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The Reflexive Properties of Corporate Governance Codes : The Transplantation and Reception of the ‘Comply or Explain’ Approach in Slovenia

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The Reflexive Properties of Corporate Governance Codes : The Transplantation and Reception of the ‘Comply or Explain’ Approach in Slovenia

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Abstract

The Slovenian Corporate Governance Code for Public Joint-Stock Companies was adopted in March 2004. Using a systems-theoretical approach, we examine the extent to which the implementation of the Code has resulted in the kinds of ‘reflexive’ learning processes which the ‘comply or explain’ approach aims to bring about. The adoption of the Code has already had an impact on the wider legal system, triggering certain changes in the body of core company law, and assisting the process of adjustment to EU-level norms. On the whole, companies’ implementation strategies are strikingly similar both in terms of the contents of deviations as well as in the type of disclosure and explanations for deviations. At the same time, the quality of disclosures is low, with effective comply-or-explain declarations representing only a small minority of disclosures. On this basis, the Code has been more effective, to date, in legitimating Slovenia’s adjustment to transnational norms and standards, than in stimulating institutional learning.

1. Introduction

Corporate governance codes are traditionally viewed as a mechanism to foster the evolution of capital markets by increasing the transparency of business and the level of shareholder protection. Standard law and economic approaches to corporate governance codes, however, fail to capture the complex, dual nature of the codes. They view issues of transition exclusively from an agency theory framework and are therefore able to offer a set of hypotheses about managerial entrenchment, rent seeking behaviour and legal origin. At the same time, they encounter problems in adequately presenting the process of the transplantation and transmission of norms. These issues prompt a deeper look into the nature and evolution of legal norms, of the kind offered by systems theory.

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Systems-theoretical approaches agree with those of the modern law and economics tradition concerning the need to escape from crude command and control forms of regulation. However, having observed the frequent failure of laws to have their intended effects and the persistence of inefficient laws, systems-based approaches attempt to construct a more complete theory of the relation between the law and economic relations. While law and economics explains the inability of corporate governance reform to proceed as intended on the basis of the diversity of systems, and blockages between law and economy in terms of path dependence and public choice-style inefficiencies, autopoiesis points to a much deeper, structural problem of the separation of the legal and economic spheres, and their indirect, mutual co-evolution.

This paper employs concepts of the modern theory of social systems introduced by Luhmann (1995) and Teubner (1993) and builds on the idea of system autonomy, the notion of operationally closed but structurally opened social systems linked by mechanisms of structural coupling, to offer a more complete account of the operation of corporate governance codes. By pointing to the structural problem of the separation of the legal and economic spheres and their interdependence, this approach offers a better understanding of the complex law-economy relationship and explores the contribution that corporate governance codes can make to understanding that relationship. This perspective makes it possible to study the mutual interactions between law and the economy: to examine how law influences economic changes through the code implementation process, as well as how the economic system, in its turn, triggers changes in law and affects the development of the code provisions. The merit of this approach lies in capturing complex environment of and the historical interplay between regulation and business, highlighting the non-linear and non-deterministic nature of the process of change. Moreover, by introducing the idea of social autonomy and structural coupling between social systems, systems theory does not just open up a new way of analysing the way in the legal system is linked both to political legitimization and economic efficiency; it also captures an important aspect of law's responsiveness to the dynamics of 'civil society' (Teubner, 1992: 1462).

The focus for our empirical study is the implementation and reception of corporate governance codes in transition systems. These present a particularly challenging environment for the transposition of corporate governance norms. We look in detail at the case of the

implementation of the corporate governance code in Slovenia in 2004, and examine its dual impact on the legal system and on economic relations since that point.

The paper is structured as follows. In the next section our theoretical framework is introduced. Section 3 explains the importance of the Slovenian case for studying the reflexive properties of corporate governance codes. Section 4 presents empirical findings concerning the legal impact of the code and its effects upon the practices of listed companies. Section 5 concludes.

2. A theoretical framework for understanding corporate governance ‘transplants’ in transition systems

In the countries of central and eastern Europe and the former Soviet Union, adjustment to the institutional needs of a market economy since the early 1990s has taken the form of extensive privatization coupled with far-reaching legal reforms. In terms of the formal law, shareholder and creditor rights quite quickly reached a level which was comparable (if not superior) to those in countries with a more continuous history of market-based economic development (Pistor, 2000). However, the adoption of these laws seems to have had a tenuous relationship with the growth of stock markets. Research carried out for the EBRD in the early 2000s suggested that corporate governance in transition systems was still characterised by over-strong incumbent managers, weak outside investors, a lack of external finance for firms, and a continuing heavy influence of the state, expressed through taxation policy, the retention of golden shares and the use of regulatory favours. The formal provisions of company and commercial law were less important as determinants of the use by firms of external finance than the general perception of legality (or the ‘rule of law’) and the effectiveness of legal enforcement in a given country. The authors of this study concluded that ‘it is unlikely that in the foreseeable future the development of the law will be matched by the development of financial markets’, at least until such time as a ‘more important constraint on financial market development’, the fragility of legal institutions, had been addressed (Pistor et al., 2000: 13).

For some commentators, the apparent lack of success of legal reform strategies in transition systems should not be seen to detract from a more fundamental long-run process of realignment with market-based legal orders; ‘normality’ will eventually be achieved as a consequence of the expected convergence of systems on the core features of the Anglo-

American model. Thus dilution of minority shareholder interests is a ‘nearly universal practice’ in ‘middle income and developing countries’, which legal reforms will eventually alleviate once economic development reaches a certain level (Shleifer and Treisman, 2003). An alternative view sees the experience of transition in terms of a wider difficulty in transplanting legal mechanisms and concepts across national systems. Legal transplants work best in contexts where the host state already has a developed legal order, and where foreign laws are adapted to suit local conditions; where these conditions are not present, transplants can actively undermine the effectiveness of legal institutions, while making little or no contribution to economic development in their own right (Berkowitz et al., 2003). On this basis, path dependence and cross-national diversity pose a serious obstacle to institutional reform, which may nevertheless be addressed by measures which are sensitive to the circumstances of individual countries.

