Explaining Financial Scandals: Corporate Governance, Structured Finance and the Enlightened Sovereign Control Paradigm

A thesis submitted to the University of Manchester for the degree of Doctor of Philosophy in the Faculty of Humanities

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Date 30/06/2012
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- Joint Stock Companies Act 1844
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- Joint Stock Companies Act 1862
- Insolvency Act 1986
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<th>Abbreviation</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>ABS</td>
<td>Asset Backed Securities</td>
</tr>
<tr>
<td>AMF</td>
<td>Autorité des marchés financiers</td>
</tr>
<tr>
<td>ASIC</td>
<td>Australian Securities and Investment Commission</td>
</tr>
<tr>
<td>BIS</td>
<td>Bank of International Settlements</td>
</tr>
<tr>
<td>CDS</td>
<td>Credit Default Swap</td>
</tr>
<tr>
<td>CDO</td>
<td>Collateralised Debt Obligation</td>
</tr>
<tr>
<td>CESR</td>
<td>Committee of European Securities Regulators</td>
</tr>
<tr>
<td>CFTC</td>
<td>Commodity Futures Trading Commission</td>
</tr>
<tr>
<td>CLRSG</td>
<td>Company Law Review Steering Group</td>
</tr>
<tr>
<td>CONSOB</td>
<td>Commissione Nazionale per le Società e la Borsa</td>
</tr>
<tr>
<td>CRA</td>
<td>Credit Rating Agency</td>
</tr>
<tr>
<td>DCO</td>
<td>Derivatives Clearing Organization</td>
</tr>
<tr>
<td>ESA</td>
<td>European Supervisory Authority</td>
</tr>
<tr>
<td>ESC</td>
<td>Enlightened Sovereign Control</td>
</tr>
<tr>
<td>ESMA</td>
<td>European Securities and Markets Authority</td>
</tr>
<tr>
<td>ESV</td>
<td>Enlightened Shareholder Value</td>
</tr>
<tr>
<td>EMH</td>
<td>Efficient Market Hypothesis</td>
</tr>
<tr>
<td>FSA</td>
<td>Financial Services Authority</td>
</tr>
<tr>
<td>FSB</td>
<td>Financial Stability Board</td>
</tr>
<tr>
<td>GAAP</td>
<td>Generally Accepted Accounting Principles</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>IOSCO</td>
<td>International Organization of Securities Commissions</td>
</tr>
<tr>
<td>IPO</td>
<td>Initial Public Offering</td>
</tr>
<tr>
<td>ISDA</td>
<td>International Swap and Derivatives Association</td>
</tr>
<tr>
<td>LSE</td>
<td>London Stock Exchange</td>
</tr>
<tr>
<td>MBS</td>
<td>Mortgage Backed Securities</td>
</tr>
<tr>
<td>NRSRO</td>
<td>Nationally Recognised Statistical Rating Organisation</td>
</tr>
<tr>
<td>NYSE</td>
<td>New York Stock Exchange</td>
</tr>
<tr>
<td>OTC</td>
<td>Over the Counter</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>SPV</td>
<td>Special Purpose Vehicle</td>
</tr>
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<td>SPE</td>
<td>Special Purpose Entity</td>
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<tr>
<td>SIV</td>
<td>Special Investment Vehicle</td>
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</table>
Abstract
Submitted by Vincenzo Bavoso for the degree of PhD entitled “Explaining financial scandals: corporate governance, structured finance and the enlightened sovereign control paradigm”, School of Law, Faculty of Humanities, The University of Manchester, 30/06/2012.

The explosion of the global financial crisis in 2007-08 reignited the urgency to reflect on the origins and causes of financial collapses. As the above events kick-started an economic meltdown that is still ongoing, comparisons with the Great Crash of 1929 started to abound. In particular, the externalities that a broad spectrum of societal groups had to bear as a consequence of various banking failures highlighted the necessity of a more inclusive and balanced regulation of firms whose activities impact on a wide range of stakeholders.

The thesis is centred on the proposal of a paradigm, the “enlightened sovereign control”, that provides a theoretical, institutional and substantive framework as a response to the legal issues analysed in the thesis. These stem primarily from the analysis of two sequences of events (the 2001-03 wave of “accounting frauds” and the 2007-08 global crisis) which represent the background upon which modern financial scandals are explained. This is done by highlighting a number of common denominators emerging from the case studies (Enron and Parmalat, Northern Rock and Lehman Brothers) which caused financial instability and scandals. The research is grounded on the initial recognition of theoretical themes in the field of corporate and financial law, which eventually link with the more practical events examined. This parallel enquiry leads to the investigation of two heavily interrelated spheres of law and finally highlights more practical legal issues that emerge from the analysis.

Through this multifaceted approach, the thesis contends that the occurrence of financial crises during the last decade is essentially rooted in two main problems: a corporate governance one, represented by the lack of effective control systems within large public firms; and a corporate finance one identified with the excesses of financial innovation and related abuses of capital market finance. Research conducted in this thesis ultimately seeks to contribute to current debates in the areas of corporate and financial law, through the proposals of the “enlightened sovereign control” paradigm.
Declaration

No portion of the work referred to in the thesis has been submitted in support of an application for another degree or qualification of this or any other university or other institute of learning.
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Statement

Part of chapter four of the thesis has been reworked and accepted for publication in journal article format (forthcoming *Company Lawyer* 2012, “Financial Innovation and Structured Finance, the Case of Securitisation”).

Part of chapter four has also been presented as a conference paper at the 2011 SLS under the title “SPV Governance and Fiduciary Duties”.

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Dedication
This work is dedicated to my family. For having taught me to think out of the box.

Vincenzo Bavoso, June 2012, Manchester
Acknowledgement

The last few years have been a journey beyond my expectations and an amazing learning experience. I have been very fortunate to meet a number of inspiring people at the University of Manchester since my LLM in 2005-06. The willingness to embark in a research degree and to stay in academia stemmed to a high extent from that early experience, from the truly exciting lectures I attended and from the joyous study shared with marvellous classmates.

As I resolved to pursue such a lengthy and committing endeavour that is a PhD, I knew I would incur a high number of intellectual debts. Firstly, I need to thank my supervisor Dr Pierre Schammo for the guidance he provided over the last two and half years. I am very thankful for his direction and for the intellectual stimulations that helped me to shape this work. I am indebted to Dr Sarah Wilson, who supervised me for the first two years of my degree and introduced me to the beauty of research work by awakening my motivations and by pushing me to do it full-time. I also need to thank Dr Rilka Dragneva-Lewers, my second supervisor, for always providing useful comments on my work. I am very thankful to Professor Emilios Avgouleas for the invaluable advice he offered on my research and generally for his continuous interest in my academic development. And big thanks to Dr Jasem Tarawneh for the help and support when I started teaching at Manchester.

Over the past five years I have been fortunate to interact with a number of incredibly interesting colleagues and friends. In particular I want to thank everyone who took part in the Reading Group during 2009-10, for the enriching discussions. Special thanks to Folarin and Kabir who supported the project and contributed along the way. I have also had numberless intellectually engaging debates with David, Shane, Rachael, Tim, Cecilia, Lola, Uche, Olive, Jorge, Franklin, Bo, Fang, Ozgur, Mel, Herbert, Ajay, Tareq, Tianzhu, Leander, Eduardo, Emmanuel, Swati, Lala. Thank you all for making the journey such a memorable one.

And thank you to Mary, Jackie, Stephen, Louise for the constant help whenever problems have arisen in Williamson Building (and outside it at times!).

I also need to thank my colleagues at Kingston University for their support over the past year since I joined the Law School over the Hill.

Finally, but more importantly, thank you to my family for the constant support and to Sarah, for her understanding and presence.
Chapter 1 – Introduction

“We make the rules, pal. The news, war, peace, famine, upheaval, the price of a paper clip. We pick that rabbit out of a hat while everybody sits around wondering how the hell we did it. Now you’re not naïve enough to think that we’re living in a democracy, are you, Buddy? It's the free market, and you're part of it”.

Gordon Gekko, 1987

1.1 – Research Background

Financial crises and scandals have existed for as long as it can probably be recorded, as long at least as a system of money and rudimentary banking can be traced. Events such as the Tulip Mania in mid-1630s and the South Sea Bubble in 1720 awakened very early concerns about the dangers and oscillations of finance, at a time when the success of geographical and industrial enterprises were deemed worth the exploration of innovative commercial models.

From those early days finance has developed into an increasingly complex “science”, one which over the last three decades has come to represent a very substantial slice of the economic system, particularly in certain countries where legal reforms and economic theories have contributed to the flourishing of financial economies as opposed to industrial ones. The progressive globalisation of this economic model over the last fifteen years made societies around the planet increasingly dependent on (and acceptant of) market fluctuations and cycles, on the “ups” and “downs” deemed intrinsic features of financially driven economies.


5 L.E. Mitchell “Financialism. A (Very) Brief History”, 2010, available at http://ssrn.com/abstract=1655739. Even though this economic model has become virtually global, it can be said to refer predominantly to Anglo-American economies where financial markets have become the beacon of a new economic order where institutions therein trade to serve their own purposes and do not provide resources to fund industry or society. This development will be further illustrated in the thesis.
Chapter 1 - Introduction

Over the last decade then, a number of corporate and financial events have severely shaken the foundations of economic systems based on financial services industry. The thesis contends that two sequences of events (the 2001-03 wave of accounting frauds and the 2007-08 global crisis) provided the background to analyse and explain modern financial scandals. It starts with the observation that financial crises from the last ten years are essentially rooted in two main problems: a corporate governance one, represented by the lack of effective control systems over those who run the company, and a corporate finance one identified with the excesses of financial innovation and related abuses of capital market finance. In response, the thesis offers a new paradigm – referred to herein as “enlightened sovereign control” (ESC) – which encompasses a new institutional framework for the regulation of certain corporate and financial activities and substantive solutions to the legal issues emerging in the research.

The backdrop of the thesis is, as mentioned, made of a number of case studies (Enron and Parmalat first, and then Northern Rock and Lehman Brothers) which, by pointing at a number of common denominators underscoring the emergence of financial scandals and general instability, provide evidence to corroborate the thesis’ hypothesis. The analysis and explanation of financial scandals is conducted by highlighting the legal issues that have consistently arisen as main themes from the case studies. In particular, the study of financial scandals follows the path of the two main legal strands of the thesis, that is: corporate law and financial law. In the context of a legal enquiry into financial crises, these areas provide an ideal setting to examine theoretical and practical determinants recurred over the past decade. Moreover, the combination of these two spheres of law offers a comprehensive perspective into the study and a multifaceted approach to the understanding of events that have otherwise been often branded with mono-dimensional slogans.6

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6 Arguably most of the works that followed corporate and financial scandals have concentrated on the analysis of one of these two legal aspects and have therefore looked at financial scandals from the perspective of either corporate law or financial law. This approach is probably what led in the aftermath of Enron, WorldCom and Parmalat, to tag these events as accounting scandals, or as corporate governance collapses, whereas the corporate finance side of the story proved later to be equally central.
1.2 – Current status of research

The explosion of corporate and financial collapses has over the past decade triggered research and debates on their origin. Some of them have to a substantial degree been employed to validate the theoretical base of this thesis and are herewith briefly signposted.

In the area of corporate law, the work of Berle and Means\(^7\) represents a starting point of the research, especially with regards to their recognition of new ownership patterns appearing in the American corporate world. Empirical data collected over a number of American corporations in the 1930s led to a redefinition of the legal environment within which shareholders and managerial powers were divided. Berle and Means in particular introduced the concept of “managerial power” that had come to dominate US firms, as a consequence of increasing dispersion of share ownership and new legal framework governing shareholders’ rights.\(^8\) Similarly, Cheffins more recently conducted a parallel enquiry into the changing business environment characterising UK corporations, and he strongly pointed at the role played – within different stages of British history – by widely-held firms in the broader legal and economic environment.\(^9\)

In the attempt to define the causes of different ownership structures and their conduciveness to corporate instability, Coffee investigated the interplay between legal rules and institutional dynamics, such as the development of market-based, self-regulatory institutions, as main determinant, denying therefore a more central role played by the “legal origin”\(^10\) theory.\(^11\) A similar conclusion is reached by Roe, who, defying the centrality of “legal origin” explanations, pointed at both historical

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\(^8\) Ibid.


and political factors influencing corporate and financial environments. A different perspective on the debate is offered by Gilson, who emphasised the importance of good corporate laws rather than ownership structures, as main reason for corporate failures. The argument in particular refers to the different possible strategies to face agency issues and to the trade-off ensuing from either corporate model.

The issue of the corporate goal is a central one within the research as it defines a number of corporate governance issues that permeate the very essence of the theory herein proposed. In this area the work of Keay is fundamental in illustrating the contours and main underpinning of the two main paradigms, namely shareholder value and stakeholder theory. In particular, his research highlighted the links between each theoretical proposition and the resulting legal framework applied in this corporate governance context (more specifically with regards to directorial duties). A very useful approach to the study of corporate powers is provided by Parkinson who referred to the influence of politico-economic theories on legal rules in place. The focus is of particular importance in the context of liability rules and of how regulation in this sense has been frustrated by neoliberal corollaries that advocated reliance on market-based mechanisms.

On the above subject a very valuable American perspective is also offered by Blair who countered a number of assumptions upon which shareholder value theory is premised. Similar arguments are brought about by Stout whose main criticism

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against the above theory stemmed from the misguided economic view of shareholders as owners of the company.\textsuperscript{17}

In the area of financial law, essential contribution to the thesis’ theoretical background is provided by Mitchell, who highlighted the changes occurred over the past three decades in the financial world and the far-reaching consequences these changes had on the economic system and on society more broadly.\textsuperscript{18} This path is followed by pointing at the role played by stock markets within economies and at the persisting differences and implications between two broad patterns of financial development, namely bank finance on one hand and capital market finance on the other.\textsuperscript{19} These considerations are linked to reflections on the more recent issue of financial innovation, and on the role it had in the context of the global crisis. Avgouleas provided a very useful perspective on the legal and socio-economic mechanisms that led to the creation of the bubble burst in 2008\textsuperscript{20}, while Blair exposed some key legal-economic arguments, pointing specifically at the importance financial innovation had in the growth of the shadow banking system and of leverage.\textsuperscript{21}

In the context of financial regulation, initial reflections on general regulatory functions in the financial industry are grounded on the work conducted by Goodhard and al.\textsuperscript{22}, and also by Wood.\textsuperscript{23} The role played by financial regulation in allowing the formation of a huge bubble and eventually of its burst is explored by Schwarcz whose research represents an ideal point of reference. In particular, a number of

\footnotesize{\textsuperscript{17} L.A. Stout “Bad and Not-So-Bad Arguments for Shareholder Primacy”, 75 \textit{Southern California Law Review} 1189, 2002. \\
\textsuperscript{18} Supra Mitchell 2010. \\
\textsuperscript{23} P.R. Wood “\textit{Law and Practice of International Finance}”, Sweet and Maxwell London 2008.}
essential issues are tackled in his work, namely the complexity that resulted from the innovation of financial products, the failure of disclosure mechanisms in unbundling the obscurity of financial information, and the systemic risk generated by the whole financial system.

On the adequateness of different regulatory techniques, a very critical approach is offered by Avgouleas, again with regards to the issue of disclosure and to possible alternatives to it. These debates are also complemented by broader enquiries into different regulatory models and cultures that have been eventually reflected in regulatory policies in place.

Beyond the above theoretical background, the thesis as announced culminates with proposals under the ESC. The paradigm is introduced by providing a review of the relevant theories upon which it is grounded and by developing its theoretical framework. This represents the foundation for institutional and substantive proposals linked to legal issues exposed in the thesis.

