perform better and more efficient. This system is either largely abused and therefore outdated, or from the point of bad managers, weakly constructed so that legislation and other measurements are actually closing in on the entire culture of outrageous opportunism. An obvious risk is that they have moved on from public control, into a state of shadow where no or little insight is possible. This either means that the owners of delisting companies have potential to create corporate scandals that make Enron fade. But, this will probably not happen. Why? The managers are working with their own money!

The antithesis would be that; there is room for improvement in corporate structures, and this reorganisation is best done when the light in the theatre has gone dark. Possibly is it done in this way due to keeping the formula and recipe secret to others. Subsequently, this might be a tendency: that listed companies delist since they comprise hidden potential and needs to be assessed and reorganised in order to utilize their full potential.

Interestingly, in Sweden, the Wallenberg family is at the forefront also when owner structures seem to change. They are taking the role of a private equity player and stays on top of the game. This way, they might be able to manage their trust in a new form, something that can be valuable when doing the deferred “new” IPO with the delisted companies after a couple of years.

Whether the new owner structures, being Private Equity companies, are interested in complying with corporate governance standards is rather uninteresting. Privately held companies seldom have any governance problems. One potential thing that might arise is governance issues of for example pension funds or hedge funds, when and if they for example invest in private equity companies or funds.

However, environmentally interested people in society, can still consider themselves as stakeholders to companies.

## 6 Conclusions

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*Transparency is good, utterly good if you ask some academic scholars and the Swedish government. I agree, but only to a certain extent. I believe that disclosure “beyond” transparency will only bring contra productivity and costs for the company, and as a bi-product for the society in general. There is an obvious risk that the haunt for transparency will border line naivety, typically presented by the Swedish Government in the early preparatory work of the legislative proposal where Volvo and Ericsson would had have to attach details of over 1000 individuals.*

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The basic assumption of the thesis was that the Swedish government addressed an issue of cognitive nature, declining trust for the business community, among people in general i.e. society. The government realized that the only way being an institution to get to peoples cognitive patterns, tendencies and minds is to use the channels that are open to intervention. Hence, proposals for new legislation and normative structures, and in this case self-regulating standards on executive compensation were born. Keeping in mind that it is a rather intangible target; trust, that is supposed to be addressed through relatively tangible means; laws and regulations. The result here from is as initially mentioned not measurable for several reasons, one is being due to the relatively age of the entire initiative, another is the nature of the subject intangibility that makes hard to quantify.

Probably it is not enough if the pendulum swings back only once and completes the oscillation. Maybe the pendulum has to swing a second, or even complete more oscillations in order to carry the wished effect of the regulative and normative initiatives into the third, cognitive pillar. Cognitive behaviour is after all, about common conceptions. Such patterns normally takes long time to establish, however they can be abolished in no time. Therefore, initiatives has to be done in an intelligent and adjusted manor. Especially since the basic conflict between legal and business aims, most likely will remain, which in turn can create undiscovered contra productive consequences that also might affect cognitive patterns and tendencies.

The legislative initiatives were from my point of view sound and correct. Distinct rules regarding shareholder influence on the decision process on executive compensation regarding per person level for directors of the board. Further increased power to the annual general shareholder meeting, being the superior deciding organ in the corporate body. Exclusive power over adopting guidelines on executive compensation to the CEO, and other senior executives will give the shareholders a clear and useful tool to regulate one of the main areas that have been target for discussion. This is all good so far, however, are there any flip-sides of this? Why is competence taken from a corporate body organ and is moved to the owners, that can not be held responsible for their decisions. Has the risk, and opportunistic

behaviour in terms of avoiding responsibility among directors of the board also been put at the agenda when former Enron executives in the US, and Skandia executives in Sweden are facing imprisonment?

As emphasized by consultees, the flexibility of the company functions is extremely important to keep intact. This is done through the new proposal at the same time as transparency both in terms of information and deciding powers towards shareholders are enhanced. This will likely, but not necessarily, have positive effects on the societal approach to the institution corporations. Good governance will create goodwill, and hopefully will the newspapers just as with bad news also bring forward the good which will re-establish trust among people in general.

Having a corporate governance code, from which new legislation is stealing the light, and furthermore without any form of deterrence will make its standards run into difficulties gaining the credibility it is aimed to reach. Probably companies will adhere to the standards only if the code really finds the normative acceptance within the business society. In Sweden, such acceptance seems rather easy to acquire, otherwise the risk to fade adherence to the standards over time is obvious. Failure to establish acceptance will most certainly lead to a significant number of obstacles that in turn will leave the code with marginal or no credibility.

Mass media's impact on a social democracy with a culture of trust is twofold. First, based on the fact that Sweden has a well developed infrastructure, media's importance cannot be overestimated. On the other hand, it seems like today's news is already old and everybody is heading for tomorrow without paying any real attention to what just happened. This might as well be a result of a never ending media buzz. Probably, a self regulating code will work in Sweden, since we have a culture of trust, and people are well developed media and newspaper users.

One obvious risk with lean intervention in society, is the risk of continence as that could then mean introducing executive compensation on a per person basis as a mandatory disclosure item and not seeing the potential problems. The administrative-audit-vehicle and the potential benchmarking between individuals at similar positions, as well as other potential contra-productive threats.