The recent adoption of corporate governance codes in several transition systems offers an important opportunity to re-evaluate this debate. Corporate governance codes consist of guidance for firms (normally, listed companies) on what constitutes best practice on matters which include board structure, executive compensation and relations with shareholders. Following the model of the UK’s Cadbury Code of 1991, they tend to be principles-based rather than relying solely on prescriptive rules (although many, including the UK’s own Combined Code, now contain quite detailed rules). They do not depend on the legal system for their enforcement but on a mixture of regulatory authority exercised by stock exchanges and listing authorities, and on investor opinion. This is the core of the ‘comply or explain’ approach: companies have a choice of whether to follow the guidance set out in the code, or to explain why they have chosen not to, leaving the final judgment to the stock market. Although claims that codes improve corporate performance directly have proved difficult to substantiate (see Gompers, Ishii and Metrick, 2003), there is evidence to suggest that, in the context of systems which already have liquid capital markets such as Britain and America, compliance with codes helps to cut the cost of raising external capital for firms, and enhances investor confidence (McKinsey, various years).

Since the adoption of the Cadbury Code, which was not the first corporate governance code but which has been the most influential, there has been a rapid dissemination of the code model worldwide. If the adoption of a code is generally understood as a signal that a country

is committed to improving its corporate governance system, this is because of widely held belief that ‘countries with effective corporate governance systems become not only attractive locations for domestic companies to prosper and invest, but also for foreign investors, and thus promote economic growth’ (Aguilera and Cuervo-Cazurra, 2004: 416, references omitted).

From a law-and-economics perspective, corporate governance codes complement the basic provisions of company law in providing a template for the publicly listed corporation which serves to reduce agency costs and align managerial behaviour with shareholder interests. According to this point of view, there is an emerging global consensus that companies are managed most effectively when managers are made ‘strongly accountable to shareholder interests, and (at least in direct terms) only to those interests’ (Hansmann and Kraakman, 2000: 9). Obstacles lie in the path of convergence, in the form of resistance from vested interests such as those of incumbent managers and owners who are in a position to extract private benefits from controlling stakes, coupled with the costs of making legislative changes. However, there is an expectation that ‘corporate governance practices will generally precede the reform of corporate law, for the simple reason that governance practice is largely a matter of private ordering that does not require legislative action’ (Hansmann and Kraakman, 2000: 17), a trend which will be accelerated by the growing influence of institutional shareholders and by their greater willingness to invest on a global scale.

A comparative political economy perspective offers a more sceptical point of view. This stresses the diversity of contemporary systems of corporate governance and questions the universal relevance of the agency model (Hall and Soskice, 2001; Amable, 2003). From this angle, the dissemination of corporate governance codes is likely to run up against resistance in ‘coordinated market economies’ for which an agency model of the firm is inappropriate. The model of the corporate governance code, with its stress on aligning managerial interests with those of shareholders and offering a limited role (at best) for labour in governance processes, bears the marks of its origin in Anglo-Saxon corporate governance practice. As such, it can be seen as a response to a particular set of problems, associated with the separation of ownership and control in large corporations, which are particular to so-called ‘liberal market’ systems with diffuse share ownership and liquid capital markets. In ‘coordinated market’ economies, the concentration of ownership in the hand of insider shareholders has historically

been counterbalanced by the provision of voice rights to employees at the level of the firm in various forms up to and including the model of codetermination found in German-influenced systems, and these complementary institutions have helped to foster competitive strategies based around a high degree of firm-specific investments in skills and capabilities. Given the presence of strong insiders, it can be argued that the problem to be addressed by governance structures is the potential exploitation of minority shareholders by those with controlling stakes, rather than the danger of incumbent managers exploiting shareholders as a group. To that extent, the model implicit in Anglo-Saxon corporate codes may just be irrelevant.

More negatively, the introduction of a corporate governance model which stresses managerial accountability to shareholders *alone* would go against the grain of managerial strategies and organisational practices which characterize large publicly-held firms in coordinated systems. For the proponents of a shareholder value approach, the disturbance induced by corporate governance reforms would be welcome in so far as it served to undermine managerial strategies which are, at their core, inefficient, in the sense of favouring private interests at the expense of the value of overall returns to the firm (Hansmann and Kraakman, 2000: 23). However, from a comparative institutional viewpoint, the danger with such an approach is that ‘grafting market-based institutional forms onto a model organized according to very different complementarities ...is bound to be inefficient’ (Amable, 2003: 24), an argument which may also be relevant to transition economies which have not historically had high levels of capital market liquidity (Berglöf and Van Thadden, 1999).

Empirical evidence on the adoption of corporate governance codes does not clearly support either point of view. Aguilera and Cuervo-Cazurra (2004) , in their study of 49 countries (none of which were transition systems), found that countries which had weaker shareholder protection regimes were more likely to adopt new codes in the period 1978-1999, but that, cutting across this finding, those with civil law legal systems were less likely to do than those of common law origin. One reason for this is that ‘the intrinsic characteristics of the common-law legal system facilitate the enforceability of codes of good governance’ (2004: 434). This is because, these authors argue, good practice in the area of corporate governance is more likely to influence the courts and thereby to achieve a degree of legal enforceability in common law systems, which rely on rule-making through judicial precedents, than in civil law systems, where there is greater reliance on legislation and statutory reform to achieve

legal change. In making this argument, they assume that countries with a common law legal system are, for that reason, those with ‘more effective governance systems in terms of the overall legal system’, a view which, while compatible with an agency approach, may be questioned. The reason they give for thinking that common law systems are more efficient than those of civil law origins is not particularly convincing; the assertion that the common law adjusts more flexibly to changes in commercial practice, thanks to the more prominent role of the courts in decision making, ignores the predominant role of legislation in the development of Anglo-American company law and its variants, while glossing over the often very active role of the courts in shaping company law in civilian jurisdictions (Pistor, 2005; Ahlering and Deakin, 2007). Their finding is however, compatible with the possibility that corporate governance codes, because of their origins in Anglo-American practice, are more complementary to the institutions of common law systems than to those of the civil law, a position which is consistent with a comparative political economy perspective. They also find that factors influencing the adoption of codes are not confined to a desire to enhance the effectiveness of systems, but include pressures to legitimate systems by responding to what is seen as an emerging global standard, regardless of how it is implemented. Thus the rate of code adoption is linked to the degree to which a country is integrated into the world trading system, how far it has undergone a process of internal economic liberalization and privatisation, and to the presence of foreign institutional investors. This implies that the diffusion of codes is only partly related to efficiency considerations, and may even be in the nature of a ‘fad’ (Aguilera and Cuervo-Cazurra, 2004).