The research carried out in the thesis ultimately purports to contribute to the ongoing debate in corporate and financial circles as regard the causes of the global crisis (and of modern financial scandals more generally). This is achieved by presenting a multifaceted analysis of events occurred over the past decade and an original approach to possible solutions, grounded essentially on a revisited “role of law” in the two above areas. The ESC paradigm offers in this respect a different perspective on the regulation of specific corporate and financial activities, whereby the role of state in regulating and supervising such activities and its actors is envisaged as guarantor for the inclusion of broader societal interests within the regulatory process.


1.3 – Aim of the research

As announced, the thesis’ fundamental aim is to propose a paradigm, the ESC, as response to the financial crises occurred over the last decade. The paradigm purports to contribute to current policy debates in the areas of corporate and financial law firstly by constructing a theoretical framework upon which it is grounded, and secondly by presenting both institutional and substantive solutions to the legal issues analysed in the thesis.

In order to come forward with the proposals, a legal analysis of financial scandals will be conducted. This is done by firstly providing a theoretical background which identifies key issues in the areas of corporate and financial law. The theoretical enquiry leads to the more in-depth analysis of legal issues identified as recurring over the last decade. These are examined also in connection with the relevant legislation that ensued the last crisis. This enquiry culminates with case studies which have the function of firstly illustrating the legal issues arisen as common denominators of financial scandals, and secondly of corroborating the hypothesis formulated in this research.

Admittedly, the two areas of law – corporate and financial law – on which the thesis is centred, could alone provide explanations to financial scandals without imminent necessity to look beyond their confines. However, the case studies herewith selected expose a high degree of interdependence between corporate governance structures and the strategies pursued by those firms on the capital markets. More generally, literature in the field of corporate governance has increasingly focused on the broad interplay between financial markets and corporations, especially insofar as the former can exert pressure and condition corporate behaviours and strategies. This phenomenon progressively developed over the last three decades and reached its apex with the liberalisation and then with the globalisation of financial markets occurred during the 1980s. The expansion of capital markets in other words created the condition for what has been referred to as “financialisation” of corporate law in general, and more specifically for a tighter

influence market logics have come to play on corporate executives. Prominent examples in this sense can be provided by looking at the extent to which corporate remunerations have been increasingly aligned to stock market valuations, and by pointing at the reliance on the market for corporate control in the shape of hostile takeovers to create a means to discipline managerial behaviours.

By looking beyond more classical approaches to the interplay between corporate governance and corporate finance, the thesis focuses on the impact that corporate structures and corporate objectives have on financial strategies. Abuses of capital market finance transactions (some of which have become predominant corporate finance patterns) are in turn explained by looking at the short-term, rent-extraction effects they have for shareholders and executives.

The way in which corporate governance and structured finance problems are intertwined is above all manifested in the multidimensional reactions that the recent financial meltdown has generated. In particular, a multifaceted approach to the solution of regulatory issues seems to be emerging in the aftermath of the crisis, in contrast with responses that followed the Enron-type scandals almost a decade ago. At that time, as the collapses were labelled mainly as accounting and gatekeepers’ failures, regulatory responses were centred on strengthening accounting and financial reporting standards, leaving outside the scope of that regulation other central issues that had contributed to cause those scandals. The case studies conducted over Enron and Parmalat will expose the relevance of legal issues (the abuse of structured finance transactions), beyond the corporate governance ones, that contributed to cause those corporations’ collapse.

From what has been outlined, interrelations between corporate governance and financial transactions are at the centre stage of the research. This is to a large extent reflected by the ESC paradigm which is conceived to encompass institutional and substantive proposals in both areas of law.


29 Preeminent example was the Sarbanes-Oxley Act enacted in the USA in 2002 as a response to Enron, WorldCom, Adelphia, Tyco International, otherwise known as “Company Accounting Reform and Investor Protection Act” in the Senate and “Corporate and Auditing Accountability and Responsibility Act” in the House. See http://www.soxlaw.com/.
With regards to the corporate law strand, the first enquiry is centred on the relevance of corporate ownership in the context of financial scandals and the extent to which the ensuing agency problem can be seen as a cause of concern. The second enquiry revolves around the difficulty of establishing in whose interest corporations should be run. While this theoretical discussion can shed light on the principles underpinning corporate culture over the last three decades, it also triggers more practical questions as to the legal mechanisms in place to monitor those in control of the firm and to make sure that they act in accordance to their duties. These theoretical enquiries flow into the questions addressed in chapter three where legal issues related to the control of managerial behaviours are tackled.

The financial law research strand follows a parallel approach by firstly exploring different patterns of financial development, whereby the chief demarcation is between bank finance and capital market finance. Ultimately, the intrinsic question within this enquiry is the extent to which financial models over-reliant on innovative and complex structures are needed at all to sustain economy and society. This leads to a second enquiry within this strand, namely that related to the regulatory models available to discipline financial markets and set constraints on the activities therein. A theoretical overview of this issue addresses the recurring question related to the regulatory culture from which the current global crisis underpinned and from which the complexity inherent to certain transactions generated. The above theoretical investigations are completed by a practical examination conducted in chapter four, on the way in which structured transactions developed in the context of capital market finance.

Addressing the above legal issues, and critically appraising post-crisis reactions, paves the way for the presentation of more substantial contribution of this research, reflected in the measures proposed in the paradigm to establish long-term solutions to different institutional and substantial problems exposed in the analysis.

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30 See S.L. Schwarcz “Markets, Systemic Risk, and the Subprime Mortgage Crisis”, 209 SMU Law Review 61 2008, p.211. The prevailing trend has seen over the last decade an increasing disintermediation from banks, with corporations resorting to capital markets finance, through the employment of structured finance transactions like securitisations and derivatives.
1.4 – Methodology
Research in this thesis is conducted using chiefly a qualitative literature-based approach, which is complemented by legal resources (both primary and secondary sources). The project is to a large extent concerned with the analysis of the legal and socio-economic literature that serves firstly to illustrate the theoretical framework of the thesis and secondly to substantiate the critical review of legal issues. Similarly the case studies conducted to expose the emergence of certain theoretical and legal issues, are based on literature or reports reviewing different aspects of the highlighted events.

It is worth pointing out here that while the main point of reference for legal analyses carried out in the thesis is English law, some aspects of the research involve areas of law that are to a substantial degree practice-driven and do not necessarily attach to a particular legal system (straightforward examples could be that of some corporate governance arrangements that reflect cross-border similarities, or the way in which some financial transactions are structured, which results in rather converging international practices). Beyond this, reference to relevant laws in the research is made with regards American laws, EU laws and also Italian laws. This phase of the analysis also seeks to explain that much of the literature available relates to the USA and the UK, and that writings relating to corporate and financial developments beyond this are more limited.

To the extent that the study involves a parallel examination of different legal systems, a comparative research methodology is employed whereby literature and norms from appropriate sources are examined to expose the relevant dichotomies (for instance that between Anglo-American and continental European corporate

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31 The former consisting of both statutes (UK, EU or US when relevant) and common law, the latter represented also by reports, journal articles and reviews of events and legal reforms.

32 R.K. Yin “Case Study Research: Design and Methods”, Sage Publications 2003, p.13, where a case study is defined as “...an empirical enquiry that investigates a contemporary phenomenon within its real life context...”.

33 This is due to the wider development of the Anglo-American literature in the field, which indeed reflects the impact on society of an economy characterised by large public corporations and deep and liquid financial markets, which are two common factors emerging from the research.

governance, or between bank-centred financial systems and capital market driven ones).

Finally, it also needs to be pointed out that the research has followed in some chapters a selective approach to the issues analysed. In particular, chapter three and four take under consideration a number of legal matters that are naturally linked to both the theoretical themes on one hand, and the case studies on the other. Chapter three however, in dealing with controls of managerial behaviours, addresses two specific legal questions (fiduciary duties and compensation structures) while this area of corporate law could easily be covered by pointing at a broader range of issues, like that of institutional investors or the role of the market for corporate control to name but two. For reasons of space of course, treating all these issues would be impossible in the present format, and the selection reflects to a certain degree the centrality of the above discussions and the measure in which they have influenced the scandals herewith examined.

Chapter four presented a more straightforward selection, because in the context of abuses of capital market finance, securitisation (more generally financial innovation) and the role of rating agencies have both been at the heart of current debates.

1.5 – Structure of the thesis
The thesis comprises eight chapters, and is divided into four parts. Part I (chapter two) relates to the theoretical background of the project; part II (chapter three and four) is concerned with the examination of legal issues; part III (chapter five and six) illustrates case studies; part IV (chapter seven) presents the ESC paradigm. Individual chapters are organised as follows.

Chapter Two forms the theoretical background of the thesis. The chapter is divided into two main parts, each reflecting the two main research strands of the work, namely corporate law and financial law. Within each part, themes are identified and their theoretical underpinnings are exposed in order to substantiate the discussions conducted in subsequent chapters.

Chapter Three analyses the corporate law issues arising in connection with the theoretical themes identified in chapter two. They are concerned with the broader question of controlling managerial actions, and two control strategies are specifically evaluated in the chapter, namely fiduciary duties, and compensation structures.
While the former represent the archetype of old common law and equitable remedies (now statute-based provision), the latter are typical market-based mechanisms. The chapter is completed with an evaluation of recent regulatory responses to the above legal issues.

Chapter Four explores the financial law issues emerging from the theoretical analysis conducted earlier in the thesis. The research involves the general examination of financial innovation and the more detailed analysis of how securitisation evolved into schemes like CDO and CDS. Secondly, the chapter looks at the role played by credit rating agencies in the regulation of capital markets and in particular at their role in structured transactions. A critical evaluation of related post-crisis regulation completes this analysis.

Chapter Five introduces the first case studies of the thesis, which refer to the 2001-03 wave of corporate (accounting) frauds. Enron and Parmalat are here comprehensively explored and the two dimensions of their failures – the corporate governance and the corporate finance one – are both highlighted in each exposition.

Chapter Six completes the case studies with the account of the global financial crisis and with a critical evaluation of the themes emerging from it. This is complemented by the analysis of the Northern Rock and Lehman Brothers collapses, whereby the strategies in place at both institutions are also evaluated.

Chapter Seven defines the foundation of the concept that is proposed within this thesis – the enlightened sovereign control. The paradigm is first of all illustrated by exploring the main theories upon which it is grounded, again both in respect to company law and financial law. The chapter then explores the institutional framework of the paradigm which is essential to understanding the more substantive proposals envisaged in the context of specific legal issues.

Chapter Eight is the conclusion of the thesis and provides both an overview of themes discussed and an analytical schematisation of the proposals brought forward.
Chapter 2 – Providing a theoretical background to financial scandals

2.1 – Introduction

This chapter provides a theoretical background to the legal issues that will be analysed in the thesis. Since the interrelation between corporate governance and structured finance is central to the way in which financial scandals are explained in this thesis, a separate discussion is conducted for these two main dimensions of the research. For this purpose a number of themes (or determinants) are identified in the context of corporate and financial law and a theoretical framework is provided for their subsequent legal analysis.

The first part of the chapter identifies the two themes that form the corporate governance analysis. Firstly, a fundamental issue is to explain the relevance of corporate structure in the context of financial scandals and the extent to which difficulties in monitoring decision-making processes within certain governance structures have resulted in managerial abuses. Secondly, it is essential to establish in whose interest the company should be run. While this theoretical discussion – involving mainly the dichotomy between shareholder value and stakeholder theory – can shed light on principles underpinning corporate culture over the last three decades, it also triggers more practical questions as to which legal mechanisms are in place to monitor those in control of the firm.

The second part of the chapter focuses on structured finance, and more generally of capital market finance, which is recognised as a fundamental factor behind the scandals. This enquiry is initiated by exploring different patterns of financial development, whereby the demarcation between bank-based finance and capital market-based finance is introduced. It is also pointed out that the prevailing trend over the last decade has been one characterised by disintermediation from banks, with corporations resorting to capital markets finance, often through the employment of structured finance transaction. The second theme identified here relates to the regulatory models available to discipline financial markets and the way in which activities therein are regulated. A theoretical overview of these issues addresses the question related to the regulatory culture from which the current global crisis surfaced and from which certain transactions developed.
Chapter 2 – Providing a theoretical background to financial scandals

The chapter is organised as follows: section 2.2 identifies the corporate governance elements of the research, while section 2.3 of the chapter exposes the corporate finance elements of the research whereby the main themes are discussed within each part. Section 2.4 serves as a conclusion to sum up the concepts and the issues presented in the chapter.

2.2 – Identifying the corporate governance themes
The study of corporate governance is traditionally concerned with how the relationship between different constituencies within large public corporations is regulated, with how in other words an appropriate balance of powers between directors, management, and shareholders is established in order to contribute to business stability.¹

A prominent recurring feature behind corporate and financial scandals over the last decade is recognised in the general uncertainty surrounding decision-making processes, an issue that has become increasingly delicate with regards to certain strategic choices and in the general context of financial reporting. Corporate failures have highlighted concerns on the workability of the governance system overall and particularly on the lack of board accountability and control over financial matters.²

The increasing interaction of firms with capital market finance has magnified the above concerns, which are reflected in two enquiries conducted in this section: firstly, the definition of firms’ ownership structure which explains the balance of powers between different corporate constituencies; secondly, the examination of the corporate objective, that is to say the question of in whose interest companies should be run. These enquiries are commenced in the following section with the main corporate governance classifications (2.2.1); an examination of the historical development of the corporate governance debate follows in section 2.2.2, after which the main themes of the theoretical background are analysed: firms’ corporate structure (2.2.3), and the definition of the corporate objective (2.2.4).


² See Sir D. Walker “A review of corporate governance in UK banks and other financial industry entities”, 16 July 2009, p.9; and also Cadbury Committee “Report on the Financial Aspects of Corporate Governance” 1992; the DTI in 1998 also adopted the definition of Corporate Governance provided by the Committee in the Paper that established the Company Law Review: “system by which companies are directed and controlled”.

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2.2.1 – Corporate governance classifications

Corporate control and accountability are issues that need to be analysed in the broader context of some preliminary corporate governance classifications. Specifically, firms’ ownership structure, identified with the degree of separation between ownership and control, is the starting point to understand the rationale behind different corporate strategies and the way they weigh on different corporate constituencies. This first investigation leads to the introduction of a broad differentiation between two categories of ownership, which inevitably affect the respective corporate governance systems. Concentrated ownership on one hand, predominant in continental Europe, is characterised by the presence of a controlling shareholder or a family group or else a small number of block-holders who *de facto* can control the board of directors. Dispersed ownership on the other hand, typically an Anglo-American feature, generates from a sharp separation of ownership and control, whereby shareholding is normally spread among many institutional and retail shareholders who own an insufficient percentage of shares to exert substantial control.  

These two models of corporate organisation mirror different approaches to corporate governance generally and more specifically to the legal tools employed to control corporate decision-making. The persistence of different governance systems leads to the necessity to define the main underlying traits of each model.

A classic approach to corporate governance classifications consists of looking at the dichotomy between the two main legal families, common law and civil law, which represent different legal traditions and therefore dissimilar solutions to social and economic issues. This categorisation has also come to be identified with the “legal origin” theory, which points at the influence of legal rules on different laws and regulations. Even though corporate governance models do not necessarily

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4 Interestingly, two of the major corporate scandals occurred at the start of this decade – Enron and Parmalat – involved very different corporate cultures and legal systems and this epitomised how similar corporate frauds could be achieved through the spectrum of dissimilar ownership structures, breaking therefore different governance systems.

correspond to the above legal families, it can be argued that different corporate
governance models, just like different legal families, represent a peculiar strategy of
social and economic control. To this extent the broad distinction between common
and civil law can provide an initial insight into the way in which a different balance
between “state intervention” and “market mechanisms” is reached in the above
families. This balance and the ensuing relevance it bears on certain corporate law
mechanisms are central to the corporate governance debate that is further developed.

A different approach to corporate governance looks at political and economic
factors influencing legal mechanisms that in turn characterise the way in which large
corporations are governed. The centrality of politico-economic dynamics could be
exemplified by the fact that the policies endorsed in the UK and US over the last
three decades produced a convergence towards a corporate governance model that
departed to a substantial extent from typical Anglo-Saxon ones, despite the
persistence of very similar legal systems (common law).

