Corporate Governance Adrift: A Critique of Shareholder Value
Michel Aglietta Antoine Rebérioux

Book Description

Michel Aglietta and Antoine Rebérioux do not subscribe to the belief that shareholder value should be the ultimate driving force behind companies, or that financial markets produce the most accurate valuation of a company's activity. In the US the most widely accepted explanation of the financial scandals typified by Enron is that there was a failure of gatekeepers. The authors assert that the US reaction to Enron – the Sarbanes-Oxley Act – does not address the core problem of corporate governance in the US: of having a mode of governance geared towards satisfying the financial markets. Sarbanes-Oxley, it is argued, "far from attacking the root of evil, fertilises it". The scandals are seen as a product of the spread of shareholder value, driven only by liquidity and profitability; and the adoption of international financial reporting standards, bringing Europe closer to the US model, is seen by the authors as coming at a time when the model seems at its most fragile. The authors contend that there is a major dysfunction at the heart of corporate governance, and that if the lack of democracy in companies, spreading beyond the interests of the shareholder, remains unaddressed, then financial scandals will continue unabated and social injustice will persist and grow. Corporate Governance Adrift is a challenging book and the ideas it expresses will not meet favour with some, but the authors have succeeded in creating a work that is consistently fascinating and an argument that is lucid and gripping without ever compromising its intellectual weight.

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CONTENTS

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EDITORIAL

Is finance-driven capitalism finally going to realise its fantasy of shareholder governance? Michel Aglietta and Antoine Rebérioux analyse the legal origins of this notion and demonstrate the logical contradictions of outside control, the real collusion between management and market finance, the inevitable duplicity this implies and the risks of crisis it presents. They suggest that the firm should instead be considered as the locus of a negotiated compromise between capital and wage labour—an approach which would imply far-reaching reforms in order to set up what they call the 'partnership firm'*.

* For a comprehensive presentation of the theses of the authors, see the recent book, M. Aglietta and A. Rebérioux, *Corporate Governance Adrift. A Critique of Shareholder Value* (Cheltenham, U.K.: Edward Elgar Publishing, 2005).

THEORETICAL NOTE

Regulating finance-driven capitalism

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In 2001, two of the most eminent representatives of the Law and Economics prophetically announced the 'end of history' in the area of corporate governance, with the North American model taking hold throughout the world (Hansmann and Kraakman 2001). This model gives decisive weight to minority shareholders, the emblem of mass capitalism. But more broadly, it comes within a type of regulation dominated by the financial markets.

The stock-exchange reversal of March 2000, the financial scandals of the Enron era and management seizure of profits have been the most obvious pathologies of the contradictions specific to this type of regulation. The U.S. Federal Reserve Board's rescue of the financial markets in early 2001 also provoked a massive transfer of company indebtedness onto households purchasing real estate, from the richest households onto the federal government and from the entire economy onto the rest of the world.

In order to grasp the mainsprings of finance-driven capitalism, it is useful to consider the theories of the firm on the one hand and the macroeconomics of the financial system on the other and bring out the reciprocal influences between these two levels of analysis. Finance capital is indeed based on a particular doctrine of the firm, 'shareholder sovereignty', which legitimates shareholder control of the companies. Given the impossibility of maintaining any real surveillance of corporate executives from the outside, this control results in a management standard which takes the form of obligations to achieve certain results or requirements of financial returns. The spread of this imperative is an endogenous source of instability for capital markets, which means that the abuses of contemporary capitalism cannot be corrected without significant changes in corporate governance.

1. The logical contradictions of shareholder control

The doctrine of shareholder sovereignty, which is rooted in legal precepts, makes the firm an object of ownership; the shareholders, as the subjects of this ownership, thus possess real property rights over the firms. Economic analysis justifies this sovereignty in terms of the risks shareholders assume relative to other parties (employees, creditors, etc.) involved in the entrepreneurial activity. This doctrine has served as the basis for the legal principles imposed on companies quoted on the U.S. stock market since the early 20th century and it is particularly influential in the area of stock-exchange law, which originated at federal level.

The doctrine of shareholder sovereignty generates tension, however, with the second basic pillar of finance-driven capital: the promotion of the liquidity of capital markets.[1] This liquidity has two effects. For one thing, it leads to a 'separation of ownership and control' as Berle and Means (1932) were the first to point out. Because they are dispersed, shareholders do not have the means to exercise their sovereign control, which thus escapes them. For another, this liquidity reduces the risk borne by the shareholders, who

[1] Liquidity is taken here to mean the possibility of selling an asset as quickly as possible without loss of value.