So far we have been considering the question of corporate governance transplants from the point of view of alternative economic-theoretical perspectives. However, corporate governance codes are not simply instantiations or expressions of a particular economic model of the firm; they are autonomous institutional phenomena with the potential to reshape the legal and economic orders into which they are incorporated, and to be modified in their turn by those orders. From this angle, the issue is not so much whether they can be successfully transplanted; the transplant metaphor overstates the degree to which there are just two alternative outcomes of the diffusion process, acceptance or rejection of the rule or institution which is being transposed. Instead, as Teubner (2001) suggests, legal or regulatory transfers more often operate as ‘irritants’ which trigger unexpected consequences in host systems.

Consistently with the autopoietic or systems-theoretical approach which informs his work, Teubner insists that a distinction be drawn between economic and legal institutions: if ‘economic institutions are constraint and incentive structures that influence cost-benefit calculations of economic actors’ then legal institutions ‘are ensembles of legally valid rules that structure the resolution of conflicts’ (2001: 435). It follows that ‘economic institutions and legal ones are not only analytically but empirically distinct from each other’ (ibid.). This account is not necessarily incompatible with the idea of Aoki’s ‘comparative institutional analysis’ (Aoki, 2001), namely that economic institutions are summary representations of equilibria which emerge from the interaction of agents in particular contextual settings. However, rather than saying, as Aoki does, that ‘statutory laws or institutions may induce an institution to evolve, but they themselves are not institutions’ (Aoki, 2001: 20), Teubner’s approach presupposes that legal phenomena have an institutional quality within their own ‘domain’ (to adapt Aoki’s term), that is to say, at the level of the legal system itself. The validity of legal norms is determined by internal rules of recognition, rather than their functionality with regard to external economic phenomena. Legal and economic phenomena nevertheless co-evolve, in the sense of reciprocally influencing each other’s development over time; neither one is reducible to the other. It follows that legal institutions are fitted, to some degree, to the economic environment or background against which they emerge.

To illustrate his argument, Teubner gives the example of the civil law concept of good faith in commercial dealings: its development has been ‘closely linked to a specific production regime’, associated with the German model, in which corporate governance and corporate finance favour a long-term strategic approach, industrial relations are based on explicit norms of cooperation between management and labour, inter-firm relations take the form of networks of relational contracting, and trade associations play a prominent role in standard setting in conjunction with government. When the concept of good faith was transposed into English law, thanks to harmonizing legislation at EU level,¹ the result was a ‘perturbation’ of the legal system which had the potential for knock-on effects on commercial relations. However, it is essential to Teubner’s argument that this should not be seen as a case of a ‘rejected transplant’. Although, in the context of the German system, good faith operated to mitigate some of the risks of mutual dependence of the contracting parties, in the British

¹ Directive 93/13/EC on unfair terms in consumer contracts, implemented in the UK in the form of the Unfair Terms in Consumer Contracts Regulations 1994 (SI 1994/3159) (now in a revised form: SI 1999/2083).

context it had the potential to function somewhat differently, to '[set] firm boundaries to market dynamics' (2001; 439). Thus it cannot be assumed that legal and economic institutions are *so* tightly coupled as to rule out the possibility that they will be adapted, in some way, to their new setting. This is partly a function of the growing influence of transnational sources of legal norms. The meaning of the term 'good faith' had already been altered when it was included in the European directive on unfair terms in consumer contracts; this process continued when the directive was implemented at the level of the individual member state.

Teubner's analysis highlights the need for empirical analysis which is capable of identifying with some precision the complex effects which transplants or 'irritants' may induce. His suggestion that the consequences of transplantation are often unexpected, and, indeed, unpredictable, should not be taken to suggest that they cannot be effectively studied. It does, however, imply that the use of generalised models of national regimes of production – whether based around the contrast between liberal and coordinated systems, or between developed, developing and transition economies – may not be much guide to the way codes are received and operate in practice. Individual country studies are needed in order to assess the impact of codes at the level of the legal orders into which they are implanted, and the wider economic systems of the countries concerned.

With this type of comparative institutional analysis in mind, three particular features of corporate governance codes stand out. The first is that, notwithstanding their origins in systems of the common law tradition, and in American and British practice in particular, they should not be seen as irredeemably tied to the particular features of liberal market systems, such as diffuse share ownership and liquid capital markets. Corporate governance principles are now formally stated in transnational instruments, the most notable being the model code of the OECD, which, while still retaining much of the shareholder value orientation of the original Anglo-American codes, also makes reference to stakeholder concerns. The implementation of codes at national level is quite often sensitive to local circumstances, so that the basic model has been adapted (formally at least) to systems with two-tier boards, concentrated share ownership, family control, and codetermination (Aguilera and Cuervo-Cazurra, 2004: 436). This leaves open the question of how codes operate in practice – their formal implementation provides only part of the picture. How do codes operate in practice in

systems – such as those of transition economies – which do not have experience of stock market liquidity or a prominent role, as of yet, for institutional shareholders? Can codes be used in such circumstances to trigger a loosening of existing ownership blocks? What are the effects of their introduction upon managerial structure and behaviour?

Secondly, corporate governance codes are a particularly interesting case for empirical study because of their dual nature as products of both the economic system and the legal system. The earliest codes were the result of deliberations by autonomous industry bodies, such as the City institutions which supported the setting up of the Cadbury Commission in the UK. In the case of the Cadbury Code, the indirect influence of government, and the possibility of government action if an effective self-regulatory solution was not forthcoming, was present in the background, and government influence has been even more strongly to the fore in some of the more recent amendments to the UK's Combined Code, such as those following on from the Higgs Report of 2002. However, it remains the case that the basic model of the corporate governance code is one which attempts to abstract from good practice as it is generally understood to apply among the better run companies and to express a consensus among the relevant business and professional bodies. As successive countries have adopted the basic model with variations, and the earliest codes have been modified in their countries of origin, additional attempts have been made to encapsulate developments in the practice of large corporations, and to respond to new issues as they arise. In this sense, corporate governance codes can be seen as products of the economic system, broadly understood to include practices at firm level and at the level of business associations and self-regulatory bodies.

Codes are, at the same time, outputs of the legal order. Like standard form contracts or collective agreements, while they derive their substance from the deliberations of autonomous social actors, they take a form which is to large degree influenced by the legal system, and which is designed to be compatible with and recognisable by it. Corporate governance guidelines may be non-binding, in a strict legal sense, but they are produced in a 'script-coded' form which mimics that of legislation. They are open to interpretation in a way which makes them amenable to being incorporated into rules of the positive law at appropriate points.