This last consideration seems thus to point at a distinction between different
types of capitalism reflected in the legal framework that applies to corporations: the
Anglo-American model that can be labelled as capital-market capitalism and the
welfare capitalism that remains the predominant political-economic expression of
most civil law countries.

6 Civil law countries can be associated with a heavier hand of government ownership and tighter,
more prescriptive type of regulation. Common law is associated with lower formalism of judicial
procedures and greater judicial independence. From a different perspective, within common law
jurisdictions, priority is to support private market outcomes, whereas civil law systems are more
concerned with replacing such outcomes with state-desired allocations. See supra LLSV.

7 The wave of financial liberalisation and privatisations reached its peak in the USA and in the UK in
the 1980s, at a time when the free market ideology was endorsed by the Reagan and Thatcher
governments. The corporate and financial worlds were then driven by a new capitalist model
permeated by the over-emphasised shareholder value principle upon which managers based their
strategies, under pressure to deliver steep increases in stock market returns. See K. Williams “From
Shareholder Value to Present Day Capitalism”, Economy and Society, Volume 29, Number 1,


Vol. 7, N. 1, 2002
2.2.2 – The historical development of the corporate governance debate

Providing a historical context to the development of the corporate governance debate is of fundamental importance, as it clarifies the origin of the themes that are analysed in the next sections. To this end, attention is drawn to two main phenomena: the evolution of statutory provisions on limited liability, and the development of the definition of shareholders’ proprietary rights. The background of this historical enquiry is provided by English law, because this can be regarded as the ideal platform to analyse common patterns of corporate organisation and structure within Anglo-American tradition and their theoretical and practical implications as opposed to those flowing from continental European culture.\(^\text{10}\)

With regards to the first phenomenon, the joint stock companies of the 19\(^{\text{th}}\) century are the starting point to analyse the evolution of corporations in England and the change in their ownership structure. At the beginning of the 1800s joint stock companies were the main vehicle for the conduct of business and were still treated by courts through the lens of partnership, whereby members were co-owners of the company’s assets. Business enterprises were in fact still organised in partnerships as they were constrained by the restrictions of the Bubble Act 1720\(^\text{11}\) that prohibited joint stock concerns for commercial purposes whereby their capital derived from subscription of transferable shares.\(^\text{12}\)

Although there was formally a board of directors, these large partnerships were virtually controlled by their shareholders who, according to partnership law, were liable for all debts incurred by the company. Unlimited liability implied an unlimited power of control and direction over the business itself.\(^\text{13}\) This structure however, seemed already problematic in the 19\(^{\text{th}}\) century, mainly for the large

\(^{10}\) This mainly because of the role played by English Law in the different context of the industrial revolution, the railway boom during the 19\(^{\text{th}}\) century and the growth of the British Empire. See G. Robb “White-Collar Crime in Modern England”, CUP 1992, p.11-14

\(^{11}\) There remained few exceptions to the above restrictions, such as the East India Company and the Bank of England, for which limited liability was granted.


number of members that caused inconvenience in the application of partnership rules.\textsuperscript{14}

The demand for incorporations, following the great industrial expansion of the 19\textsuperscript{th} century, prompted the Parliament to finally repeal the Bubble Act in 1825 with the subsequent enactment of a series of special Acts that until 1844 performed the function of granting incorporation to different groups of enterprises. In 1844 the Joint Stock Companies Act was enacted with a view to providing a more practical framework with regards to the issue of incorporation. This was done by introducing a simpler process for registration, coupled with disclosure requirements designed to protect against abuses.\textsuperscript{15} Finally, the Joint Stock Companies Act 1856 provided limited liability to all except banking and insurance firms\textsuperscript{16}, granting incorporation under registration and moving away therefore from the idea of privilege concurred by the State.\textsuperscript{17} The new legislative framework passed between 1844 and 1862 perfectly complemented the new scenario\textsuperscript{18} since limited liability became the necessary term under which potential investors could conveniently join a business in relation to which they had no sufficient knowledge.\textsuperscript{19}

The advent of limited liability, coupled with the growth in number and size of joint stock companies can be regarded as what ultimately gave pace to the process of “depersonification” of company ownership. This was also reflected by a new approach to shareholding, consisting of diversified portfolios of shares, rather than a

\textsuperscript{14} P. Ireland "The Triumph of the Company Legal Form, 1856 - 1914", in Essays for Clive Schmitthoff, 1983, p.31.


\textsuperscript{16} The Joint Stock Companies Act 1862 was the first piece of legislation to regulate comprehensively issues of incorporation and limited liability, setting new and lower criteria as regards minimum number of members and minimum share capital, but increasing disclosure requirements. Supra Boyle and Birds 2007, Ch.1.


\textsuperscript{18} This was mainly represented by the fact that the immediate relationship among partners (on which partnership was based) started to disappear, to give way to a more impersonal approach to the business. See supra Miller 1994, p.150.

limited range of ventures. This implied, among other things, a lack of involvement in the business on the part of shareholders, also because of the highly specific and technical aspects of the business which required specific skills and qualifications.\(^{20}\)

The need for skills and qualifications is what created the premise for delegating the management of the business to a body within the company that could perform managerial functions with expertise and authority \textit{vis-à-vis} third parties. Within the ensuing organisational structure the separation of ownership and control produced the dichotomy between the two main functions within the firm: shareholders as providers of capital and directors as those who contributed by managing the firm.\(^{21}\)

A clear division of powers between shareholders and directors was then also enshrined in a number of judicial decisions that established that once power had been vested on the board through the articles of association, the general meeting could no longer interfere with the exercise of managerial power.\(^{22}\)

The second phenomenon pointed out is the progressive shift in the context of litigation to shareholders’ proprietary rights. Interestingly, the process of “depersonification” of company ownership was accompanied by a consistent attenuation of the rights and obligations flowing from shareholders’ proprietary claims.\(^{23}\) It can be observed that by the end of the 19\textsuperscript{th} century, further to the widespread application of the \textit{Salomon} rule\(^{24}\) and to the rise of private companies,


\(^{21}\) It is debated whether Britain was a “first mover” with regards to the separation of ownership and control; whether in other words London’s tradition as a dominant financial centre and the consequential stock market oriented corporate economy provided an early natural platform for the above separation; or whether Britain lagged behind US and Germany whose manufacturing firms established themselves at an earlier stage with more sophisticated managerial hierarchies dominated by trained executives. Supra Cheffins 2008 p.11.

\(^{22}\) See P.L. Davies “\textit{Gower and Davies Principles of Modern Company Law}”, Sweet and Maxwell 2008, p.378,380; and \textit{Automatic Self-Cleansing Filter Syndicate Co. Ltd v. Cuninghame} [1906] 2 Ch. 42 (C.A.). The articles were held to constitute a contract by which the members had agreed that “directors alone shall manage”.


\(^{24}\) See \textit{Salomon v. Salomon & Co. Ltd} [1897], A.C. 22. The House of Lords established a very formalistic approach to incorporation by dismissing the arguments uphold by the Court of Appeal whereby the company was alleged to be a sham, and by affirming that the incorporation was to be considered valid despite some of the members in the firms being “dummies”. Interestingly, this approach corroborated a contemporary US case, \textit{Santa Clara County v. Southern Pacific Railroad} 118 US 394 (1886).
the role of shareholders changed dramatically. The change was twofold since it concerned the practical interests related to holding shares, as well as the legal interpretation given by courts to the definition of shares. As regards the first point, it has been mentioned that, as the right to interfere with the day-to-day running of the company became a prerogative of the board, shareholders’ main concern was the right to receive dividends or to assign their shares.25

With regards to courts’ interpretation, a number of decisions started, from the first half of the 19th century to set limits to shareholders direct and severable interest in the company’s assets.26 This principle then became well established and defined with the decision in *Borland’s Trustees v. Steel Brothers & Co. Ltd*27, where Farwell J. identified a share as the interest of the shareholder in the company, measured by a sum of money, in order to quantify his level of liability in it and his interest.

Another consequence of *Borland’s Trustees* was that in, in describing shares, courts started referring to them exclusively in terms of a right to dividend, a return of capital or a vote, omitting any reference to shares as an interest in the firm’s assets. The apex of this conceptual change was reached with the decision in *Short v. Treasury Commissioners*28 where the capital of the company had been subject to a compulsory acquisition by the Crown and the court had to assess the compensation payable to shareholders. The Court of Appeal rejected the view that shareholders were entitled to the entire value of the company, which would have been greater than the aggregate value of their shares. It stated instead that the shareholders were entitled to be compensated for the value of what had been expropriated to them: that being the shares, and not the company.29

At the beginning of the 20th century the divorce between ownership and control became a more definite feature of the corporate structure since the vesting of the firm’s management in the board of directors was enshrined in the law, due to a number of judicial decisions that specifically expressed the exclusive right and

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26 See *Bligh v. Brent* (1836) 2 Y. & C. 268 and also *Myers v. Perigal* (1852) 2 De G.M. & G. 599.

27 [1901] 1 Ch. 279, 288.


29 Ibid.
competence of each constituency within the company.\footnote{See Automatic Self-Cleansing Filter Syndicate Co. Ltd v. Cuninghame [1906] 2 Ch. 42 (C.A.) and Salmon v. Quin & Axtens Ltd [1909] 1 Ch. 311 (C.A.). It has to be observed that from a Company Law perspective, the allocation of authority to the board of directors occurs via the articles of association which in their content are determined by shareholders. See R.H. Kraakman et al “The Anatomy of Corporate Law: A Comparative and Functional Approach”, OUP 2004, p.33-35.} It also became widely accepted that a delegation of power from security holders to managers was a necessary and effective allocation of corporate resources\footnote{See H. Hansmann and R.H. Kraakman “What is Corporate Law?”, Yale Law School Centre for Law Economics and Public Policy, Research Paper No.300, 2004.}; within this delegation mechanism however rests the premise of what is referred to as “agency problem” and more specifically the difficulty of controlling managerial conduct, ensuing from the naturally diverging interests of decision-makers (managers) and from the role of shareholders in monitoring them.

2.2.3 – Corporate structure: the separation of ownership and control

The historical context provided in the previous section lays the foundation to explore the ownership structure of large public firms. This has fundamental implications on the broad governance model in place and more importantly on the legal strategies employed to control those who manage the firm. Since different degrees of ownership dispersion characterise different jurisdictions, leading to a dichotomy (dispersed vs. concentrated), academic works have strived in the first instance to establish the origin of the above phenomenon, and secondly to assess what system leads to better corporate governance.

In an attempt to investigate what prompted ownership dispersion, Berle and Means originally highlighted \textit{inter alia} a substantial change in the US legal environment that accompanied the weakening of shareholders’ powers \textit{vis-à-vis} directors. This, they argued, contributed to a situation of disperse shareholding and managerial power.\footnote{Supra Berle and Means 1932, ch.1. The authors pointed particularly at the power to vote by proxy, the power to remove directors from their office, and the principle of pre-emptive right.} Changes in legal rules in other words were singled out as conducive to a modified balance of powers in the context of corporate governance. This approach would later lead to another explanation of ownership dispersion,
which is referred to as “legal origin” theory.\textsuperscript{33} This theory has indulged in the broad claim that the legal family to which a country belongs can explain the development of strong securities markets as well as the degree of ownership dispersion.\textsuperscript{34} It is further postulated that common law jurisdictions developed stronger stock markets than their civil law counterparts and that they have a higher proportion of widely held firms. The reason for this tends to be identified with a stronger legal protection of outside investors that common law offers, and more generally with stronger emphasis on the protection of private property rights against state interference, coupled with a general independence from the state that normally characterises common law countries, which in turn has been congenial for the development of market-based, self-regulatory institutions.\textsuperscript{35}

According to this theory, the assumed lack of shareholder protection in civil law countries would discourage outside investors from purchasing shares in the stock market, because of fear of exploitation from those in control of the corporation. This is exemplified by considering that in contexts of good legal protection, investors will be willing to pay full value of shares made available for sale; this in turn lowers the cost of capital for firms that choose to sell equity in financial markets. Shareholders at the same time will be prone to selling shares since the law precludes control exploitations.\textsuperscript{36} In sheer contrast with the above scenario, countries with little shareholder protection would see potential investors shying away from buying shares, and shareholders reluctant to selling equity to the public, the resulting outcome being a persistence of closely-held ownership.\textsuperscript{37}

In contrast with the above theory, it is suggested that common law and civil law do not present such stark distinctions as far as corporate governance is concerned and for some aspects they are actually converging. More importantly,


\textsuperscript{34} The interrelation between these two points will be further clarified in this chapter.

\textsuperscript{35} Supra Coffee 2001.


\textsuperscript{37} Ibid.
among the common law family, only two countries have emerged with clear preponderance of dispersed ownership, the US and the UK, making therefore the legal family argument difficult to sustain.\(^{38}\)

Other theories have looked at a different chain of causation, whereby ownership patterns are seen as consequential to political and historical factors or to cultural traditions.\(^{39}\) This finds confirmation partly in the US in the 1930s and the UK in the 1980s, where regulation to protect shareholders was enacted only as a result of a growing number of individuals owning shares and an increasing separation of ownership and control.\(^{40}\) The wave of regulation in other words could be seen as a response to protect the interests of new large and influential constituencies.\(^{41}\)

Another explanation of ownership dispersion points at political preconditions, postulating that social democracies are likely to have fewer publicly traded firms and a higher level of ownership concentration than “right-wing” countries with less social democratic concerns.\(^{42}\) The argument suggests that social governments favour employees over investors and use regulation accordingly, in order to increase workers’ leverage. Executives in this context tend to align with employees rather than with shareholders, and this balance exacerbates the conflict of interests between management and shareholders, causing a divorce between ownership and control to be unlikely in social democracies.\(^{43}\) The case of Britain however partly defies the above explanation since it is observed that ownership split from control in

\(^{38}\) M. Roe “Legal Origins and Modern Stock Markets”, 120 Harvard Law Review 460, 2006, p.475. Beyond this, many exceptions to the “legal origin” paradigm contribute to defy the theory; examples like Scandinavian countries, which offer good shareholder protection but have not moved towards dispersed shareholding are typical. On the other hand, common law countries like Australia, Canada or New Zealand have not developed substantial degrees of ownership dispersion.

\(^{39}\) Supra Coffee 2001 p.4-5.

\(^{40}\) Ibid; See also M.E. Parrish “Securities Regulation and the New Deal” Yale University Press, 1970, p.42-44.

\(^{41}\) Ibid. It needs to be pointed out that even before the above regulations there were in the US and UK other market-oriented factors, like the stock exchanges, which served to enhance investors’ confidence.


\(^{43}\) Ibid.
connection with a number of political and economic moves in the post-war decades that were pre-eminently social-democratic in nature.44

While none of the above theories provides exhaustive arguments on the causes of the separation of ownership and control, what results from this overview is that investigating the features of different corporate structures inevitably flows into politico-economic considerations (on whether political and economic powers are separated) and more importantly on reflections on the interaction between corporations and financial markets. To expand this point, the section looks at the dichotomy between close and dispersed ownership by exposing related practical implications and corporate governance mechanisms.

**Anglo-American ownership structure**

In their seminal work in the 1930s Berle and Means were pioneers in recognising the emergence of managerial power within US corporations as a consequence of the divorce of ownership from control.45 Their findings were based on empirical research conducted over the largest two-hundred American firms, revealing the phenomenon of shareholders’ loss of power and influence in the conduct of business, together with the trend of companies growing dramatically, with larger amount of stock being held by an ever-increasing number of shareholders.46 This scenario flowed into what is referred to as dispersed ownership, a situation where none of the shareholders has a sufficient proportion of voting power, leaving managers in a position to self-perpetuate their control over the firm.47 Because of their unique position within the business and because of legal devices through which they were retaining control, managers became the only ones in a position to understand complicated problems and reach difficult decisions.48 This led Berle and Means to

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47 See T. Nichols “Ownership Control and Ideology” Allen and Unwin 1969, ch.1 and 2. It can be observed that similar considerations have been made by Robb with regards to the increasing distance between capital providers and managers in Victorian Britain. See supra Robb 1992 p.125.