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can diversify their portfolios. The economic justification for the primacy accorded to shareholders, in terms of risk, thus ceases to be relevant.

This tension has not led to a rejection of the doctrine, however. After a long period of dormancy, the idea of shareholder primacy re-emerged during the 1970s, in theory and practice, with the shareholders' loss of control seen as a kind of *dispossession*.

The rise to power of 'contractualism' in economics and its gradual extension into the legal field (with the Law and Economics) constituted a powerful vehicle for the dissemination and legitimisation of shareholder sovereignty. The principal-agent model played a key role here, to the extent that it provided a formal representation of the idea of dispossession. According to this model, management is 'hired' by the shareholders to serve them. But the opportunism of these officers, combined with their privileged access to information concerning company management, requires the setting up of safeguards in order to avoid the misappropriation of assets as much as possible.[2]

Updating the application of this doctrine in terms of corporate governance has thus consisted of establishing external and internal controls aimed at compensating for the 'liquid' shareholders' structural inability to exercise their sovereign control. Externally, a decisive role is accorded to hostile takeovers (codified by stock-exchange and corporate law), as well as to the 'gatekeepers' who serve as financial information intermediaries. The latter (auditors, financial analysts and rating agencies) are thus responsible for verifying and synthesising accounting information for investors. Internally, the board of directors assumes the task of re-establishing shareholders' real rights. The doctrine thus maintains that the board has the shareholders' mandate to keep watch over management. In order to guarantee the strictly disciplinary role of this board, the directors' independence from management is considered a categorical imperative. While it is quite difficult to give practical content to this idea of independence, it tends to merge with a criterion of external status, relative to the company but also, most often, relative to the activity sector involved. This means the absence of family, financial, social or other ties between watchdogs (directors) and those being watched (corporate executives). But in this very way, the board loses the monitoring ability conferred by its internal status, via the special knowledge of the company and its management this entails. Instead, a remote, ex-post control is exercised, in the manner of the gatekeepers. It is one of the paradox of shareholder sovereignty to introduce external status into the heart of a body whose very raison d'être is precisely its internal status.

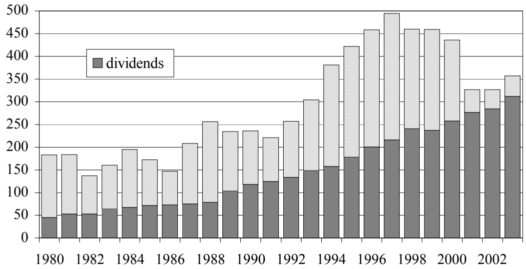
This situation brings out one essential feature of the governance specific to finance-driven capitalism: the absence of an opposition force within the company. In this respect, it is useful to compare this configuration to the ideal type of the 'Fordian' firm, where monitoring was jointly carried out by the shareholders with controlling blocks (inexistent on liquid markets), an internal technostructure (weakened by the suppression of the levels of authority) and employee representatives (eliminated, by definition, from pro-shareholder governance). Thus, the desire to combine liquidity and control—which is at the basis of finance-driven capitalism—implies an externalisation of control, which leads to a monitoring vacuum and the decline of corporate management responsibility. This point is most clearly illustrated by the financial scandals of the Enron period, which saw the systematic failure of pro-shareholder monitoring mechanisms.

2. Demands for financial returns

Shareholders' inability to monitor management effectively—notwithstanding the claim of the shareholder primacy doctrine —should not lead to underestimate the changes affecting quoted firms since the 1970s. Essentially, the power of finance capital is expressed by the imposition of constraining criteria of financial returns. The competition among investment funds to attract collective savings is transferred onto the companies, which are judged by these funds on the basis of their ability to meet the financial demands imposed on them. The figure below, which traces the changing share of dividends in corporate profits in the United States, gives an idea of the scope of the redistribution taking place in favour of shareholders.

Evolution of the share of dividends in total profits (before taxes) for non-financial corporations (excluding agriculture) in the United States

(*Flow of funds* , Federal Reserve Accounts, Table F.102)



2. We are not saying that there is a necessary, logical tie between the contractualist approach and the defence of shareholder sovereignty. Our argument here is of a different nature and has more to do with sociology of science: the overwhelming majority of the authors with a contractualist perspective and an interest in corporate governance have become the promoters of this doctrine. On this point, see Rebérioux (2005).