From a systemic viewpoint, then, corporate governance codes are ‘linkage institutions’ which operate at the point where ‘structural coupling’ between the economic and legal systems can be identified. Structural coupling, in Teubner’s sense, does not imply a point-by-point similarity or congruence of legal and economic forms; on the contrary, he views structural coupling as based on a ‘productive misunderstanding’ of each system by the other; the legal system, through its own distinctive processes and discourses, ‘distorts’ the social order and ‘recontextualises’ the meaning of social phenomena in its own terms. The same process is at work when the economic system receives ‘instructions’ from the legal order, in the sense of attempting to implement legal norms at the level of the market or individual firm. The governing assumption of systems theory is that information from one system cannot be transposed *directly* into the other. However, their interaction takes a particular form when it is mediated by ‘hybrid’ institutions such as codes or standards which operate simultaneously in both the legal and economic orders. This opens up a further set of empirical questions for analysis. What types of evolutionary responses do codes trigger in the legal and economic contexts in which they are applied; and can any conclusions be drawn concerning the implications of these responses for the regulatory effectiveness of codes?

Thirdly, and relatedly, corporate governance codes are an example of regulatory instruments which are explicitly designed to be ‘reflexive’ – that is, to trigger a learning process which will over time will enable them to incorporate developments from practice. Thus codes are not just non-binding in a strict legal sense; through the ‘comply or explain’ mechanism, they are meant to induce a range of responses from firms. Non-compliance with the formal terms of the guidance is, in fact, an option, as long as the firm in question offers a reasoned explanation for the choice it has made. The sanction of de-listing as a penalty for failing to offer a clear explanation is present in most cases, but this is rarely exercised; market pressure, investor sentiment and reputational effects may be more effective sanctions in practice. But this prompts an additional set of questions. When codes are implemented, what degree of variation in the responses of firms can be observed? How is the information processed by market actors? How are the results to be evaluated?

With these considerations in mind, we now turn to our empirical study.

3. Transitional systems and the importance of the Slovenian case

In the last few decades the countries of central and eastern Europe have been dominated by transition processes that had shaped their economic development, institutional set up and balances of power. Different privatisation techniques were applied, resulting in various ownership structures and varied indicators of economic stability. Slovenia has followed a gradual approach in transition. The priority of the reform was macroeconomic stability, resulting in Slovenia being the first and only new EU member state to adopt the single European currency, the euro, in January 2007. At the same time, institutions were being set up to enable Slovenia become part of the European Union. The legal framework was reformed so as to provide protection of property rights, including shareholders' rights, resulting the situation that in Slovenia, as elsewhere in transitions systems, the 'law on the books' provided a higher level of shareholder protection than in most civil law countries, and was surpassed in aggregate only by the common law group of countries.

While the processes of economic and legal transition into market economy with a system of private ownership have to a great extent been concluded, with regard to the corporate governance system Slovenia is still in a transitional phase. Concentrated control structures, a prevalence of insider ownership, the relative absence of a cadre of professional managers, low liquidity of capital markets, an over-heavy role for the state in the economic system, and a continued role for informal networks of relationships in business and government, reflect to a great extent the former system of collective ownership and workers' management, and also echo the chosen method of privatisation.

Privatization in Slovenia resulted in a relatively dispersed ownership structure by transition standards. The Law on Ownership Transformation² provided for the obligatory distribution of 60% of the capital of privatised enterprises on the following basis: 20% was allocated to the two state-controlled funds (that is, the Pension Fund – KAD, and the Restitution Fund - SOD), 20% was distributed among inside owners, while 20% was granted to Privatisation Investment Funds (PIFs). The remaining 40% of the capital was distributed according to the model chosen by each company itself, that is, companies could either sell shares to inside owners (management, employees and former employees – the 'internal privatisation' method)

² Official Gazette of RS, No.55/1992 and further changes.

or to the public (the ‘external privatisation’ method). More than 90% of companies opted for the former, the internal model (Simoneti et al., 2001). This ownership distribution resulted in the two main groups of shareholders were contending for control and the right to exercise voting rights at general meetings: outside blockholders on one hand, and dispersed insider owners on the other hand.

The privatisation period has been followed by post-privatisation processes of intense ownership and voting rights consolidation. In particular, a steady increase in the size of the largest blockholder has been observed. The share of the largest shareholder in companies entered in the companies registry maintained by Central Securities Clearing Corporation Inc. has increased by 14% in the last five years (Bratina et al., 2005). In 2004, as a result, the largest shareholder in listed companies held on average 36.9 % of the company’s capital. The shares of the second and the third largest shareholder, on the other hand, have remained fairly stable, with the average of 12.5 % and 8.2 %, respectively (see Figure 1). This, however, is still lower than in other CEE countries in which the median largest stake was reported to be over 40%, in some countries even well exceeding 50% (Berglöf and Pajuste, 2003).

		Listed				Non-listed			
		C1	C2	C3	sum	C1	C2	C3	sum
1999	mean	23.7	13.0	8.6	45.3	39.2	15.4	9.3	63.9
	n	69	69	69	69	388	388	388	388
2000	mean	24.5	12.7	8.5	45.7	40.2	15.6	8.7	64.5
	n	76	76	76	76	469	469	469	469
2001	mean	28.6	13.4	9.2	51.2	43.5	15.9	8.1	67.6
	n	80	80	80	80	476	476	476	476
2002	mean	23.5	13.4	9.0	54.8	46.8	15.5	8.1	70.3
	n	90	90	90	90	543	543	543	543
2003	mean	33.3	13.5	8.8	55.6	48.7	15.4	7.7	71.8
	n	88	88	88	88	527	527	527	527
2004	mean	36.9	12.5	8.2	57.6	52.2	14.9	7.4	74.5
	n	89	89	89	89	506	506	506	506

Figure 1: Descriptive Statistics of the Percentage Share of the Three (C1,C2 and C3) Largest Shareholders
Source: (Brezigar Masten et al., 2006)

At the same time, insider control has been undergoing a process of increasing homogenisation.³ Post-privatization adjustments in Slovenia reveal an increase in managerial

³ Insider privatization prevailed in Russia, the former Yugoslavia and Poland. Outsider privatisation, on the other hand, was carried out in the Czech Republic by voucher privatization and Estonia by direct sales of state

ownership while employee ownership is reported to be declining (Simoneti and Gregoric, 2004). The trend of a slow but steady increase of managerial ownership is expected to continue - empirical studies show that in 2001, the actual level of managerial ownership was still 10.83 % below the average level desired by managers (Simoneti et al., 2001).