48 Supra Berle and Means 1991, ch.5, book 1. Five types of control were identified: control through almost complete ownership; majority control; control through a legal device without majority ownership; minority control; management control.
recognise the importance of the new managerial power not only in the context of corporations but more broadly within society.\textsuperscript{49} A community consensus in fact is what managers should have been responsible for, in accordance with self-discipline mechanisms that should have (in theory) led managers to perform their duties with “corporate conscience” and with regards to “public consensus”.\textsuperscript{50} At the same time however Berle and Means repeatedly pointed out that, regardless of any incentive policies, those in control of the corporation could favour their interests by profiting at the expense of the company rather than by making profits for it.\textsuperscript{51}

Despite the predicted risks of this corporate structure, Anglo-American corporate governance has come to be progressively dominated by the “managerial model”, based on dispersed ownership and delegated management. This organisational structure has moreover found corroboration in both theoretical and practical arguments as it has been widely agreed that a delegated management is an optimal organisational form of most large firms with numerous fractional owners. Delegation permits a centralised management which is necessary to coordinate the activity of big corporate entities and provides the apparatus for gathering capital under the collective control of professional managers.\textsuperscript{52} Delegation of decision-making powers to specific professionals also provides third parties with certainty as to who in the firm has authority to finalise binding agreements.\textsuperscript{53} Within most corporate law systems the delegation mechanism sees power and authority over corporate affairs being vested in the board of directors, which is in turn elected by shareholders (to which the board is accountable), who only retain competence over most fundamental decisions.\textsuperscript{54}

Even though delegated management has come to be recognised in the context of dispersed ownership as an efficient allocation of corporate resources, the resulting

\textsuperscript{49} Ibid, introduction; ch.2, book 1.

\textsuperscript{50} Supra, ch.2.

\textsuperscript{51} Ibid.


\textsuperscript{53} Supra Hansmann and Kraakman 2004, p.11,12.

\textsuperscript{54} Ibid.
organisational structure has also generated both theoretical and practical concerns.\textsuperscript{55} It has been observed that a natural offshoot of delegation is what is referred to as “agency problem” which arises when the decision-making process of the company is vested on managers, who are not the firm’s security holders and retain therefore different interests, as well as risks, in the exercise of their managerial duties. This condition entails a rather unbalanced relationship since the risk-bearer who has ultimate right of ownership transfers and delegates the right over his resources to an agent. Agents, as said are chosen with regards to their higher degree of specialisation and expertise, which principals do not necessarily possess. The position of agents/managers can therefore bring about a monopoly of information that principals/shareholders are not in a position to access and verify readily, hence causing asymmetric information”.\textsuperscript{56}

Theoretically this issue has been tackled by law-and-economy scholars by presenting corporate law as a “nexus” of contracts among factors of production, all contributing towards efficiency maximisation in the context of dispersed ownership.\textsuperscript{57} The theory envisages that all complex relationships between different constituents in the firm are contractual and this in turn creates binding promises and rights among members. The advantage of this network of contracts is to provide the firm’s participants with a set of terms that can optimise the cost of contracting and facilitate parties’ bargain.\textsuperscript{58}

The downside of the theory however, which is more generally associated with the agency problem as a whole, is represented by costs generating from the structuring, monitoring and bonding of a set of contracts among agents with substantially different interests. Agency costs can therefore be identified as direct


\textsuperscript{56} S.P. Shapiro “Collaring the Crime, not the Criminal: Reconsidering the Concept of White Collar Crime”, \textit{American Sociological Review}, Vol. 55, no.3, (Jun. 1990), p.347,348. Asymmetric information can be of two kinds: 1) adverse selection when the agent’s action is based on hidden information available to him; 2) moral hazard when agent’s obligation is discharged with hidden action.

\textsuperscript{57} Supra Fama 1980.

consequence of the delegation of decision-making to agents, who as “utility-maximisers” will tend to pursue diverging interests from the principals. What actually creates costs is the set of activities put in place by principals to minimise divergences and limit agents’ deviant activities.59

From a different perspective, the agency problem is tackled by providing a separation within decision-making processes which would be divided into two phases: decision-management and decision-control. 60 Although this further separation among managers could theoretically provide risk-bearers with a layer of protection against managers’ eventual opportunistic behaviours, it is also likely that this more sophisticated decision-making process would entail an increase in agency costs.61 This model however, has found widespread application, since board of directors tend to include a high percentage of non-executive directors especially within specialised committees where a higher degree of independence is required to guarantee a balance of powers.62 As evidenced by some of the corporate scandals occurred over the last decade, the costs associated with this model can often be unproductive because of conflicts of interest that persist despite the presumed independence of non-executive directors and because of their affiliation with CEOs.63

The level of ownership dispersion in Anglo-American corporations has traditionally posed peculiar challenges to the solution of the ensuing agency issues. Even though a more practical reflection on this is conducted in the next chapters, it is worth pointing out that issues of monitoring and control in widely-held firms have led to the employment of certain legal strategies. These can primarily be identified

59 Supra Jensen and Meckling, 1976 p.4-7. Agency costs are likely to flow from the setting up of incentives, from monitoring activities and from bonding on the part of agents; it is also argued that in most cases where managers are not residual claimants, it is virtually impossible to avoid agency costs.

60 Supra Fama and Jensen, 1983.

61 Ibid.

62 This was highlighted in 2003 with the D. Higgs “Review of the role and effectiveness of non-executive directors”, 2003, ch.6, and former Combined Code, section 1A (now UK Corporate Governance Code 2010).

with the market for corporate control and with the incentive system based on compensation packages. The former represents a means to discipline or replace incumbent management and is premised on an active takeover market that in fact developed in the US and UK during the 1980s;\(^{64}\) the latter stems from the need to align the interest of managers to those of shareholders and to motivate executives to meet predetermined targets.\(^{65}\) Various corporate and financial scandals over the past decade have however seriously questioned these strategies’ suitability to provide consistent control over managerial actions. An appraisal of alternative measures to tackle agency problems has to be necessarily conducted in conjunction with different ownership structures.

**Continental European ownership structure**

While widely-held corporations characterise Anglo-American markets, the same ownership structure does not extend to firms outside the UK and US.\(^{66}\) European and Asian (but also Canadian or Australian) firms have maintained a closely-held ownership structure and are therefore characterised by the presence of a dominating controlling block-holder or a family exerting substantial influence on the board.\(^{67}\) It is observed that despite the converging force exerted by globalised financial markets to adopt a governance system leaning towards the Anglo-American capital-market model, dispersed ownership has not become the prevailing feature of corporate organisation outside the US and UK.\(^{68}\) This has been explained traditionally with a lack of good laws protecting minority shareholders against the extraction of private

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\(^{65}\) See M. Jensen and K. Murphy “Remuneration: Where we’ve been, how we got to here, what are the problems and how to fix them”, *ECGI Finance* Working Paper N. 44/2004.


\(^{67}\) Supra Cheffins 2003 p.2.

benefit of control by dominant shareholders\textsuperscript{69}; and alternatively through other factors pertaining to politico-economic balances that have compromised the dispersion of ownership in continental Europe.\textsuperscript{70}

More interestingly, the different ownership structure prevailing outside Anglo-American confines could be well illustrated by the intrinsically different nature of agency issues (and related agency costs) entailed as a consequence of the ownership model. In widely-held firms, managers tend to have broad discretion and need to be monitored by independent boards, whereas within close ownership the monitoring concern moves towards controlling shareholders.\textsuperscript{71} The variety of underlying agency issues in other words involves a trade-off for minority shareholders, between rent-extraction on the part of managers and private benefits of control from shareholders.\textsuperscript{72} In the context of close ownership, the trade-off results in shareholders’ perception that having a truly independent board would actually be remote, and therefore a different type of protection against managerial rent extraction needs to be found elsewhere.\textsuperscript{73}

It is here envisaged that the process of delegation can be singled out as the defining moment in assessing whether block-holders decide to sell their equity and lose control over corporate affairs. Lack of trust in the delegation (and in the delegated) can in other words be identified as a variable behind this choice.\textsuperscript{74} Trust could represent for shareholders a surrogate of the personal knowledge of the business that eventually wanes in the context of dispersed ownership.


\textsuperscript{70} Supra Roe 2000, p.544. This occurred mainly because corporations lacked the springboard effect of a developed stock market on which they could trade their securities.

\textsuperscript{71} Supra Coffee 2010 p.3.

\textsuperscript{72} On this debate, supra Gilson 2005, p.10,11. In particular it is suggested that closely-held ownership does not necessarily lead to private benefits of control at the expense of minority shareholders; the example of Sweden is emblematic in this sense.

\textsuperscript{73} Supra Coffee 2010 p.4.

\textsuperscript{74} See R. La Porta, F. Lopez de Silanes, A. Shleifer and R.W. Vishny “Trust in Large Organizations”, 87 American Economic Review 1997, p.333-335. It is suggested that a high level of diffused trust should improve economic performances, increase stock market participation, and decrease the percentage of stock market capitalisation that remains closely-held.
The concept of trust leads inevitably towards a cultural and socio-economic reflection underlying corporate development in continental Europe. Corporate scenarios in continental Europe are historically the result of the prevailing and sometimes overwhelming force of family networks within corporations. The firm, and more generally the commercial environment, are permeated by personal and familiar relationships, where the economic power is conceived as a personal achievement, rather than a corporate one.\textsuperscript{75} Cultural and socio-economic factors also provide a clearer understanding of how different dimensions of the agency problem caused the persistence of block-holding. It is suggested that closely-held ownership serves the scope of narrowly screening and motivating managers through an authority that dispersed owners lack for practical reasons. In the absence of other tools, close ownership represents a means to lower agency costs and keep managers loyal.\textsuperscript{76} In this context, a controlling shareholder could be then better placed to monitor corporate activities than the standard combination of market-oriented techniques employed in widely-held corporations.\textsuperscript{77} In light of the mentioned trade-off, a controlling shareholder will definitely represent a reduction in agency costs, as long as minority shareholders are adequately protected against the risk of private benefits that the controlling shareholder may extract.\textsuperscript{78}

From a different perspective, it is also argued that widely-held corporations would face higher agency costs within social democracies, like Germany, Sweden or France. It is observed that in these politico-economic contexts, governments play a central role in the economy and tend to favour employees’ interests over capital owners’, emphasising therefore a managerial agenda that often lowers shareholders’ interests.\textsuperscript{79} This is also reflected by the lack in the above jurisdictions, of legal tools


\textsuperscript{76} Supra Roe 2000 p.545.

\textsuperscript{77} Supra Gilson 2005, p.12. Because of the large equity in the firm, a controlling shareholder is more likely to have the incentives to monitor effectively and to catch problems at an early stage, therefore providing a means to ameliorate the frictions associated with the separation of ownership and control.

\textsuperscript{78} Ibid, p.13.

\textsuperscript{79} Supra Roe 2000, p.547.
like hostile takeovers and stock options\textsuperscript{80}, which have been illustrated as mitigating the agency problem in contexts of dispersed ownership.\textsuperscript{81}

Labour interests on the other hand are strongly represented in the corporate governance structure within the above contexts, either through political influence exerted by powerful trade unions, or via legal mechanisms that guarantee employees representation on the board of directors. This latter situation is best epitomised by the codetermination system adopted in German corporate governance. The idea of codetermination of labour and shareholders was developed in Germany after the First World War initially and then expanded in the 1970s to half of the supervisory board.\textsuperscript{82} From an agency cost perspective, German ownership structure is clearly affected by this institution. The example of a family firm weighing up the possibility of going public is emblematic, because of the concerns this would entail on withdrawing ownership of the firm and its management.\textsuperscript{83} The separation between ownership and management in this context is therefore weaker and agency costs are kept lower; private family firms will likely choose to avoid the costs inflicted to shareholders of an enhanced labour voice inside the firm.\textsuperscript{84}

The assumption traditionally associating concentrated ownership with “bad law” and unsophisticated corporate governance could in light of the above be revised to encompass a more far-reaching approach to the analysis of corporate structure. It

\textsuperscript{80} Ibid p.558. It is observed that incentive compensations are traditionally regarded as socially destabilising in France, since disclosing compensation details to public would create tension with employees. Moreover, governments in social democracies tend to be hostile to stock options because their undesired effect would be to bind too tightly managers to shareholders; it is also observed that in Germany and Sweden, stock option are not even considered ethical, since managers are expected to act in the interest of all firm’s constituencies, rather than solely in shareholders’.

\textsuperscript{81} Ibid. See also A. Przeworski “Socialism and Social democracy”, in The Oxford Companion to Politics of the World, 1993, p.832-835.

\textsuperscript{82} See K. Pistor “Codetermination: A Sociopolitical Model with Governance Externalities” in “Employees and Corporate Governance”, by M.M. Blair and M. Roe, 1999 p.163. Under most continental law systems, the control function within management is delegated to a supervisory board that creates a two-tier board system; within the supervisory board workers representatives would by law hold 50% of seats in all companies with more than 500 employees. The approach to labour representation is slightly different in the UK, where the new Companies Act 2006 refers in section 172 to the interests of employees as one of the constituencies that directors have to consider while performing their duties.

\textsuperscript{83} Supra Roe 2000 p.548-550.

\textsuperscript{84} Ibid p.550.
can be argued that the trade-off mentioned with regards to different agency issues, could rather divert the attention towards the quality of the corporate law of each governance system.\textsuperscript{85} If not all controlling-shareholder regimes lead necessarily to private benefits of control at the expense of minority shareholders (the Parmalat case), the issue at stake is rather a normative one and it points at the quality of law in disciplining controlling shareholders (as controllers of the firm) in each country.\textsuperscript{86} The resulting trade-off may then reflect an efficient ownership structure characterised by close ownership, where because of good laws, the benefit of more direct monitoring exceeds the cost of private benefit extraction.\textsuperscript{87}

\subsection*{2.2.4 – Defining in whose interest the company should be run: Shareholder value vs. Stakeholder theory}

The second theme within corporate governance is premised on the previous assertion that the evolution of corporate ownership led to the necessity to delegate managerial functions to a professional body. While this balance of powers became synonymous of optimal allocation of corporate resources and sound decision-making\textsuperscript{88}, the separation of ownership and control triggered the emergence of the issue of overseeing managerial behaviours.

It is worth stressing that once shareholders appoint the board they cannot influence its day-to-day activity, which becomes the domain of management.\textsuperscript{89} Under UK legal tradition the board of directors represents the body within the firm to

\textsuperscript{85} Supra Gilson 2005, p.9. It is observed that both Sweden and Mexico have a controlling shareholder system in place. However, the latter is characterised by a very high level of private benefit extraction, while the former by a corporate law system that substantially limits rent extractions from controlling shareholders.

\textsuperscript{86} Ibid, p.13. The law in this case would be an alternative technique to independent directors, or takeovers for instance.

\textsuperscript{87} Ibid p.14.


\textsuperscript{89} In UK company law this is reflected in two principles: once powers are delegated via articles of associations, shareholders cannot interfere with directors’ decision-making, for which they would need to either alter the articles or refuse to re-elect directors (Shaw & Sons (Salford)Ltd v. Shaw [1935] 2KB 113 CA), or alternatively they could through special resolution instruct directors with regards to specific actions; s.168 however, provides that shareholders can remove directors before expiration of his office by ordinary resolution.
which power and authority are delegated; consequently, all but the most influential
decisions (for which shareholders’ vote is still necessary) are taken by the board that
is overall responsible for the firm’s strategic planning, the monitoring of executives’
performances as well as the supervision of the company’s divisions and
subsidiaries. The executive function within firms is thus of paramount importance
as it determines the performance of the business and the means through which its
success should be achieved.