The Economic Value Added (EVA) indicator is emblematic of shareholder sovereignty insofar as it theoretically underlies the demands of finance capital. If all the quoted companies have not adopted this indicator as such, it has nonetheless, by virtue of its widespread dissemination, contributed to legitimating the investment funds' demands for financial returns (Plihon et al. 2002). The most simple expression of a company's EVA is the following:

$$\boxed{\begin{aligned} EVA &= R - kEC \\ &= (ROE - k)EC \\ &= (ROA - Cmpc)K \end{aligned}}$$

R represents the company's net profits; *k* the equilibrium return on equity capital as determined by the CAPM[3], *EC*, the accounting (book) value of the equity capital, *ROE*, the return on equity (*R/EC*), *ROA*, the return on assets, *WACC*, the weighted average cost of capital and *K*, the total (book) value of the assets (liabilities + equity capital). This equation beings out the specific nature of the EVA: while the wealth going to shareholders is normally measured by net profits (*R*), the EVA indicator is based on the assumption that value actually created for shareholders comes from surpluses relative to the profitability demanded by the market (*kEC*). The market return at equilibrium becomes a minimal return. And this results in a profound modification of the shareholders' status (Lordon 2000). Through the EVA, residual creditors become privileged creditors, as if they were lenders. They acquire guarantees of returns on their investments and although these guarantees latter are not contractual, they are no less real. This change, it should be noted, once again undermines the ultimate economic justification for shareholder sovereignty: risk-taking.

The creation of shareholder value thus originates in a logic of imbalance transformed into a permanent objective. The macro-economic inconsistency of this principle is obvious. At micro-economic level, methods for doping financial returns beyond what the companies' economic potential would permit are sustained by elevated stock-exchange prices with the aim of fostering their rise through speculation. These methods combine the increase of the debt-capital ratio (financial leverage), external growth, asset light strategy and the repurchase of shares.[4]

Asset light strategy automatically increases the return on assets (*ROA*), while the repurchase of shares increases the return on equity (*ROE*). The equation presented above shows that this results in a rise in the EVA. Increased ROE also stem from the introduction into equity capital of elements whose value depends in large part on management decisions. External growth provides an opportunity for this, especially if the official share prices of the companies practising it are high enough to serve as advantageous bargaining chips. Indeed, mergers permit considerable revaluing of the intangible assets of the companies acquired and profiting from goodwill. The investment banks and their analysts play a considerable role in these operations by underestimating acquisition values and specifically recommending the purchase of the consolidated group's shares to institutional investors. Afterwards, it suffices to realise potential surpluses by deconsolidating the assets with the greatest market value through judicious resales and extracting the company's cash flow through the cashing in of stock options. Companies incur further debts so as to repurchase their own shares in such a way as to preserve managerial control by avoiding the dilution of equity capital while continuing to declare their allegiance to shareholder sovereignty. Thus, the officers involved in these strategies for the creation of value, who are backed up in turn by the financial players, retain the instruments of the power deployed for their personal gain.

This process leaves 'refuse' behind it, however, in the form of unprofitable and thus unsaleable assets which get dumped in the game of consolidations and deconsolidations. This is the most frequent source of frauds. In order to get rid of these assets profitably, company heads organise fictitious sales with the help of the investment banks. Special Purpose Entities (SPEs), spuriously independent of the selling companies, then 'buy' these stocks at grossly over-evaluated prices. In the last instance, these transactions are guaranteed only by the shares of the selling company, since the latter is secretly bearing the risk for the debts created by the SPE in order to carry out the fictitious transactions. Enron, for example, had set up no less than three thousand SPEs in order to post fictitious profits and hide its colossal debts.

Ultimately, the company executives involved in the market finance game carry out operations with the support of the financial system, which proposes risky behaviours and encourages bold innovations flaunting acceptable standards of caution. Compounded by the structural handicaps of the players and mechanisms responsible for monitoring (see above), the tensions brought about by these behaviours are resolved in the kinds of fraudulent operations which multiplied in the United States at the turn of the century.[5]

[3] The CAPM (capital asset pricing model), developed in the 1960s, permits the calculation of the premium which rational investors expect for holding risky assets (with high volatility).

[4] If the interest rate is below *k*, the capital-debt ratio reduces the WACC and thus increases the EVA (cf. the equation presented above).

[5] Europe has also been hit by management scandals but to a much lesser degree, doubtless because the financialisation of

Shareholder sovereignty fails exactly where it intends to succeed: it undermines management responsibility, as can be seen most clearly with the explosion of executive remunerations tied to stock options. Thus, according to the survey carried out regularly by the magazine *Business Week*, in 1980 the average income of the CEO of the largest American companies represented 40 times the average wage of a worker; in 1990, this income was 85 times greater and in 2003, 400 times greater. The new capitalism has not made officers more disciplined; it has transferred the control from an 'entrenched' managerial elite to one which is 'financialised', with the support of consulting firms and other finance players. The shareholders profit when stock prices rise; employees bear the brunt, regardless.