In terms of the identity of large blockholders, the public sector is to the fore. Privatization established two main groups of blockholders: Privatisation Investment Funds (PIFs) and state-controlled funds (KAD and SOD), which on average jointly obtained 40% of equity capital at the end of the privatization period (Simoneti et al., 2001). During the consolidation period which followed, shares of the latter increased so that at the end of 2004 the largest shares in about 44% of Slovenian companies were owned by the two state-controlled funds (Bratina et al., 2005). In addition, post-privatisation processes led to the emergence of a new type of large blockholder, that is, domestic non-financial firms with large blocks of shares which had been transferred to them from the privatization investment funds (Brezigar Masten et al., 2006). Strategic and foreign ownership, on the other hand, is very limited, with banks and foreigners having obtained less than 3 percent of firms' shares during the privatisation period (Simoneti et al., 2001). At the present time, foreign investors hold approximately 13 % of all Slovenian companies, which still puts Slovenia well beyond other transition economies as well as the EU average. For foreign portfolio investors Slovenian companies largely remain of limited interest, with an entry to the company only being attractive as controlling shareholders.

The chosen privatization method which combined voluntary listing with an admittance of securities in the official capacity of LJSE has also influenced the pace of the evolution of Slovenian capital markets. The Ljubljana Stock exchange (LJSE) was re-established and stock markets opened at the end of 1989. The regulated LJSE market is today divided into an official and semi-official market, with over 200 securities listed on both markets. A special segment of the official market is the prime market, which aims at promoting the most prominent Slovenian issuers to the international investment community. Issuers on the prime market are required to meet certain quantitative and liquidity criteria as well as observe

property. In these countries as well as in Slovakia, insider control is weaker. There, special investment privatization funds were created specifically for the purpose of ensuring the accountability of management.

additional disclosure obligations.⁴ With total capitalisation of around 22.5 billion EUR, the LJSE is fairly small compared to other CEE markets. Despite its small size, however, on a relative basis the LJSE market is well developed, with market capitalisation of shares (excluding investment funds) reaching 42% of Slovenian GDP in 2006.

However, the LJSE market is characterised by low liquidity. The average daily turnover in 2006 amounted to modest 4.03 million EUR and the total turnover amounted to around 996.48 million EUR – although following on from an increase of over 70% from 2005, the turnover figures have recently reached their second highest level in the history of the LJSE.⁵ The general illiquidity of the market is however further pronounced when the limited range of traded shares is taken into account: in 2006 the great majority of the trades were executed on the prime market with only 8 listed shares, which represents an overwhelming 72.2 % of the total trade in shares.⁶

Several features of the current situation suggest that the process of transition in Slovenia is still going on. The state is expected to diminish its role in economy further and, in particular, to exit from the banking and insurance sector. Ownership concentrations have not yet been solidified, with domestic households still holding a sizable portion of equities. At the same time, trading on Slovenian capital markets has not reached the levels hoped for. A second wave of privatisations is expected to provide a trigger for liquidity and the further adjustment of corporate ownership structures. As this further phase begins, a greater prominence is being given to EU-level norms and self-regulatory codes. The Slovenian corporate governance code was adopted against the background of adjustment to EU legal requirements in the run-up to Slovenia's entry into the Union. Unlike in other transition countries, the adoption of the Slovenian Code (in March 2004) almost exactly coincided with the Slovenian accession to the European Union (in May 2004). At this time, there was a perception that a number of outstanding issues – the question of minority shareholder protection, the lack of the robust pressure from foreign investor community, the role of the state as a powerful owner, and underdeveloped role of domestic capital markets as in sanctioning weak or inefficient

⁴ As of 31 May 2006 market capitalisation of shares on the Prime Market accounted for 72.9 % of market capitalisation of all shares traded on the official market.

⁵ See LJSE Annual Statistical Report 2006.

⁶ See LJSE Annual Report 2006.

managements – needed to be addressed. The 2004 Code was therefore introduced at a critical point in Slovenia’s corporate governance development.

4. Empirical findings on the reception and implementation of the Slovenian Code

In this part we examine the evolution of the Slovenian legislative framework following the adoption of self-regulatory Code and analyze companies’ responses to the Code. The analysis is based on a population of companies whose shares were traded on the official market of the LJSE as of 31 May 2006, comprising of 26 companies, 7 of which were listed on the LJSE Prime market. Data are gathered from companies’ declarations of compliance with the Code issued on or before 31 May 2006⁷ and relate to the implementation of the revised text of the Code of December 2005.

The text of the Code of December 2005,⁸ which is addressed to all joint-stock companies, consists of recommended governance principles organised by paragraphs. The text of the Code contains eight paragraphs, which are further divided into several subparagraphs or provisions, following the Preamble and a definition of terms used in the Code. The first paragraph determines the relationship between the corporation, shareholders, and other stakeholders. It contains provisions on the company’s goals; equal treatment of shareholders and protection of their rights (including protection of minority shareholders); provisions on general meeting of shareholders; and provisions on the relationship between the company and other stakeholders. The second paragraph focuses on the management board. It restates the statutory duties and liabilities of the management board; it recommends detailed criteria for its composition, remuneration, compensation and other benefits and ownership of company shares; it also addresses the issue of conflicts of interest of management board members. Similarly, the third paragraph defines duties and liabilities of the supervisory board; it recommends criteria for the composition, remuneration, compensation and other benefits and ownership of company’s shares and addresses the conflict of interest of supervisory board members. In addition, it also defines the supervisory board’s role in the appointment and

⁷ The LJSE Rules require issuers whose shares are traded on the official market to make a public disclosure of the declaration of compliance no later than on the publication date of the summary of the annual report, that is, five months after the termination of a business year (Articles 36a and 42 of the LJSE Rules).

⁸ Further amendments to the Code were adopted in February 2007.

removal of the management board as well as containing detailed recommendations on the formation of supervisory board committees, and specifically an audit, a nomination committee and a remuneration committee. This is the longest and most detailed chapter of the Code. In the fourth paragraph, the nature of cooperation between management and the supervisory board is considered, including provisions on compliance with corporate governance principles and provisions on actions related to takeover procedures. In the fifth paragraph, associated companies are addressed. The sixth paragraph focuses on audit and the system of internal control, and the seventh paragraph contains detailed recommendations on disclosure of the relevant information. To mention but a few, this chapter includes provisions on reporting and annual and semi-annual reports; data from the corporate prospectus; the schedule of the company's more significant announcements; resolutions of the supervisory board; the company ownership structure cross-holdings and takeovers; share ownership of members of a company's management board and supervisory board; amendments of the articles of association; admission to and withdrawal from the regulated market; the manner of dealing with press rumours including the form and location of disclosure; public announcements outside the country; data confidentiality; the company's communication strategy; and the company's website. The eighth paragraph contains provisions on implementing the code.