This governance structure has traditionally given rise to debates concerning
the extent of managerial powers, the way they should be used, and most importantly
in whose interest. The origin of the debate can be traced back to the 1930s when
American Professors, A.A. Berle and E.M. Dodd, exchanged views on the matter of
whose benefit managerial powers should be exercised for. The former upheld a
“minimalist” approach, postulating that providing managerial powers are held in
trust and are not absolute powers, the beneficiaries of that trust should be the
shareholders as owners of the firm. His view was that the role of law was to protect
shareholders by creating legal safeguards against management’s deviation from the
profit motive. Dodd on the other hand, envisaged what could be defined a
“maximalist” vision, whereby the power held in trust by managers was not to be seen
only for shareholders’ benefit, but for other social groups as well. Although in its
infancy, this debate set the scene for what from the 1970s would become a broader
dispute on the objective of the company and on the means to control managerial
powers. This issue has become increasingly pressing in recent times, with corporate
and financial scandals highlighting deep-seated concerns on the efficiency of the
corporate system. A reflection on the principles and theories underlying the question
of the corporate objective leads to a fundamental dichotomy between two main
strands, whose practical applications are particularly relevant in the context of
directors’ duties: shareholder value and stakeholder theory.

91 See A.A. Berle “For Whom Managers are Trustees: A Note”, (1932) 45 Harvard Law Review 1365.
92 Ibid.
93 See E.M. Dodd “For Whom are Corporate Managers Trustees?”, (1932) 45 Harvard Law Review 1145.
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**Shareholder value**

Shareholder value has traditionally found application across a wide range of Anglo-Saxon economies and to a higher degree in the UK and US. It essentially envisages the company to be run in such a way as to maximise the interest of shareholders ahead of other constituencies within the firm.\(^9\) Stakeholder theory on the other hand has mostly been employed within continental European economies, most prominently Germany, Sweden, France and to an extent Japan, and it focuses on a different corporate objective, since directors are not deemed to manage the company in the prime interest of shareholders, but they are expected to consider a much broader range of stakeholders who have interest in the firm.\(^9\) A critical analysis of these two theories, pointing at respective peculiarities, will shed light on the rationale behind managerial behaviours and on the question of their control.

It is fair to say that until the Enron case unfolded in 2002, together with a number of similar corporate scandals, shareholder value was still regarded as the dominant corporate ideology, leading to the best possible corporate governance system in most Anglo-Saxon countries, where the underlying market-based capitalism had proven to be the only paradigm that could produce sustained economic growth.\(^9\) The supremacy of shareholder value was based on a number of assumptions that only recently have been seriously questioned, even though they remain parameters of how corporations should be governed.

Firstly, the supremacy of shareholder value stems from a “contractarian” view of the firm adopted by corporate finance scholars in the 1970s in the US, whereby the company was identified as a “nexus of contracts” entered into by different parties “inter se”, with shareholders among all constituencies, retaining the role of residual claimants as they would be entitled to what is left over once all other participants receive what they are entitled to by contract.\(^9\) This theory has led to the


\(^9\) Ibid.


rhetoric of ownership advocated by most economic scholars who have postulated that public corporations belong to their shareholders. 98

The second assumption of the theory relates to its interplay with stock markets and to the belief that share prices are a good measure of the actual value of corporations. This theorem has to be understood in light of the expansion and globalisation of capital markets which played a prominent part, especially in the US and UK, for the application of this proposition. 99 The theory postulates that if financial markets are deep and liquid enough, the price of traded securities is the best estimate of the value of the company. 100

Thirdly, it is observed under the theory that executives are better held accountable under a single metric, such as shareholder value, because otherwise they would not be accountable at all. In other words, from an agency perspective, since directors are seen under this theory as agents of shareholders, without this primacy they would more easily lean towards opportunistic behaviours, causing therefore an increase in agency costs. 101 Moreover, from an efficiency perspective, it is argued that directors need to focus on one identified objective – maximising shareholder wealth – rather than attempting to fulfil diverging interests of more constituencies. 102

A fourth assumption looks at the way in which managers and directors should be compensated in order to keep their interests aligned to shareholders’. It is believed that stock options should serve the purpose of creating incentives for

98 M. Friedman “The Social Responsibility of Business is to Increase its Profits”, NY Times Magazine, Sept. 13 1970, p.32-33. The underlying argument was that because of the risk they bear, shareholders have to be identified as owners of the firm, even though legally they are not.

99 M. Aglietta and A. Reberioux “Corporate Governance Adrift. A Critique of Shareholder Value”, The Saint-Gobain Centre for Economic Studies Series 2005, p.3-5. The centrality of capital markets has been epitomised by the fact that the creation and distribution of value added from financial assets became an expectation for shareholders, which in turn pushed executives to pursue short-term gains.


102 Supra Keay 2007, p.581.
executives to maximise share value and therefore pursue strategies that favour their personal interest as well as shareholders’.

Linked to the above, the disciplining effect of financial market is recognised as another assumption of shareholder value. Market discipline is believed to be achieved through an active market for corporate control in the shape of hostile takeovers, which is thought to represent a threat for underperforming boards as well as an ideal allocation of corporate resources to those who are better equipped to manage them.

Criticism towards shareholder value has become particularly intense following the wave of North American corporate scandals at the start of this decade, which has inevitably led to revisiting some of the assumptions upon which the theory is based. The first argument brought forward against the theory relates to the misguided idea that shareholders are owners of the company. It has been mentioned that this assumption stems from an economic perception of the firm, which inevitably overlooks the blatant fact that shareholders are legally not owners of the company, but merely of its shares. Their rights and expectations therefore are by law limited to those flowing from their shares, and this defies the rhetoric of ownership based on the economic redefinition of property rights of one class of participants within the corporation.

Another assumption that needs to be clarified is the identification of shareholders as residual claimants, because unlike other corporate participants (such as employees, managers or creditors) they have no right to a fixed claim, but rely on whatever remains after the firm has paid its fixed claims. As residual claimants and ultimate risk-bearers, the proposition suggests that shareholders should benefit from the firm being run with an eye towards maximising shareholder wealth. It is

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103 Supra Blair 2003, p.60.
106 Supra Blair 2003, p.57.
107 Supra Easterbrook and Fishel 1991, p.36.
observed however that this assertion is also based on an incorrect proposition, since shareholders are actually treated by corporate law as residual claimants only when the firm is insolvent.\footnote{Supra Stout 2002, p.1193. Although the argument here is based on American Bankruptcy Law, it is correct to say that a similar approach is followed by most Corporate Law systems.} Outside this circumstance, shareholders are entitled to receive their payments if the firm has retained enough earnings and then if directors decide to distribute dividends.\footnote{Ibid. This leads to concluding that shareholders are just one of several groups that can be described as residual claimants in the sense that they can enjoy benefits beyond those provided in their explicit contracts.}

What has probably represented the main criticism of the shareholder value foundation is the belief that share prices are a reliable index of the actual value of the firm. If on one hand it is ascertained that deep and liquid stock markets do respond quickly to good or bad news, it is also evident that through periods of boom and bust, share prices have deviated substantially from their actual value. It is suggested that this may depend on a number of factors, first of all on the complexity of information that can be processed only very slowly and imperfectly.\footnote{See L.A. Stout “Stock Prices and Social Wealth”, HLS Discussion Paper No. 301, 2000; and S.L. Schwarcz “Regulating Complexity in Financial Markets”, 87 Washington University Law Review 2, 2009.} It is also argued from a behavioural finance perspective that financial markets overreact, leading to investors’ herding that in turn allows stock prices to go badly out of line with reality before enough investors can react.\footnote{Supra Blair 2003 p.59 and E. Avgouleas “The Global Financial Crisis, Behavioural Finance and Financial Regulation: In Search of a New Orthodoxy”, 23 Journal of Corporate Law Studies, Vol.9, 2009.} General market or industry fluctuations are also regarded as a misrepresentation of the real long-term value of the firm.\footnote{See T. Clarke “Accounting for Enron: Shareholder Value and Stakeholder Interests” (2005) 13(5) Corporate Governance 598.}

All this means that share prices can be subject to manipulations, and misleading information can be released into the market. It can be observed that the ethos of shareholder wealth maximisation has pushed executives to pursue short-term strategies only finalised at inflating firms’ share value; this has happened through the employment of fictitious structured finance transactions or through accounting practices better known as “cooking the books”. Interestingly, in
connection with the Enron scandal, reference has been made to the “dark side of shareholder value”, since the practical application of the theory showed clear systemic malfunctions due to capacious demands by shareholders, often beyond firms’ productivity, coupled with consequential short-termism on the part of executives who felt justified to pursue short-term growth numbers and earning manipulations.\textsuperscript{114}

Another fundamental criticism relates to the role played by stock options, and more generally compensation structures, as corollary of shareholder value. Even though a more practical analysis of this legal mechanism is conducted later in the thesis, the problem with stock options can mainly be recognised with the twisted incentives they create. First of all, there is an element of moral hazard involved with it because option holders win big if the option goes up, but are not penalised if the stock price plunges.\textsuperscript{115} Moreover, although stock options do help to tie executive compensation to share price, they also create perverse incentives to pursue risky strategies. The options in fact are more valuable the more risky is the underlying security, which means that CEOs are encouraged to gamble on risky and short-term strategies.\textsuperscript{116} Additionally, the nature of these compensation packages has led executives to manipulate stock prices so that at the time of exercising their options, they are above strike price (“in the money”). This phenomenon has been reflected by CEOs’ practice of shifting their focus from the fundamentals of their firms’ business to share price. WorldCom and Enron perfectly illustrate how seductive stock options could become, with the latter in particular turning its business into a “trading activity amounting to little more than a massive con game to create the appearance of growing revenues and profits, to try to keep the stock price rising”.\textsuperscript{117}

Further criticism against shareholder value points at the proposition that market mechanisms, mainly in the shape of hostile takeovers, should provide control


\textsuperscript{115} S.L. Gillian “Option-Based Compensation: Panacea or Pandora’s Box?”, \textit{Journal of Applied Corporate Finance} 14, 2001, p.116.

\textsuperscript{116} Supra Blair 2003, p.61. This is the case when options are “out of the money”, meaning that current stock price is below the strike price of the options, as opposed to “in the money”.

\textsuperscript{117} Ibid, p.62.
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to managerial behaviours and thus liability rules and statutory company law mechanisms would become superfluous.\(^{118}\) From a certain perspective, this ideology also found fertile soil in the UK with traditionally low standards of duties of care and skill set by courts\(^{119}\) (in the US too managers are protected by the “business judgement” rule which makes it difficult to find them liable), and in the relative “quiet life” directors could enjoy under the old Companies Act 1985.\(^{120}\)

However, despite apparent gains to target company shareholders in hostile takeovers during the 1980s, it has been later observed that those gains remained either unexplained or were the result of workers layoffs or reductions in wages.\(^ {121}\) Overall, past the 1980s frenzy, the inconsistency of hostile takeovers to provide a threat for executives and to improve corporate performances has become more widely accepted today.\(^ {122}\) It has also been suggested that in many cases hostile bids can have detrimental effects on employees’ interests or on other stakeholders, since the premiums paid to target shareholders enable managers to capture future rents that could otherwise have benefited other constituencies.\(^ {123}\) It further needs to be pointed out that hostile takeovers have the potential to exacerbate short-termism, since executives often embark on “empire-building” strategies whose only aim is to make their firm bigger (with an obvious rise in share price) and therefore insulated from threats of takeovers which would become too costly.\(^ {124}\) It can be said that although takeovers do perform to an extent an “allocative” function of corporate resources,

\(^{118}\) Supra Parkinson 2002, p.132-134. It was suggested that the effect of implementing legal regulation on top of what is already provided by the market would be an inefficient distortion of managerial behaviour.

\(^{119}\) Traditionally case law established a low and subjective requirement of the “ordinary prudent man” that directors had to satisfy. See generally Overend & Gurney v. Gibb (1872) LR 5 HL 480, HL; more specifically Re City Equitable Ltd [1925] Ch 407 on the duty of care and Dorchester Finance Co. Ltd v. Stebbing [1989] BCLC 498 which highlighted the subjectivity of the duty of skill.

\(^{120}\) There was however a shift in the common law approach towards duties of care and skill in the late 1980s, further to the enactment of sec. 214 Insolvency Act 1986 (wrongful trading), since courts started to follow the same rather objective test. See Norman v. Theodore Goddard [1992] BCC 14.

\(^{121}\) Supra Blair 2003, p.63.

\(^{122}\) Supra Parkinson 2002, p.113.

\(^{123}\) Supra Deakin 2005, p.15,16.

and a disciplining one of managerial behaviours, their role should be revisited as a last resort, *ex post* one, whereas internal monitoring should be designed to detect inefficiencies before outsiders do, and before the market reacts by discounting shares.\textsuperscript{125}

**Stakeholder theory**

If shareholder value focuses on firms’ profit maximisation, the stakeholder theory is based on a pluralistic premise whereby the company is viewed as a vehicle encompassing the interests of all the firm’s constituencies affected by its activities.\textsuperscript{126} While economic efficiency and firms’ productivity are still pursued, the theory seeks to foster social cohesion and economic equality among corporate groups.\textsuperscript{127}

The development of stakeholder theory originated in the post-war years from social-democratic ethos, and subsequently from communitarian philosophy that proposed among other things broader accountability, inclusion of different corporate groups, premised on the principle that all constituencies that contribute to corporate success should be recognised. Under this theorem therefore, shareholders are regarded as just one among many stakeholders that should be involved in the firm’s decision-making process.\textsuperscript{128}

Although the stakeholder theory has been traditionally associated with some continental European jurisdictions that have applied its principles, the decade preceding the global financial crisis has seen a clear attenuation of its peculiarities *vis-à-vis* shareholder value. This convergence can be explained by looking at the definite integration of international financial markets in the early 1990s, mainly prompted by developments in the US and UK with regards to financial markets discipline and corporate governance. The conventional wisdom was that shareholder value should be the guiding principle of corporate governance and this spread


\textsuperscript{127} J. Gray “False Dawn”, Granta 2009, p.94.

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beyond Anglo-American boundaries to Europe and Japan. Even at international level, financial institutions have been pushing for the application of shareholder primacy in both developing countries and transition economies, pointing at the success of the US economy in the 1990s in comparison with the decline of German, Japanese and French economies.\textsuperscript{129} The result of this trend was that up until the recent crisis unfolded, several European countries dominated traditionally by a stakeholder value approach to corporate governance, were revisiting these paradigms in order to move towards an Anglo-American market-based model.\textsuperscript{130} It is altogether observable that despite a sharp increase in the capitalisation of their stock markets over the last fifteen years, countries like Germany and France have maintained a more balanced approach to corporate governance and financial development, prioritising issues of social stability over more typical capitalist features of Anglo-American economies.\textsuperscript{131}

The pluralistic character upon which stakeholder value is grounded finds its roots in the view that shareholders are not the only residual risk-bearers; in contrast other constituencies can equally suffer from the company’s business, namely employees, creditors, suppliers, who all stand a significant risk.\textsuperscript{132} The proposition that the interest of these groups is essential to corporate life and success – as much as shareholders’ – entails that a shareholder-primacy system inevitably fails to address these implications. A stakeholder approach on the other hand considers these interests to be central in achieving corporate success and establishes for this purpose systems and structures that allow different stakeholders to be represented in the company’s decision-making process. This can happen in different ways, either through direct participation and board representation, or through consideration at AGM level as well as through non-executive directors safeguard, or eventually by imposing a duty on directors to consider their interest (which is the tentative


\textsuperscript{131} Supra Williams 2000, p.12.

approach of the UK Companies Act 2006). Traditionally, Germany epitomises the typical stakeholder approach to corporate governance with its codetermination system, which grants employees a voice in the management by allowing representatives to sit on the supervisory board. Similarly, Japanese corporate governance employs a relational board structure with representatives of different stakeholder groups included in the decision-making process.