The most widespread explanation for the increase in the number of financial scandals among the big names of the American stock exchange points to the weaknesses in monitoring—especially that of auditors, analysts and directors—owing to a lack of independence.[6] This interpretation of the crisis prevailed during the drafting of the Sarbanes-Oxley Law (July 2002), which was aimed at putting a halt to accounting irregularities.[7] Our analysis runs counter to this interpretation, however: the failings of monitoring are *congenital defects* of a form of governance which is totally oriented towards satisfying the interest of shareholders concerned above all with the liquidity of their liabilities. In other terms, the source of the crisis is to be sought first of all in the growing power of the shareholder sovereignty model over the past three decades. Seeking to reinforce pro-shareholder control mechanisms amounts to taking the effect for the cause, at the risk of aggravating the present excesses.

3. The instability of the capital markets

The creation of shareholder value also disrupts stock-exchange evaluation. The systematic search for profits beyond the market yield at equilibrium, when it is validated in stock prices, feeds expectations which are illusory because they are impossible to meet in future operating balances. This amounts to a speculative bubble provoked by a management standard which the investment funds impose but which the financial elite circumvents through the methods discussed above.

The incentives for stock-exchange abuses brought about by shareholder value enjoy a fertile breeding ground. Indeed, the world of asset evaluation is non-gaussian, contrary to the theoretical hypotheses which assume that the markets are efficient. In other words, the stock exchanges are drawn towards extreme trends by their own endogenous dynamics much more often than they would be if prices followed a random path. The reason for this lies in the numerous sources of uncertainty intervening in the fixing of asset prices. Uncertain variables are not limited to future profits but also include the components of the actualisation rate (discount rate plus risk premium). Even worse, some sources of uncertainty, the ones which cause the confidence in the liquidity of the markets to vary, are purely self-referential and as such, permit disconcerting figures which change in unpredictable ways: cumulative increases in prices with low volatility but which are abruptly halted by the bursting of the bubbles, periods of sharp rise in volatility without the emergence of either a trend or a stabilisation, prolonged slumps without a return to earlier levels.

From the standpoint of the economy as a whole, however, the greatest perturbations have come from the close ties between equity and debt markets. We have already seen why indebtedness is a powerful means of satisfying the financial criteria of shareholder value. But the quality of the debts depends on the value of the assets and this is estimated on the basis of the equity prices. Thus, if the stock exchange is swept up by a speculative bubble, which is itself fed by external growth operations and resale of assets financed by indebtedness, the quality of the debts is illusory. It is based in fact on the false guarantee of over-evaluated assets. The process which consists of evaluating the debts on the basis of stock-exchange capitalisation thus underestimates the credit risks when the equity markets are grossly over-evaluated. The result is thus an over-indebtedness which prolongs the market euphoria and then leads to a financial crisis when the bubble bursts. At that point, the flimsiness of the corporate balance sheets becomes apparent and the attempts to restructure them (through the sale of non-strategic assets, for example) reinforce the financial deflation, in other words, the drop in asset prices.

Financial deflation spreads recessive trends throughout the economy: pressures on costs are passed on to wage-earners, a drastic cut in investment depresses overall demand, an abrupt rise in risk premiums leads to a general rise in the preference for liquidity. Macro-economic changes then depend entirely on monetary policy. In this respect, the U.S. Federal Reserve Board has played a decisive role, averting deflation by bringing the interest-rate curve to extraordinarily low levels over the 2001-2002 period. The result was a massive transfer of corporate risk onto households, which thus saved company profitability.

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the economy is less advanced. It should also be noted that the companies which were in the news-- whether the Italian dairy group Parmalat or the French telephone operator France Télécom--are those which jumped right into the game of capital markets and external growth.

6. Coffee (2002) provides the most successfully developed version of this thesis.

7. Beyond increased penalties for such deviations, the two key measures of this law involve stricter supervision of audit activities and increased independence for directors.

The instability of the stock exchanges, regardless of its origin, is a major obstacle to the regulation of finance capital. We have emphasised the role of these markets in the discipline supposedly imposed on officers, via OPA/OPE and stock options, when in fact the distortions of stock prices, fed by these same officers, necessarily lead to inefficient allocations of capital. This is how the mergers and acquisitions of the late 1990s massively destroyed shareholder value, when the market reversal transformed the promised goodwill into gaping losses to be compensated for. And this is how the stock options which were not posted in operating costs served to siphon off the cash flow to the sole advantage of the financial elite.