Code provisions specify and clarify a number of statutory rules, set out good corporate governance practice, and summarize relevant regulation. As stated in the Preamble of the Code, 'the purpose of the Code is to define in more detail the principles of directing and managing public joint-stock companies, whose shares are listed on the regulated market'.⁹ Notwithstanding its focus on public joint-stock companies whose shares are listed on the regulated market, the signatories of the Code also made an appeal to the other public and non-public companies to apply the recommended governance practices, in order to establish a transparent and understandable governance system that would enhance the investor confidence and overall trust in the management of Slovenian public companies. In addition, by clarifying statutory rules and summarize relevant regulation, the Code aims to make core corporate law more accessible to domestic and foreign investors. It is particularly significant that the Code aims to bridge the gap between existing and the future legal regulation. In line with the purpose of the Code, its provisions encompass not just certain part of the relevant Slovenian legislation, but also ethical standards of business culture and the internal bylaws of

⁹ The Corporate Governance Code for Public Joint-Stock Companies, Preamble.

the three organizations that drafted and signed the Code (the Ljubljana Stock Exchange, the Managers' Association of Slovenia and the Association of the Supervisory Board Members of Slovenia), as well as internationally recognised governance norms.

4.1 The impact on the legal system

Our analysis suggests that the adoption of the Code has already had an impact on the wider legal system within which it is placed, triggering certain changes in company and financial law and supporting the process of adjustment to the EU-level norms. Several norms that had initially been introduced as self-regulatory recommendations have subsequently found their way into the legislative framework. To illustrate, the use of a company's website as means of facilitating the access to the relevant information related to the company was an initial recommendation of self-regulatory Code. The Code specified that the contents of the company's website should be made available in both the Slovenian and English language and recommended that the company should ensure access on its website to all information that should be publicly available, after this information had been publicly announced. Extensive deviations from these Code provisions in 2004 led to increased statutory requirements. The Securities Market Act was amended (ZTVP-1A) to add an obligation of a company to ensure that all information that has the characteristics of insider information is available on the official website of the company for at least seven days, violation of which results in heavy fine.¹⁰

In a similar way, provisions on the role of supervisory board committees have been transformed from soft law recommendations to regulatory norms. In 2004 the corporate governance code introduced the recommendation for the supervisory board to form special committees with the aim of improving the effectiveness of the board's work. The Code recommends the use of board sub-committees to carry out governance tasks and refers specifically to the role of an audit committee, nomination committee and remuneration committee; it provides detailed recommendations as to their formation and responsibilities. Since 2005, these recommendations have also been incorporate into the new Companies Act (ZGD-1), as opt-in provisions. Pursuant to the ZGD-1, the supervisory board may set up one

¹⁰ ZTVP-1A, Article 391, Para. 1, Line 7.

or more committees, with the same aim as the one declared in the Code.¹¹ The Act specifically regulates the audit committee, reiterating and extending its responsibilities established in the initial text of the Code. Notwithstanding the generally established possibility to opt-in, however, companies that have opted for a one-tier system of corporate governance are obliged set up an audit committee, if their securities are traded on the organised market or employees exercise their co-determination rights in compliance with the law.¹²

Individual disclosure of financial benefits of members of the management board offers a further example of regulatory learning. The initial text of the Code had introduced a provision recommending that remunerations, compensations and other benefits of the management board members should be disclosed for each individual member rather than for the board as a whole, as it had been the practice in Slovenian companies. This provision initiated an intense public debate and was one of the most frequently deviated from Code provisions in 2004. As a response, an amendment to the Securities Markets Act of August 2004 (ZTVP-1A) introduced the individual disclosure of financial benefits of members of the management board as an obligatory element of a company prospectus. Pursuant to ZTVP-1A, material changes of all data contained in the prospectus, including individual disclosure of financial benefits of members of the management board had to be specified in the annual report and its summary. Nowadays the content of prospectuses and individual disclosure of benefits are regulated by the directly applicable Commission Regulation 809/2004¹³ as an implementing measure of the Prospectus Directive.¹⁴ Similar recommendations as regards the contents of the prospectus, the manner of its publication and issuance of an annual document were introduced into the Code as a result of amendments of December 2005. The Code recommends that companies should publish their updated prospectus, or the significant changes of data stated in the prospectus at least once a year. In addition, it states that a company's website should contain all essential information on the company and its business operations, including the updated prospectus or significant changes of data stated in the prospectus. Subsequently, after a period to allow for adjustment on the part of companies,

¹¹ ZGD-1, Article 279.

¹² ZGD-1, Article 289, Para. 3.

¹³ Commission Regulation (EC) No 809/2004 of 29 April 2004, *Supra*, n. 129.

¹⁴ Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (OJ L 345, 31 December 2003).

these recommendations were embedded into Slovenian legislative framework as amendments to the Securities Markets Act of 2006 (ZTVP-1B) that has transposed into Slovenian law requirements of the Prospectus Directive concerning the annual document and Commission Regulation 809/2004.

In a similar way, the Code has assisted the process of adjustment to the EU Accounting directives.¹⁵ This is done via the requirement of a declaration of compliance with the provisions of the Code. Pursuant to the 2006 amendments to the Companies Act (ZGD-1), joint-stock companies as well as large and medium-size limited liability companies are obliged to issue this declaration of compliance as a part of their annual report. Furthermore, the Code recommends the introduction of requirements of the prospective Directive on the exercise of the shareholders' voting rights,¹⁶ including the facilitation of proxy voting and an obligation to post all relevant information for the general meeting and adopted resolutions on the issuer's website. Once the final text of the Directive is adopted, these recommendations will be transmitted into the Slovenian legislative framework.

Thus the Code has played a significant role in triggering developments in the wider legal system. In many cases, provisions of the Code which started off as voluntary measures (or at any rate subject to the requirement of comply or explain) were then transmitted into legislation. At first sight this might seem to undermine the reflexive dimension of the Code. However, the Code is playing a wider role in Slovenia's legal transition: by means of an 'indirect' legal strategy, through the incorporation of measures into the Code prior to their inclusion in legislation, the Code has increased familiarity with the relevant provisions, and has cushioned their immediate impact on companies. This has also served to smooth the process of adjustment to EU standards.