It can be thus argued that one of the pillars of stakeholder value is to have boards that perform the function of balancing the interests of different constituencies, rather than focusing on the prevailing interest of one group.

Even though the stakeholder theory has been object of severe criticism in the 1990s, when it was associated with the general stagnation of continental European economies, the wave of corporate scandals in 2001/03 made the theory increasingly popular and its principles central to corporate law reforms. Corporate governance failures underlying the global financial crisis have prompted more reflections on the merits of stakeholder theory vis-a-vis shareholder value.

The main benefit of stakeholder theory is represented by the facilitation of long-term strategies and goals, which on the other hand seem to have been impeded by the shareholder value theory’s focus on maximising shareholders wealth in the short-term. A key issue here is that the stakeholder theory rejects the reliance on share price as main financial indicator and it considers a broader range of factors that impact on firms’ long-term success. Share prices in fact are likely to reflect factors that are not necessarily related to company’s performances, like general economic or

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134 Ibid.


136 A. Keay “Shareholder Primacy in Corporate Law: Can it Survive? Should it Survive?”, Working Paper, November 2009, p.3, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1498065. It is observed that half of the states in the US enacted constituency statutes that required directors to consider the interest of stakeholders other than shareholders. This was also evident in the UK where the Company Law Review Steering Group was established with a view to addressing the issue of the objective of the company and finding a balance between the interests of all stakeholders in the company. See Keay 2007, p.588.

sector booms\textsuperscript{138}, while the value of stock can drop when a company has chosen to invest in new technology or research, which are bound to be long-term strategies.\textsuperscript{139} Stakeholder value’s main focus, in other words, lies in the development of trust within corporate groups and this is emphasised by search for long-term success and firm’ sustainability.\textsuperscript{140}

These characteristics have made stakeholder value particularly appealing within certain industries, such as high-tech knowledge-based companies, where the main asset is the knowledge and experience of employees, who have come to be regarded as important as shareholders.\textsuperscript{141} More broadly, modern corporations’ success is linked to their degree of social responsibility, as society at large has become more concerned about environmental issues and employees’ conditions. It is argued that issues of social wealth are more likely to be overshadowed by the lust for short-term profits under shareholder value, whereas sustainability and long-term focus paradigms are better equipped to enhance social wealth.\textsuperscript{142} Stakeholder value is generally considered better positioned to address issues of social responsibility and to facilitate relationships of trust among different corporate groups and then between the company and the community around it.\textsuperscript{143} This is also true for issues of environmental responsibility, where a stakeholder value approach can enhance firms’ reputation and therefore profits.\textsuperscript{144}

As already suggested, despite recent appeal, the stakeholder theory has been heavily criticised, especially on the ground of its “efficiency”. One of the pillars of stakeholder value, the balancing function the board should play, is seen as a central

\begin{flushleft}
\textsuperscript{138} Again Enron is emblematic, just like many firms involved in the recent financial crisis, as their shares were highly valued just before their collapse. See Kiarie 2006, p.6.


\textsuperscript{140} Supra Kiarie 2006, p.7.

\textsuperscript{141} Supra Clarke 2005, p.196.

\textsuperscript{142} Supra Keay 2009, p.26. A clear example is that of the closing down of a factory or the redundancy of some employees in order to boost share price and distribute dividends to shareholders.

\textsuperscript{143} D. McLaren “Global stakeholders: Corporate accountability and investor management”, (2004) 12(2) \textit{Corporate Governance} 191 p.192.

\textsuperscript{144} Supra Kiarie 2006, p.6.
\end{flushleft}
flaw in the application of the theory and as a possible source of inefficiency. It is in fact unclear how directors should balance different stakeholders’ interests and use their discerning power in favour of some rather than others. The theory does not provide criteria for balancing conflicting interests, and it does not classify which groups can be regarded as stakeholders, leaving therefore a problem of subjectivity in the identification of these interests. Consequently this affects the enforceability of stakeholders’ rights, since it would be difficult for courts to interfere with board policies, trying to impose objective standards.

Another problem associated with this theory is the lack of standards to evaluate corporate performances, since share value is no longer envisaged as the determining index. Since there are no stakeholder standards upon which directors can be evaluated, they are not accountable to any specific group in the firm, and from a different perspective it is unlikely that any group will perform an efficient monitoring function.

A final criticism towards stakeholder theory stems from the decline in competitiveness that a departure from shareholder value maximisation is thought to entail. This would be particularly evident in the context of takeovers and mergers, where the interest of employees or creditors are more likely to be conflicting with those of shareholders and may therefore induce directors to frustrating the bid.

### 2.3 – Identifying the corporate finance themes

Stock markets have become over the last three decades increasingly important for corporations and financial institutions as they are the platform on which different businesses rely for financing their operations. The process of liberalisation and integration of capital markets that occurred in the 1980s brought about definite

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146 Supra Kiarie 2006, p.9.

147 Supra Salacuse 2004, p.75.

148 Supra Kiarie 2006, p.10; see also City Code on Takeovers and Mergers 2009.

149 See J.A. Frieden “*Global Capitalism, its Fall and Rise in the Twentieth Century*”, New York Norton 2006, ch.16. This process initiated with the liberalisation of capital and the abolition of restraints to participate in other countries’ capital markets; after the collapse of Bretton Woods, exchange rate constraints were removed and governments were free to stimulate their economies, taking full advantage of the revived international financial markets.
changes with regards to facilitated tradability of securities and transfer of underlying risk, all made possible by the creation of new and innovative financial products employed by market participants.\textsuperscript{150} The globalisation of financial markets went along with an increasing process of disintermediation that enabled financial institutions and corporations to directly access capital markets as a quicker and cheaper source of funding, avoiding the traditional intermediation of banks.\textsuperscript{151}

This trend, known as “financialisation” or “financialism”, refers to the influence that finance (more specifically capital markets) has exerted on economic systems as a whole, particularly in the US and UK.\textsuperscript{152} It is worth noting that some changing patterns within the financial industry clearly moved banks away from their traditional function of providing funds for business. Firstly, a change in focus occurred with the substantial deregulation of the financial industry and the passage in the US of the Gramm-Leach-Bliley Act in 1999\textsuperscript{153} that allowed investment and commercial banking activities to merge, becoming therefore too-big-to-fail.\textsuperscript{154} This in turn prompted the resulting institutions to move their business focus towards proprietary trading and speculation through high level of leverage.\textsuperscript{155} Secondly, the development of new and more sophisticated financial products (such as mortgage-backed securities, collateralised debt obligations, credit derivatives) further exacerbated the separation between finance and the real economy. Not only

\textsuperscript{150} Supra Aglietta and Reberioux 2005, p.2,3.

\textsuperscript{151} See S.L. Schwarcz “The Global Financial Crisis and Systemic Risk”, Leverhulme Lecture, Oxford University, 9 November 2010. Disintermediation is defined as the process that enables companies to access the ultimate source of finance, the capital markets, without resorting to banks or other financial intermediaries.

\textsuperscript{152} L.E. Mitchell “Financialism. A (Very) Brief History”, 2010, available at http://ssrn.com/abstract=1655739. Capitalist economies, where institutions of finance should ideally provide funds necessary for the production and trade of goods and services, have been supplanted by a new economic order in which financial markets exist primarily to serve themselves; within this system, capital is raised for the creation, sale, and trade of securities that do not finance the industry, but trade within markets that exist as an economy unto themselves.


\textsuperscript{154} E. Avgouleas “The Global Financial Crisis, Behavioural Finance and Financial Regulation: In Search of a new Orthodoxy”, Journal of Corporate Law Studies, Vol. 9, Part 1, 2009, p25,26. Banks were thus allowed to increase their profitability and speculate on a vast scale thanks to the implicit guarantee offered by central banks.

\textsuperscript{155} Supra Mitchell 2010, p.7.
investment banks, but also commercial banks started to employ exotic financial products in order to move assets and liabilities off-balance sheet.\textsuperscript{156} Financial liberalisation then continued almost uncontrolled when the Commodities Futures Modernization Act left over-the-counter derivative transactions unregulated.\textsuperscript{157}

The process of “financialisation” had a significant impact also on the structure of corporations and on the managerial drive that characterised them. As investors’ appetite shifted from steady dividends to quicker gains from trading activities, leverage became the main source to fund them. This of course prompted managers to seek short-term share price management, rather than long-term profits; the introduction of stock options in the 1990s further aggravated the problem of financial manipulation aimed at achieving higher stock prices.\textsuperscript{158}

The corporate and financial collapses that occurred over the last decade are all, to similar degrees, related to firms’ activities on the capital markets. From Enron and Parmalat, to Northern Rock and Lehman Brothers, the common trigger of the firms’ downfall has been the persistent recurrence of structured finance, and more generally capital market finance.

The above scenario leads to two fundamental enquiries: firstly, the extent to which different financial developments led to a varying exposure to the perils of uncontrolled financial innovation and financial scandals. This enquiry looks at the historical expansion of stock markets within some major economies and traces their development into what has become a dichotomy between capital market finance and bank finance (section 2.3.1). Secondly, of equal importance is to establish the role played by financial regulation – more specifically by the dominating regulatory culture – in prompting the emergence of uncontrolled financial innovation that has in turn led to excessive leverage, reckless risk-taking and bubbles (section 2.3.2).

\textsuperscript{156} Ibid, p.8.


2.3.1 – Analysing different patterns of financial development

The importance of financial development as a research theme is herein analysed with respect to its implications on the financial system as well as on the broader legal-economic environment. Different levels of growth are traditionally measured through stock market capitalisations as a percentage of the national GDP\(^{159}\) and more generally through the resulting depth of the stock market.\(^{160}\) This in turn leads to a distinction between stock market finance and bank finance, which is identified by firms’ approach to corporate finance: on one hand there is a system relying mainly on bank-based, intermediated financial products (like Germany for instance); on the other, a system where capital market-based, disintermediated products prevail (like the US).\(^{161}\) What is of prime importance here is to assess whether a certain scenario, resulting from the emergence of one pattern rather than the other, is more conducive to financial instability and bubbles, and more specifically whether the resulting corporate finance model is more difficult to regulate.\(^{162}\)

Before outlining the theories that explain the emergence of different patterns of financial development, it is worth emphasising that this enquiry finds several parallels with the one carried out earlier, as regards ownership structure. It is in fact suggested that deep and liquid stock exchanges are conducive to dispersed ownership\(^{163}\); since they profit from high-volume trading, they are likely to blossom through the activity of many small stockholders who constantly revise their portfolio and as a result keep trading. On the other hand, controlling shareholders or blockholders have little reason to trade and will therefore deprive the market of the resulting liquidity.\(^{164}\) It has also been observed that within Anglo-American

\(^{159}\) Supra Siebert 2004, p.23. At the time the article was published, it was observed that Germany had a percentage of stock market capitalisation of 40% of its GDP, against 48 of Italy, 106 of France, 128 of the UK, and 140 of the USA.

\(^{160}\) This can also be measured by the number of listed firms and by the overall level of capitalisation.

\(^{161}\) Ibid, p.3,4.

\(^{162}\) This refers to the enquiry conducted in Ch.4.

\(^{163}\) Supra Roe 2000, p.605. An interesting table is provided here, showing the percentage of market capitalisation, together with the degree of ownership dispersion.

jurisdictions the corporate governance system relies substantially on stock markets, both in terms of firms’ strategies and as a means to achieve shareholder protection.\textsuperscript{165}

Stock markets have been defined as the means by which securities could be converted into liquidity, a meeting point for buyers and sellers of stock.\textsuperscript{166} Beyond this, capital markets have traditionally represented for corporations a means to raise funds without the intermediation of banks and at the same time a financial strategy (in case of debt finance) that does not necessarily entail dilution of capital. It is worth emphasising the importance of big-scale stock exchanges, such as New York and London, where a public free market is assured - in principle - by conditions of tight listing requirements, continuous disclosure of information and appraisal of securities’ value through professional agencies.\textsuperscript{167}

It is correct to say that, before the advent of “financialisation” in the world’s main financial markets, capital markets had followed different development patterns around the world, mainly along the same differentiating lines traced in the context of corporate ownership structures. Questioning the roots of this demarcation leads to revisiting some of the theories already illustrated to explain the separation of ownership and control.

Substantial theoretical contribution in this area is provided by the “legal origin” theory that postulated a chain of causation assuming that common law legal traditions facilitate the emergence of vibrant financial markets, because of certain typical features, such as better minority shareholder protection through fiduciary duties, adaptive judges, judicial discretion, and the importance of private contracting.\textsuperscript{168} It has also been argued however, that “legal origin” has over-emphasised common law institutional advantages, taking a biased stand against civil law institutions such as prescriptive regulation, codification, and public

\begin{flushleft}
\textsuperscript{165} See supra Aglietta Reberioux 2005, p.55-58.
\textsuperscript{166} Supra Berle and Means 1932, book 3, ch.1.
\textsuperscript{167} Ibid.
\textsuperscript{168} Supra Roe 2006, p.7-9. See also T. Beck and R. Levine “Legal Institutions and Financial Development”, \textit{NBER Working paper series}, 10417/2004, p.13. English common law asserted its independence from the state (the Crown) as the Parliament, composed mainly by merchants and landowners, sided with courts in affirming the importance of property rights against the Crown. This allowed courts to place the law above the Crown and limit the Crown’s power to alter property rights.
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enforcement.\cite{footnote169} This argument stems from the substantial convergence that occurred following the liberalisation and subsequent globalisation of financial markets, which pushed countries to adopt similar regulatory institutions in areas of corporate governance and financial regulation.\cite{footnote170}

It has also been suggested that changes in political economy have determined institutional differences in certain jurisdictions. This shifts the focus of the enquiry towards history rather than legal origins.\cite{footnote171} The 20th century is testimony of cataclysms that shaped some European economies and hindered the development of their markets. Before 1914 some civil law countries in central Europe had strong securities markets which were subsequently highly affected by devastation and political instability after 1945. It is worth reflecting on the fact that almost all of the civil law countries in Europe were hit by war and military occupation to a higher degree than their common law counterparts, where institutions somewhat remained intact after the war.\cite{footnote172}

The fact that post-war political environments in civil law countries did not favour stock markets, because social policies were rather directed at protecting labour markets and privileging state-allocated capital, draws attention towards politico-economic issues. It is observed that countries that support labour markets tend to disregard financial markets to a certain extent, for reasons that can be found either in the labour interests that influence government’s policies\cite{footnote173}, or in the power of incumbent capital owners who do not want a strong financial market to develop because that would facilitate and strengthen new competitors.\cite{footnote174}

\footnote{\cite{footnote169} Ibid p.10,11. It is argued in this sense that civil law tends to over-regulate, killing securities market before they can develop; this does not facilitate private marketplace transactions that allow securities markets to thrive.}


\footnote{\cite{footnote171} Supra Roe 2006, p.28-30.}

\footnote{\cite{footnote172} Ibid. p.33,34.}

\footnote{\cite{footnote173} Supra Roe 2000 p.546; it is observed that when labour’s influence is strong, concentrated ownership should persist as a countervailing power, and as a consequence equity markets should develop less strongly.}

\footnote{\cite{footnote174} See generally R. Rajan and L. Zingales “Saving Capitalism from the Capitalists”, 182 J. Fin. Econ. (2003).}
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The politico-economic argument finds corroboration in the development of Anglo-American securities markets. Stock exchanges developed in the UK and US before the industrial revolution, mainly as a trading venue for debt securities, and grew exponentially during the industrial age. Political economies in the US and the UK remained rather decentralised and never suffered from the economic planning that occurred in continental Europe, mainly as a consequence of the cooperation between Ministries of Finance and largest banks.175 As far as the US are concerned, during the late 19th and early 20th century, the banking system was very fragmented and did not even have a central bank. As a consequence, in the absence of an interfering state, stock exchanges grew rapidly, facing less resistance and developing through private law-making into robust self-regulatory institutions.176