Benchmarking of compensation levels, is just as many scholars recognizes a clear side-effect of disclosing executive compensation. I believe that the effect on top-tier management might be minimal, but the effect on second and third tier of a company management latter might have significant effect if the numbers became public. Another aspect of this is that a CEO of a subsidiary to a large mother company can be responsible for enormous amounts of money, for example a treasury centre, and therefore maybe he is well paid. A person in another company realizes the same second as he hears or sees the other persons compensation, and potentially starts negotiating with his superiors. Since most companies are using consolidated



accounting standards, a comparison on group level might make sense, thus benchmarking compensation of executives in subsidiaries is probably misleading.

The issue of integrity in terms of discretion is questionable, but to some extent and considering the Swedish culture the argument has some merit. However, the other potential consequences on integrity are more severe. The fact that courts, ultimately, are given competences of deciding on whether a CEO's compensation is justified or not, which might become the case if for example a company are allowed or requests to depart from the compensation guidelines and signs someone a compensation scheme that later will be considered outrageous. That risk remains. Then it will basically just as with the old Swedish Company Act be the judge that shall decide, given that there is any criminal element such as misrepresentation or fraud involved, and the compensation as such is a key issue it might theoretically come down to the judge to determine whether it was right or wrong to hire CEO X for Y money. However, it is likely that most of these cases will settle in an arbitration forum.

To restore trust and confidence through enhanced disclosure standards is probably partly achieved through the initiatives, potential contra productive consequences are only considered to a very limited extent. Transparency towards shareholders, is easier to achieve than that towards society as such and the proposed regulations both on deciding competences i.e. compensation guidelines and disclosure on executive compensation are aimed to address and will address the issue of declining trust from owners and society. In terms of society in general, the actions that have been taken through the establishment of the Commission of Business Confidence and the implementation of the initiatives taken at the EU level is signaling high priority.

Still, cognitive structures and behaviours are not easy to reach why I think there is no significant change in the short term perspective but definitely good chances in the long run. Considering aspects already mentioned, such as geographically expanding businesses and corporate initiatives a EU federal corporate governance code is more likely than not from my point of view. The increasing federal legislation on the area in the US, with SOX, already affects many European companies established in the US and thereby has to adjust their standards.

The actions and initiatives taken by the Swedish government, i.e. new legislation, the Code and the overall signal to society with a committee working with issues to restore trust and confidence for the business society is as Westholm argues severe intervention by the institution. What is the logic of regulate an area through legislation, when that same area just have been target for the development of a self-regulating corporate governance code? Effects of the code are yet due to elapsed time too scarce to be measured. The obvious aim of legislation is to restore the imbalance between agents and principals. This is done by giving principals increased

power on certain areas regarding compensation to executives. At the same time, the information asymmetry is addressed through extended and somewhat remodelled disclosure standards on executive compensation. Large portions of uncertainty remains. Is it synonymous that what is good for the principals is also good for every other constituency of the company? A naive haunt for transparency through disclosure and other means will certainly enhance transparency, but to get to the cognitive goal through intervening in the regulative and partly in the normative pillar might lead to contra productive consequences. Hence, Signalizing the magnitude and importance to society will probably partly help restoring confidence. Shareholders are better off, through directly targeted regulations that will affect their positions as principals.

Trust, social norms and belief is from my point of view rather impossible to actively create. Trust is created through consistent conduct and behavioural patterns. However, confidence is also addressed as an important aspect of attracting for example foreign investors, and is supposedly easier to create. Maybe even through intervention in the regulative and normative pillars of the institutional theory. But to reach cognitive behaviour and trust is not achieved.

## 7 Further research and ideas

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State-run companies and monopolies, a frequent phenomenon in Sweden would be interesting to use as target for a case study in Sweden. How are they working with corporate governance in general and executive compensation in particular. Interestingly, they have been deficient at the forefront in the discussion on creating trust among society and other constituencies through a sound compensation policy and high level of transparency. Instead, these executives have been highly compensated, not far from top notch in the private sector. The remunerations of these executives have been target for some media scrutiny, compared to other outrageously compensated executives in the private sector: about the same media buzz. What kind of arguments is hiding behind a compensation level from the state to their own executives well at market standards, and then regulate and take initiatives where they argue that the same level has passed reasonable boundaries!? Is it due to opportunism among executives, in combination with weak owners (the Swedish state). Is there any merit to the argument that the state has to compensate at market level? They argue that, otherwise they would not attract any potential leaders. Is this victimization of market power accurate here?

How does this affect trust in society, for all corporations, since the correlation between state run companies and private companies in the eyes of many people is: 1. Mass media is through their “normal” attention and coverage of overly compensated CEOs in state run companies confirming this hypothesis This is an important aspect, since there are obviously fundamental differences, between the two forms of companies from many perspectives. State run companies are frequently funded with state monetary means, being tax. The difference between a state run company and that of private owners, is that I voluntarily invest in the private company while all citizens invest tax money in state run companies. Hence, I contribute to the salary of the overly paid CEO in the state run company, while I can choose whether I want to contribute to the salary of the private sector CEO.<sup>171</sup>

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<sup>171</sup> Discussion with Per Samuelsson, Lund University, spring 2006

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