4.2 The impact on companies and corporate reporting

¹⁵ The proposal for this Directive was issued in 2004. The proposal, however, did not relate to the amendments to the Directive 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings (see the Proposal for a Directive of the European Parliament and of the Council, amending Council Directives 78/660/EEC and 83/349/EEC concerning the annual accounts of certain types of companies and consolidated accounts COM(2004) 725 final, 2004/0250 (COD), Brussels, 27 October 2004).

¹⁶ COM(2005) 685 final, Brussels, 5 January 2006.

Our empirical research also provides evidence on the impact of codes on organizations. Companies' responses to the Code suggest that a tendency towards a 'pooling equilibrium' can be observed. On the whole, companies' implementation strategies are strikingly similar both in terms of the contents of deviations from the Code as well as in the type of explanation for deviations. With regard to the former, a significant overlap in disclosed provisions is observed, with disclosure of information and financial reporting (paragraph 7 of the Code), issues related to the supervisory board (paragraph 3 of the Code) and the relationship between the corporation, shareholders and other stakeholders (paragraph 1 of the Code), being the main corporate governance issues challenged by the companies. In particular, over 40% of the analysed companies deviate from recommendations for companies to define corporate goals in their articles of association, define criteria for assessing the existence of conflicts of interest, publish announcements in the English language and prepare financial statements in accordance with International Financial Reporting Standards.

In addition, a trend of increased compliance with the Code is observed, revealing adaptation of corporate practices to the Code provisions in comparison to declarations of 2004. Figure 2 illustrates the most frequently deviated from provisions in 2004 and their disclosure in 2006. In 2004 non-compliance with identified provisions was disclosed by a number of companies, ranging from 40% to an overwhelming 77% of the population in the case of some provisions of the Code. 11 provisions in total surpassed the 40 % non-compliance benchmark, 5 of which exhibited non-compliance of over 60%. In declarations of 2006, however, none of these provisions was deviated from by more than 35% of all companies in the population.¹⁷ In fact, a detailed content analysis reveals that even the 35% non-compliance benchmark is misleading, as several deviations from provision 7.5.1 relate to the recommendations made for the contents of websites in the revised text of the Code of 2005, rather than to the initial Code recommendations of 2004. In reality, therefore, the number of deviations of identified provisions in 2006 does not exceed 31%.

¹⁷ It should be noted that some of these provisions were subsequently re-numbered in the text of the Code of 2005.

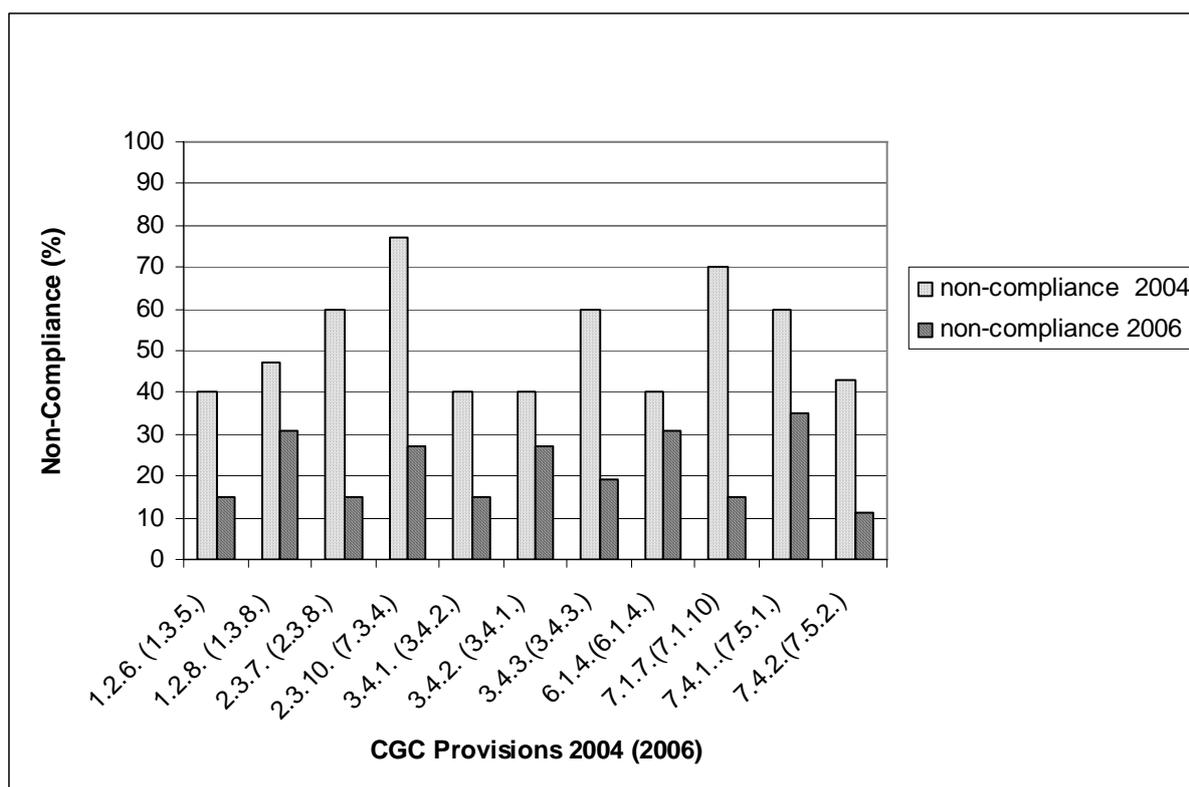


Figure 2: Corporate Governance Index 2004 and Non-Compliance with the Same Provisions in 2006.

<i>Code Provision</i>	<i>The Summary Contents of the Provision</i>
1.2.6.	The announcement of the convening of the shareholder meeting by publishing all relevant information on the company's web site.
1.2.8.	Timely public announcement of relevant information on supervisory board nominees.
2.3.7.	Individual disclosure of remuneration of the members of the management board.
2.3.10.	Internal bylaw provision to specify the rules on limitation of trading and on disclosure of trading in company shares.
3.4.1.	Criteria for the remuneration of the members of the supervisory board.
3.4.2.	Components of the remuneration of the members of the supervisory board.
3.4.3.	Individual disclosure of remuneration of the members of the supervisory board.
6.1.4.	The presence of the auditor at the shareholder meeting.
7.1.7.	Publication of the calendar of essential announcements and its availability on the company's website.
7.4.1.	The contents of a company's website.
7.4.2.	Availability of the revised version of the company's Articles of Association on the company's website.