It can also be observed that different developments of the New York Stock Exchange vis-a-vis its London counterpart could be ascribed to a stiff competition that permeated US securities markets through the 19th century and which led NYSE to enhance its reputational capital through the endorsement of tighter listing requirements than LSE. As a consequence, NYSE took a more activist approach to issues of corporate governance, taking a position of guardian of public shareholders through the enforcement of rules such as the publication of listed companies’ audited financial statements or the protection of shareholders’ voting right through the “one share, one vote” norm.177 On the other hand, prevailing interest of LSE’s shareholders was to profit from the sale of new seats, rather than maximising the value of existing ones; this certainly did not attach to LSE the same prerogative of guardian of public shareholders that NYSE enjoyed.178

Overall the development of Anglo-American securities markets laid its roots in some characteristics established in the 19th century, when private ordering and

175 Supra Coffee 2010 at p.39.

176 Ibid.

177 Ibid p.40. This among other things favoured the emergence of dispersed ownership by creating public confidence.

178 Supra Cheffins 2008, p.340-344. The offshoot of this different business focus could explain why dispersed ownership fully developed in the UK only in the 1970s. Other factors contributed to producing the separation of ownership and control in the UK, namely the rise of institutional investors (mostly pension and insurance funds) between the 1980s and 1990s; an active merger market which provided a liberal use of hostile takeovers; and a tax law regime that induced block-holders to sell their shares and institutional investors to buy them, thanks to tax immunity they enjoyed.
self-regulation started to play a decisive role. The catalyst for the growth of these financial markets stemmed from the pluralistic and to an extent decentralised societies in which political and economic powers were kept separated, allowing self-regulatory institutions to flourish. The opposite scenario characterised Germany and France and the next paragraph will explore the outcome of that different politico-economic orientation.\footnote{Supra Coffee 2010, p.57}

If self-regulatory institutions can be identified as distinctive character of Anglo-American markets, a comparison with the development of some European stock exchanges provides an interesting perspective on a different evolution of financial markets as well as on the function they played for corporations.\footnote{J.C. Coffee Jr “The Rise of Dispersed Ownership: The Roles of Law and State in the Separation of Ownership and Control”, \textit{Yale LJ} 1 (2001) p.4-5.} In the context of this comparative analysis, a prominent role is played by the German system, which is traditionally presented, because of its peculiarities, in stark contrast with the Anglo-American one.\footnote{A. Hackenthal, R.H. Schmidt, M. Tyrell “Banks and German Corporate Governance: On the Way to a Capital Market-Based System?”, \textit{Johann Wolfgang Goethe Universitat}, Working Paper Series No. 146, 2005.}

Capital markets have not traditionally played a prominent role in continental Europe, neither as liquidity providers nor as discipline mechanisms. Banks on the other hand have played a major part in the financial system, performing not only the above functions but also playing a significant role in corporate governance, by owning large blocks of shares, being members of supervisory boards and acting as proxies for voting rights.\footnote{Supra Aglietta and Reberioux 2005, p.56-57.} At the same time, the German financial system is traditionally characterised by banks having operated as “universal banks”, with no distinction between commercial and investment businesses (unlike in the US until the Glass Steagall Act was repealed in 1999), and with financial institutions usually allowed to operate in a broad range of activities.\footnote{Supra Siebert 2004, p.6.}

What this implied from a corporate finance perspective, is a resulting bank-based financial system relying primarily on bank-intermediated products, as opposed
to capital markets ones.\(^\text{184}\) Within this context discipline over corporations is achieved through a tight regulation of governance practices, mainly via two-tier board structures and labour codetermination. This balance of powers can be said to represent a compromise in management between shareholders, creditors and labour, whereby the shareholder value principle typical of Anglo-American jurisdictions does not find application because companies are deemed to be run in accordance with corporate law procedures that oblige all stakeholders to negotiate.\(^\text{185}\) As said in the previous section, this clear stakeholder orientation creates what is referred to as “inside control system”, based on internal information, rather than public one provided by capital markets.\(^\text{186}\) The difference between Anglo-American financial markets and continental European ones is best highlighted by a brief historical overview of how the German and the French stock exchanges respectively developed.

**The German case**

Germany’s securities market reveals a peculiar experience where the state clearly disfavoured the emergence of a stock exchange and enacted a number of measures to hinder its growth. Like in the UK and US, one of the main factors behind the initial development of investment banking within the equity securities market in Germany was the need of capital for the growing railroad industry in the 19\(^{\text{th}}\) century. In this context the goal of raising the necessary finance was achieved through “commandite banks” organised by German financiers who had been refused the issue of charters by the central government. The Prussian government however, perceiving the dangers of these large independent bodies, declared the “commandite banks” unlawful because in contrast with a decree.\(^\text{187}\) However, pressures from the new entrepreneurial middle class forced the government to grant access to corporate charters and by 1870 “commandite banks” obtained free incorporation. Shortly afterwards Deutsche Bank and Dresdner Bank were founded.

\(^\text{184}\) Ibid p.3. This also entails that in the financing of firms loans are more important that market products such as equity or bonds.

\(^\text{185}\) Supra Aglietta and Reberioux 2005 p.56,57.

\(^\text{186}\) Supra Hackenthal, Schmidt, Tyrell 2005, p.3. This is traditionally exemplified by the relatively modest market for corporate control.

\(^\text{187}\) Supra Coffee Jr 2001, p.60.
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The main feature of these German institutions at that time, (especially when compared with their French equivalent the Société Generale) was that the “Grossbanken” were completely private and were formed without the direct backing or support of the central government. Although the new banks were a clear expression of the desire for independence and self-regulation of the new middle class, in a later attempt the German government succeeded in the battle for nationalising all private railroads (which represented the prime demand of finance for the banks). What followed was a tight regulation of securities exchange that froze trading and speculation towards the end of the 19th century.\(^\text{188}\)

From a different perspective this centralised policy of intervention proved to be supportive of business, because it encouraged the development of “Grossbanken” together with the expansion of heavy industry. It is however also evident that this policy worked to the detriment of securities markets’ development, because the government liberalised the central bank’s discount policy to a degree that the “Grossbanken” could finance their clients’ needs mainly through debt, therefore reducing if not dissolving the industry’s need to opt for equity financing. The outcome of this was the virtual unlimited liquidity of German investment banks which unlike their English counterparts\(^\text{189}\) could rediscount their loans to corporate clients with the Central Bank.\(^\text{190}\)

Arguably, had the German government not intervened to encourage liberal lending by its major banks, the German stock market would have most likely reached a level of growth and development similar to that of the British or US market.\(^\text{191}\)

**The French case**

Another clarifying account is that of the Paris Bourse\(^\text{192}\), which unlike its English and American counterparts, was historically a state monopoly, closely run under

\(^{188}\) Ibid p.63.

\(^{189}\) Ibid p.65. The Bank of England was never willing to extend such liberal discounting to its major banks, therefore British commercial banks were aware that they could not finance long-term loans to corporate clients, based on short-term deposits.

\(^{190}\) Ibid.

\(^{191}\) Ibid p.68. Arguably this would have also led to an evolution of corporate ownership along the lines of US firms.

\(^{192}\) Currently the Paris Bourse is known as NYSE Euronext.
government supervision. The execution of all transactions in the Bourse was the exclusive right of stockbrokers appointed by the state, and every securities transaction completed outside the above scheme was considered unlawful by the Bourse. This status of publicly administered monopoly persisted unaltered until the 1980s, when because of competitive pressures the French securities market was forced to undergo a substantial restructuring.\(^{193}\) Even though during the 19\(^{th}\) century the Paris Bourse was potentially rivalling the LSE for the amount of foreign securities traded, the competition was hindered by barring financial intermediaries to deal and take positions in stock, thus denying liquidity.

When a shadow market, called “Coulisse”, arose to fill this space in the market, mainly as a market for unlisted securities, and threatened the Bourse’s monopoly, a piece of legislation was promptly enacted in order to immunise the Bourse from any competition. In the same fashion, the Government chose the dominant investment bank of the time – Sociète Generale de Credit Mobilier – to advance loans and underwrite securities to its clients. That proved to be a success and an engine for French economy, until it came to rival the monopolistic position of the Bank of France. Its failure indeed was the result of a liquidity crisis caused by the Government’s refusal to allow Sociète Generale to issue additional debenture.\(^{194}\)

In overview it can be said that state regulation governed all aspects of the Bourse’s operation. Its centralised character made it inefficiently structured and it also caused lack of liquidity. Most importantly however, the Bourse lacked real owners with the incentives to improve its structure or change its rules, since neither banks nor the government had interest in improving regulation.\(^{195}\) Because of its monopoly status, the Bourse lacked the competition spur that could induce innovation (at least until a global competition arose in the 1980s) and this led to an opposite scenario than the one found in the UK or USA. While the French

\(^{193}\) Supra Roe 2000 p.566 and Coffee 2001 p.49.


\(^{195}\) Ibid. The government used the listing of foreign securities as a political tool, by approving securities whose listing had been rejected by the Bourse.
government had precluded self-regulation, the NYSE had created a legal system with its own rules for the governing of securities’ trading and trade-related disputes.  

The brief overview of how German and French securities markets developed exposes a clear distinction between two different financial systems that has persisted until recently: a bank-dominated structure on one hand, largely premised on bank-intermediated financial products and on heavier regulatory interference of central governments; and a capital market-based systems on the other, grounded on self-regulatory principles and on the disintermediation of firms from banks. If this distinction finds suitable explanations in politico-economic as well as cultural arguments, it provides more importantly a valid background for the analysis of regulatory issues which are dealt with in the next section.

2.3.2 – The role of financial regulation

The definition of general regulatory models has become a fundamental issue in the analysis of financial scandals and is recognised as a theme of this theoretical background. The occurrence of the recent financial crisis raised concerns because of the re-emergence of legal issues that had already caused corporate and financial collapses during the last decade. The urgency to assess the regulatory framework supporting the functioning of the global financial system has therefore become of paramount importance.

In particular, a number of legal features put the events of the last decade in a league of their own (if compared to other financial scandals, such as the dotcom bubble, or further back in time the railway scandal and the South Sea Bubble). These can be identified with financial innovation and the consequential abuse of capital.

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197 The distinction was waning in the years prior 2007, mainly because of the converging forces of globalised capital markets and because of the EU willingness to promote the opening up of Member States’ markets through a common legislative framework. See N. Moloney “Time to Take Stock on the Markets: The Financial Services Action Plan Concludes as the Company Law Action Plan Rolls out”, The International and Comparative Law Quarterly, Vol.53, No.4, 2004, p.999-1012.

market finance, premised in turn on a regulatory edifice shaped by the deregulation of the financial services industry.199

Discussions following the 2008 crisis have consistently pointed at regulatory failures and most importantly at the type of new infrastructure that should be in place.200 This debate led to a deeper reflection on the role and rationale of regulation and on the politico-economic underpinnings that characterise different regulatory systems.201 Traditionally the debate results in a dichotomy, broadly reflected in two main ideological strands corresponding to a “market system” approach on one hand and a “collectivist system” approach on the other.202 The former postulates that individuals should be left free to pursue their own welfare goals; regulation under this paradigm should have no significant role because the legal system can resort to instruments of private law to be implemented. The latter in contrast envisages the state to be better positioned to direct behaviours which, it is argued, would not occur without state intervention, because of intrinsic deficiencies in the market system to consider collective and public interests.203

In “collectivist” systems the function of states as central and superior authorities, which set public goals, behaviours and threaten with sanctions, encompasses traditionally a fundamental role. Regulation within this scheme is instrumental to the implementation of laws stemming from the collectivist ideology. In sharp contrast, under market models, the law has a facilitative function as it provides individuals with a set of arrangements finalised at emphasising their

199 The coincidence of these factors together can be said to result from the development of the regulatory framework in place over the last three decades. See C.R. Morris “The Trillion Dollar Meltdown. Easy Money, High Rollers, and the Great Credit Crash”, New York Public Affairs 2008, p.xiv; Supra Deakin 2005.

200 See for instance M. Arnold “Geithner warns of rift over regulation”, Financial Times, Thursday March 11 2010; or N. Pratley “Can we have a new Glass-Steagall? Yes we can”, guardian.co.uk, Thursday 21 January 2010.

201 It is worth specifying that in this context regulation can be defined as “a sustained and focused control exercised by a public agency over activities that are valued by a community”. See P. Selznick “Focusing Organizational Research on Regulation”, in R. Noll “Regulatory Policy and the Social Sciences”, 1985, p.363.

202 A.I. Ogus “Regulation: Legal Form and Economic Theory”, Hart Publishing London 2004, p.1-3. It has to be specified that these distinctions pertain to a theoretical classification and do not necessarily find application today.

203 Ibid.
welfare activities, whereby obligations are incurred voluntarily by individuals who can enforce their rights autonomously.\textsuperscript{204}

From a different perspective, the scope of regulation can be defined as “social”, as opposed to “economic”. Social regulation finds its rationale in the public interest justification and it purports to protect society at large from market failures.\textsuperscript{205} This form of protection is guaranteed through a range of regulatory instruments which also correspond to different degrees of state intervention. Economic regulation on the other hand tends to have a more limited scope, mainly because its underlying assertion is that markets are more efficient than governments in imposing discipline and providing surveillance, without the costs associated with state intervention.\textsuperscript{206}

The above friction between two substantially diverging regulatory ideologies is most importantly reflected in the context of financial regulation, where the global and inter-connected character of financial markets and the lack of a concerted regulatory regime have magnified the centrality of the issue.\textsuperscript{207} It is fair to say that the last quarter of the century has seen the emergence of “liberal” economists who strongly advocated the benefits of a free-market regulatory system by identifying regulation as the source of financial crises of the 1980s and 1990s. It has been widely argued that regulatory interference into free-market contexts harms due diligence and monitoring incentives among market players, mainly because it creates an expectation that supervisors should provide control for institutions.\textsuperscript{208} These

\textsuperscript{204} Ibid p.3. This dichotomy can also be reflected in the “public interest theory of regulation” as opposed to the “private interest theory of regulation”.

\textsuperscript{205} Market failures are identified firstly with the inadequate information available to individuals from the market, and secondly with “externalities” that affect individuals who are not involved in transactions. Ibid p.4.

\textsuperscript{206} See P.R. Wood “Law and Practice of International Finance”, Sweet and Maxwell London 2008, ch.21; ibid p.5. It is suggested that the main function of economic regulation is to provide a substitute of competition in cases of natural monopolies.


\textsuperscript{208} See C. Goodhard, P. Hartman, D. Llewellyn, L. Rojas-Suarez, S. Waishbrod “Financial Regulation – Why, How and Where Now?”, Routledge Oxford 1998, p.2,3. Among the arguments in this sense, it has been said that excessive prescription can bring about redundant rules; that risks in the financial industry are often too complex to be covered by simple rules; that inflexible and impeding rules have the undesired effect of impeding firms from choosing their own least-cost regulatory objectives; that
concerns are not strictly related to the interference of regulation *per se*, but to regulation imposed from outside the market, as opposed to self-regulation. As hinted above, the case for external state regulation would only occur within the above paradigm in the event of market failure, which would justify public intervention as a less costly outcome than market failures.\(^{209}\)

The influence of neo-liberal economic theories has proven far-reaching within the financial services industry, since it corresponded in the late 1970s to the political drive of the US and UK governments to implement corollaries of neo-liberal ideology.\(^{210}\) The common trend across the Atlantic was to enact deregulation policies and privatisations through which the market could turn away from state control and develop its own rules in a self-regulatory fashion.\(^{211}\) What also contributed to creating a strong free-market regulatory environment was the elimination of the Bretton Woods fixed-exchange rate in early 1970s which resulted in the privatisation of foreign exchange risk. This in turn pushed banks to adopt hedging strategies to diversify their assets and to create portfolios held in offshore jurisdictions.\(^{212}\) This trend created pressure on national governments to liberalise controls on cross-border capital flows and therefore deregulate banking practices in order to allow more risk diversification and spread. As an increasing number of states liberalised and deregulated their financial sectors, this exposed them to an altogether increasing systemic risk.\(^{213}\)

\(^{209}\) Ibid p.4. In the context of financial regulation the main reasons for public intervention are identified with the protection of customers against monopolies, with prudential regulation as the protection of less informed market players, and with systemic stability.