4. The company as partnership

Just as Fordism reached its limits with wage-earners' desire for an alternative form of work organisation and more diversified consumption, the present changes raise doubts about the permanence of a finance capitalism marked by increasing irresponsibility in corporate management. In particular, we may question the lasting nature of the rise in intra-firm inequalities.

Our analysis logically leads us to place the firm and its governance at the centre of a type of regulation which, taking into account the growing role of market finance, would permit capitalism to revive its ties with social progress. The firm should thus be considered one of the institutional (structural) forms of capitalism. In addition, and contrary to the contractual approach, a non-normative analysis of the creation of wealth in the firm should recognise the collective nature of this process.

Such a process requires co-ordination of the specific competences at work in the firm and this process essentially takes place outside the contractual order (Favereau 1989). As an institutional form and a locus of a specific co-ordination, the firm is an autonomous entity—and not an object of property or a nexus of contracts. For this reason, there is a need for a radically different reading (as compared tothe defenders of shareholder sovereignty) from the 'separation of ownership and control' identified by Berle and Means (1932). If shareholders have indeed lost power, it must be recognised that they have, in a certain sense, 'exchanged' control for liquidity. And that they cannot legitimately lay claim to both. In addition to this 'moral' argument, there is also an argument of efficiency. As we have demonstrated, the claim to sovereign command coupled with liquidity of liabilities necessarily leads to an absence of control and irresponsibility in management.

While the power of the officers is inherent in the need for co-ordination, its goal should be the interest of the firm, as an autonomous entity. The identification of this interest is a classic legal debate, where the defenders of shareholder sovereignty find a recurring argument by countering the vagueness of this notion with the simplicity (and thus transparency) of the objective to maximise stock-exchange value. We propose, on the contrary, to break with a substantive definition of the firm's interest in favour of procedural one, whereby this interest is defined in the course of deliberations between the different parties involved.

These are the outlines of an alternative to shareholder sovereignty, a model which recognises the eminently political nature of the firm. We might qualify this conception as a kind of 'partnership'. If the process of institutionalising the wage-labour nexus under the Fordian regime allowed the introduction of this 'partnership' dimension, the legal guarantees which European wage-earners have at their disposal today are no longer sufficient in face of the rising power of market finance. The current popularity of the theme of corporate social responsibility reflects the widespread acceptance of this assessment. As a practice which is essentially voluntary for the firms, however, it does not seem sufficient to us. What must be envisioned is a reform of their internal structures.

Since the 'partnership' firm is conceived as a locus of powers and countervailing forces as well as a locus of co-ordination requiring the forging of a collective interest, its board of directors would differ from that of the 'shareholder' firm. This board would no longer be responsible for monitoring an interest defined ex ante (shareholder value) but rather for defining that interest and elaborating the general directions of management strategy, through deliberation. Its composition would thus have to reflect the interests of all those whose competences contribute to the firm's economic efficiency. Opening the board to wage-earners, as wage-earners and not as shareholders, would be imperative.

This change in the nature of the board of directors' missions would also modify the nature of monitoring. Running a company would necessarily be less opaque for a board which is responsible for defining management objectives. In addition, the presence of salaried directors would help to create a board which is at once strategic, defining the general interest, and disciplinary. Employee representatives would indeed have a dual status combining independence—their interests do not coincide with those of management—and knowledge of the company. Conceived in this way, independence is no longer synonymous with outsider status. The board's authority could and should be distinct from that of the corporate executives, notably with regard to its president and the control over its agenda. Similarly, the committees responsible for management remuneration and internal audits should be shielded from the power of the executives and responsible to the board. The audit should develop a warning system for monitoring deviations from management objectives in real time. This is what corporate governance inspired by a genuine renewal of social responsibility might look like.

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(Translated from the French by Miriam Rosen)

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Amable, B., and S. Palombarini. *L'économie politique n'est pas une science morale*. Paris: Raison d'agir, 2005, 288 pp.

Barrère, C., D. Barthélemy, M. Nieddu and F.-D. Vivien (eds.). *Réinventer le Patrimoine: De la culture à l'économie, une nouvelle pensée du patrimoine?* Paris: L'Harmattan, 2005, 338 pp.

Graz, J.-C. *La gouvernance de la mondialisation*. Paris: La Découverte, 2004, 128 pp.

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