At the same time, the observed quality of declarations is low and valid comply-or-explain declarations represent a minority of all declarations. What is more, some disclosures and justifications are altogether identical, even copy-pasted. In most cases, companies do not explain why they deviate from a particular Code provision but simply disclose this fact, or provide the disclosure by literally describing their corporate practices. Moreover, closer scrutiny of these disclosures reveals that several of these descriptions do not disclose non-

compliance at all, but rather indicate the way in which the particular company complied with the Code. In addition, companies frequently disclose non-compliance at the same time as indicating an intention to comply with the relevant provision in the future. The degree of variety in the type of disclosure of non-compliance has also been reduced from 2004 in 2006. Incomplete declarations (a general statement of compliance in which a company declares its overall acceptance of the Code provisions without making a specific reference to them) have been eliminated and decrease in the number of pure disclosures (without any additional explanation) can be identified, coupled with a significant increase in declarations containing both a disclosure of non-compliance and a description of deviating practices. Surprisingly, however, no increase in proper comply-or-explain declarations containing disclosure of deviation together with a description of deviating practice and a justification for this deviation can be observed.

Despite these ‘pooling’ trends, a certain degree of variation in declarations is observable along the lines of market segmentation and different listing régimes, indicating weak signs of a separating equilibrium. Companies listed on the prime market¹⁸ on the whole exhibit both greater compliance with the Code as well as a higher quality of disclosure compared to firms whose shares are traded on the official market. Of the total of seven firms listed on the prime market,¹⁹ two have disclosed deviation from one Code provision only. Moreover, the deviated-from practices in this case mainly relate to the more recently introduced Code provisions, and the quality of explanation for deviations on the prime market is above average.

Our observations indicate the existence of a common understanding of Code provisions by Slovenian companies and the emergence of a shared interpretation of the context of the Code. Companies are inclined towards achieving greater compliance with the Code without wishing to stand out with respect to the reasons given for justifying deviations; they are less concerned with improving information flows by providing detailed justifications for deviations. Accordingly, a ‘herding effect’ is observed, leading to an equilibrium in which companies end up complying and doing very little explaining if they do not. This is perhaps the paradox of the comply-or-explain principle; although it is meant to trigger an information flow and allow

¹⁸ As of 31 May 2006 market capitalisation of shares traded on the Prime Market accounted for 72.9 % of market capitalisation of all shares traded on the Official Market.

¹⁹ As of 31 May 2006.

for a market response, variety may get crowded out. The observed effect of the Code in the form of an increased overall level of governance practices may be taken to be a sign of the increasing effectiveness of the corporate governance system (Aguilera and Cuervo-Cazurra, 2004). However, if corporate governance arrangements are seen as endogenous to the managerial practices and trajectories of individual firms (Demsetz and Lehn, 1985), a certain level of variation in compliance with the Code might be expected; diversity in the justifications for deviations could be seen as desirable in order to enable investors to adopt informed investment decisions. Variable compliance that is reflected in a range of companies' responses is required, to a degree, to promote diversity and learning. On this basis, limits to the use of the Code to stimulate institutional learning are being encountered.

5. Conclusions

Our theoretical discussion identified three features of corporate governance codes around which an empirical study could be conducted. The first was the sense in which codes operate as transnational instruments of regulatory change. The law and economics approach sees codes as a mechanism for enhancing the efficiency of corporate governance regimes, but also acknowledges potential obstacles to their diffusion in the form of opposition from vested interests and institutional blockages. The comparative political economy perspective sees codes as having a potentially destabilising influence in coordinated market systems, and, by extension, in transition economies. We saw, however, that a systems-theoretic viewpoint offered a third possibility, namely that codes, as 'irritants', would not necessarily be rejected any more than they would be transposed completely straightforwardly, but could be expected to trigger a series of responses in host systems, at both the legal and economic level. We find support in our case study for the suggestion that neither complete integration, nor complete rejection, results from transposition. The adoption of the Slovenian code has not led to an alignment of the Slovenian system with the model of diffuse share ownership and liquid capital markets which is associated with the code model in general, and even allowing for the limited period of time which has elapsed since its adoption, it is not clear that it will have this effect in future. However, the code has played an important part in the wider process of assimilation of the legal system to transnational norms, in particular those of EU company law directives, and has helped to smooth the transition process more generally. To that extent, the code has operated as an important legitimating force in the sense identified by Aguilera and

Cuervo-Cazurra (2004), independently of its operation as a force for greater efficiency in the wider economic order.

The second dimension of our study concerns the nature of codes as ‘linking institutions’ with a dual economic and legal dimension. The empirical study provides support for the theoretical claim made by systems theory, namely that codes are capable of triggering ‘coevolutionary’ movements in the economic and legal systems. By means of an ‘indirect’ legal strategy, the corporate governance code increases familiarity with novel provisions, and ‘softens’ their eventual introduction into the legally binding framework. In other words, the code triggers internal demand for law within the legal system. It thereby helps ensure the internal congruence of the system, and consequently, increases the effectiveness of legal reform. Through the use of self-regulation, moreover, adjustment to the demands of legality is achieved, a necessary element of a successful transplantation and an effective corporate governance reform.

However, the third dimension of our study, which focuses specifically on the ‘comply or explain’ mechanism, suggests that there are also limits to the capacity of codes to operate as forms of reflexive governance. A critical issue is whether codes based on the ‘comply or explain principle’ result in divergence or standardization of corporate practice. To use the language of comparative institutional economics, the responses of companies are likely to result in either a ‘pooling equilibrium’, in which companies cluster around a standard set of practices, or a ‘separating equilibrium’ in which different responses to the ‘comply or explain’ requirement lead to diversity of practice and provide the basis for a learning process. In principle, either result is possible; empirical research is needed to establish which one actually prevails, and to explain why.

Our empirical study finds that a tendency towards the pooling equilibrium can be observed, reflected in responses, to the Code’s implementation, of companies whose shares are listed on the official market. Companies are complying with the Code in a broadly similar way, both in terms of the contents of deviations as well as in the type of disclosure and explanations for deviations. Over time, there has been an increasing compliance with Code provisions. However, the quality of disclosures is low, with effective explanations for non-compliance rarely being offered. This is perhaps a sign of a more general problem with ‘reflexive’

models of governance. There is evidence to suggest that corporate governance codes which are drafted as default rules subject to the ‘comply or explain’ approach, quickly acquire a hard edge in practice. While such an outcome may serve to enhance the legitimacy of the transition process, it also suggests that there are limits to the capacity of codes to stimulate organisational and institutional learning.

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