\(^{210}\) Supra Morris 2008, p.xiv.


\(^{212}\) Supra Alexander, Dhumale, Eatwell 2006, p.9

\(^{213}\) Ibid. Systemic risk in the financial industry has been identified as 1) the risk that the global banking system may collapse in response to one significant financial failure; 2) the safety and solvency risk that arise from imprudent lending and trading activity; 3) the risk to depositors because of lack of adequate insurance.
On the other hand, against the scenario influenced by neo-liberal theories, a “collectivist” or social approach to financial regulation leads to a different regulatory framework. Social regulation prioritises social welfare and in doing so it rejects assumptions upon which economic regulation is based, notably adequate information, competition, absence of externalities. In other words, the fact that these circumstances are not fulfilled leads, according to the theory, to market failures and this justifies a priori a case for regulatory intervention (which within neo-liberal propositions is eventual/ex-post).\(^{214}\) Within this regulatory context the different set of social goals (opposed to the efficiency/economic ones) flows into what is often referred to as “paternalistic” regulation, premised on the assumption that information is insufficient and beyond that the decision-making process is affected by “bounded rationality”.\(^{215}\) Such regulatory mechanism is thus based on the prescription of uniform directions and controls over certain activities which, if left unregulated, would lead to market failure and to harm for society at large.

From a regulatory perspective, the endorsement of a free-market ideology entailed the unrestrained application of market discipline mechanisms. These resulted mainly in: the self-regulatory character of the industry and in particular of certain regulatory agencies and international fora\(^{216}\); the incentive within the industry to innovate in order to adjust the risk profile of both assets and liabilities on the balance sheet\(^{217}\); and the employment of disclosure as main regulatory tool.\(^{218}\) These mechanisms will in turn be examined in this section.

\(^{214}\) Supra Ogus 2004, p.30.

\(^{215}\) Ibid p.51. Paternalism is defined as the interference with a person’s liberty of action, justified by the interest and welfare of the person being coerced. When the justification resides in the impact of the individual’s action on others, this would fall under the concept of externalities.

\(^{216}\) Supra Ogus 2004 p.8; and E. Hupkes “Regulation, Self-regulation or Co-regulation”, 427 Journal of Business Law 2009. Self-regulation is defined as the regulatory process initiated by the private sector (instead of the public one) whose actors define objectives and develop related rules. A clear demarcation is not always easy to draw; for instance in the UK the FSA is a private body (independent non-governmental) even though it was empowered by the FSMA 2000. Similarly, self-regulatory international fora (like IOSCO or Basel) issue recommendations and codes of conducts that have later been enshrined into EU legislation, losing therefore the initial self-regulatory character. In other areas however, the financial industry is more clearly self-regulated, credit rating agencies constitute prime example.

Arguments surrounding these models have inevitably become particularly intense in the aftermath of the recent global crisis. The aforementioned free-market regulatory features have been subject of criticism and in order to correct the failures of the past decade, the priority should be to strike a balance between a free-market approach and a paternalistic one. After the recent crisis burst however, public sector intervention in the sphere of financial regulation seems to be the most popular preference, as it can be gathered from the criticism against free-market mechanisms provided below.

**Self-regulation**

Under the assumptions of market discipline, market forces would be sufficient to direct and correct behaviours, without the need for external regulatory intervention. This proposition has traditionally been reflected in self-regulation, a regulatory technique that implemented the principle of “subsidiarity” which allowed state intervention only if market participants were not able to find adequate solutions within the market itself, and pushed states out of the regulatory scene. Self-regulation can be understood as a system of private governance, where the self-interest of market participants in a capitalist system allows “the invisible hand to work” as they devise mutually acceptable rules and behaviours. From the perspective of market participants, self-regulation represents a cost-effective technique and a prospect of avoiding burdensome government regulation. Also for regulators, relying on self-regulation could be convenient for a number of reasons: first of all, for the flexibility of the legislative process, and for the speed with which self-regulation responds to market developments. Expertise of the industry from which rules underpin is another element that enhances the quality of this regulatory process. More importantly, the strength of self-regulation is the applicability of the

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resulting rules across national borders, because they are defined by contracts and are not restricted by jurisdictional limits.\footnote{Supra Hupkes 2009 p.429.}

The weaknesses of self-regulation are traditionally associated with the danger of ceding too much to market participants’ discretion in a way that could favour their own interests over the public good.\footnote{Ibid p.430. This criticism is coupled with problems like conflicts of interest between self-regulatory bodies and other market participants; with competitive distortions; with insufficient scope of rules for third parties and for public interest.} Above and beyond intrinsic conflicts of interest that can affect the legislative process, self-regulatory systems suffer from the lack of adequate enforcement, because the industry may not be effective at enforcing rules. This derives from the very character of these rules, which are not binding, as they result from negotiation among industry members, who adopt these rules on a voluntary basis.\footnote{Supra Weber 2009, p.658. What this means is that enforcement measures will mostly be contractual and won’t consist in real sanctions like in the case of state laws.}

Self-regulation has historically been a central feature in the financial industry, both in the City of London and in the US, where securities regulation enacted after the 1929 Great Crash set a regulatory framework that relied on and recommended self-regulation.\footnote{Supra Hupkes 2009, p.428.} In the UK, the Financial Services Authority (FSA) established in 2000\footnote{Financial Services and Markets Act 2000.} similarly set a regulatory infrastructure based on both binding rules and principles, complemented through industry guidance.\footnote{Industry guidance is defined as “information created, developed and freely issued by a person or body, other than the FSA, which is intended to provide guidance from the body concerned to the industry about the provisions of the FSA Handbook”. See www.fsa.gov.uk/Pages/handbook/} Many countries adopt self-regulatory arrangements of their stock exchanges, whereby self-regulatory organisations have been established in order to set standards and govern members’ activities, while also providing mechanisms for sanctioning members for violations.\footnote{See S. Gadinis and H.E. Jackson “Markets as Regulators: A Survey”, Southern California Law Review, Vol.80,1239, 2007, p.1244. In most stock exchanges a certain degree of self-regulatory power is maintained, especially as regards trading rules, while the allocation of regulatory responsibilities and the regulatory structure itself vary from different jurisdictions. Three distinct models of regulatory powers are identified and they depend on the degree of government influence on the stock market.} Such regulatory model has been recommended by IOSCO
(International Organisation of Securities Commissions) as long as each country’s self-regulatory body was subject to government oversight. This requirement highlights concerns surrounding the demutualisation\(^{228}\) of most stock exchanges over the past decade and the increasing potential for conflicts of interest between regulatory activities of the exchanges and their commercial operations.\(^{229}\) Even though the weaknesses of the model have been magnified by recent market developments – primarily the demutualisation and consolidation of stock exchanges – which have undermined the securities industry as a whole, there is still a strong favour within the industry for maintaining a self-regulatory system in place.\(^{230}\)

Lastly, it is worth mentioning that the regime upon which credit rating agencies have so far operated lies at the heart of criticism towards self-regulatory mechanisms. This has consisted of self-regulatory arrangements developed in accordance with the IOSCO code of conduct, and have resulted in flawed operational structures characterised by high level of conflicts of interest between CRAs and issuers.\(^{231}\)

**Innovation**

The second feature of the free-market regulatory approach that has been heavily criticised is the ease with which innovation occurred over the last two decades. It has been noted that simple forms of securitised credit and corporate bonds had been operating (especially in the American market) for a long time and had played an important role in developing the mortgage market and more generally consumer

While a “government model” like the German one for instance sees central governments retaining a strong regulatory power of securities markets, the “flexible model” (the UK one) grants more leeway to market participants or government agencies in regulation of activities. A third model, the “cooperation model” (the US one), assigns a broader range of regulatory powers to market participants who exercise these powers under the supervision of government agencies.

\(^{228}\) Ibid p.1258. As a result of demutualisation, exchanges’ orientation shifted from meeting the interest of their members to catering the interest of its shareholders. This made conflicts of interest more apparent, since self-regulation could no longer find its justification in the alignment of interest between member firms and investing public.


\(^{231}\) A critical assessment of CRAs is provided in ch.4.
finance. In the 1990s macro-economic imbalances over-stimulated a process of innovation that increasingly focused on the packaging, trading and distribution of securitised credit instruments.\textsuperscript{232} The immediate consequences of the new trend were a huge growth in the value of the total stock of credit securities, an increasing complexity of some of the products sold, and the explosion of the volume of credit derivatives.\textsuperscript{233}

The way in which securitisation\textsuperscript{234} grew and developed into more complex contractual schemes like Collateralised Debt Obligations and Credit Default Swaps allowed financial institutions to invest on a more highly leveraged basis, on more opaque securities whose underlying value and risk became difficult to assess.\textsuperscript{235} At the same time, the innovation process led to changing risk profiles on banks’ balance sheets, both as regards assets and liabilities; this gave pace to what has become known as “shadow banking system”, resulting in financial institutions holding bad risky assets in off-balance sheet conduits that would later be sold to investors with a triple “A” rating.\textsuperscript{236} As innovation was designed to satisfy high demands for yields, the widespread belief was that “by slicing and dicing, structuring and hedging, using sophisticated mathematical models to manage risk”, value could be created thereby offering investors more attractive combinations of risk and return than those available from the purchase of underlying credit exposure.\textsuperscript{237}

Even though an \textit{a priori} condemnation of financial innovation cannot be made\textsuperscript{238}, a natural question arises as to the rationale behind the recent development


\textsuperscript{234} Securitisation is examined in ch.4.


\textsuperscript{236} Supra Mullineux 2010, p.245.

\textsuperscript{237} Supra Turner 2009, p.3.

\textsuperscript{238} Supra Mullineux 2010, p.246. When not aimed at circumventing regulation, but instead at reducing transaction costs and managing financial risk, financial innovation is good for social and economic welfare, and in that case it should be promoted and facilitated.
Chapter 2 – Providing a theoretical background to financial scandals

of the model of credit intermediation (which is commonly referred to as originate-to-distribute). It is crucial to establish whether the process of securitisation that developed from the 1980s is inherently risky or it can deliver positive benefits with the appropriate regulation.\textsuperscript{239} The pressing issue however is that of regulating product innovation, which has transformed relatively simple securitisation schemes into more obscure transactions involving the repackaging and the bundling of different securities and the creation of synthetic ones\textsuperscript{240}, not backed by any assets.\textsuperscript{241} If on one hand this process contributed to the avalanche of credit available to individuals and businesses, on the other hand the undesired effect was the level of speculation and risk-taking entailed with these contracts, which led to high level of systemic risk.\textsuperscript{242}

The essential question behind the appropriateness of financial innovation thus seems to be, what drives it: pure legal, commercial and economic rationale (as it happened for factoring and floating charge for instance or also for securitisation in the early 1980s), or regulatory arbitrage, speculation and tax avoidance (as it seems to be the case for CDO and CDS).\textsuperscript{243} The answer to this would undoubtedly point at the necessity to control the speed of innovation, and its underlying aims. Regulation in other words should prevent the innovation process that creates systemic risk and at the same time it should channel “financial engineering” into something more socially useful.\textsuperscript{244}

**Disclosure**

The third consequence of the free-market regulatory approach is the employment of disclosure as main regulatory tool in financial markets. Before identifying the pitfalls of this regulatory technique, it is worth remembering that in the context of corporate finance the debate over the benefits of market-based systems has led to identifying

\begin{itemize}
  \item \textsuperscript{239} For a description of how securitisation allowed banks to make loans without having to hold them in their portfolio until they were paid off, see: Blair 2010, p.11.
  \item \textsuperscript{240} “Synthetic” securitisation will be analysed in ch.4.
  \item \textsuperscript{241} Supra Blair 2010, p.11,12. See also Turner 2009, p.4.
  \item \textsuperscript{242} Supra Mullineux 2010, p.249,250.
  \item \textsuperscript{243} See on this ch.4.
  \item \textsuperscript{244} Supra Turner 2009, and Mullineaux 2010.
\end{itemize}
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its alternative in bank-based financial systems (traditionally prevailing in continental Europe). In the context of market-based financial systems (predominant in Anglo-American markets) the idea of market discipline is broadly presented as an essential mechanism that affects behaviours within the industry in order to provide the best allocation of resources, through a system of information-processing that minimises asymmetric information and moral hazard. The workability of this mechanism is premised on the assumption that financial markets gather rational investors who, provided with sufficient information, would make optimal allocation of resources and wealth-maximisation decisions.

The assumption of rationality pushed regulators to concentrate on ensuring an efficient flow of information in order to allow investors to access it easily and make rational choices. This in turn implied that the market would self-regulate, avoiding state intervention to a substantial extent.

Within such context, disclosure has long been regarded as the ideal regulatory tool to achieve adequate information-processing and it has represented the core of securities regulation both in the US and at EU level. Even internationally, Basel II provided in its third pillar extensive disclosure obligations for banks, under the general assumption that informed actors could de facto act as supervisors, corroborating therefore the self-regulatory structure of the industry. This consensus was largely based on certain features for which disclosure has been

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246 Ibid.

247 Supra Avgouleas 2009 (disclosure paradigm), p.3.


249 Extensive disclosure requirements were imposed in the US in the 1930s after the Great Crash, and they were enshrined in the Securities Act 1933 and in the Securities Exchange Act 1934.

250 EC Securities Directives also incorporated the disclosure paradigm, mainly with the EC Prospectus Directive 2003/71.

widely advocated in the past as an effective regulatory technique. Namely because it increases publicly available information; it consequently improves market efficiency; it reduces the costs of information access; it is conducive to competitive markets; it helps market stability; it promotes market discipline; it deters frauds; and it also has the potential for creating a more democratic capitalism.252

The pressing recurring question however, in the aftermath of the global crisis is why so many investors made poor decisions if they had all the needed information to make rational investments.253 Critics of the disclosure paradigm have argued that investors had in most cases sufficient information about the risks involved with their investments, and in the US there has been a general compliance with securities law as regards disclosure of securitised products.254 It has also been suggested that despite disclosure, investors (both retail and institutional) could not adequately access information and assess the level of risk involved, mainly because of the complexity of some products (most securitisation transactions255) and the length of relating disclosure documents (a prospectus is normally hundreds of pages long, both in the US and EU).256 In other words, investors over-relied on bilateral arrangements with underwriters of securities they were purchasing and this led to a decline in their own due diligence.257

Another line of criticism has also pointed out that the underlying assumption of rational investors does not take into account that market players tend to herd,258 and this curtails the possibility of using disclosed information in a rational way. It is

252 Ibid, p.9. Where a more detailed explanation of these features is provided.


255 Ibid, p.8. it is observed that the Efficient Market Hypothesis may not apply to debt capital market finance, and certainly does not apply to private debt markets. Virtually all securitisation transactions entail the issue of debt products and many of them (CDOs) are issued in private placements.

256 Ibid, p.2. It is argued that complexity of securitised products entailed over-reliance on CRAs, as even institutional investors were not equipped to fully understand complex products.


258 Supra Avgouleas 2009. Herding is due to either peer pressure, or reputational concerns, and it means that disclosed information is ignored for the safer “follow the herd” strategy, which is often triggered by irrational exuberance.
Chapter 2 – Providing a theoretical background to financial scandals

suggested that there is an array of behavioural factors that hinder and limit the scope of disclosure, for instance investors’ overconfidence in times of market euphoria, which means that investors will ignore warning signals of disclosed data because of the abundance of easy credit.\textsuperscript{259} In the context of behavioural finance, investors’ bounded rationality needs also to be taken into account as a limitation to the accessibility and usefulness of disclosed information. The high complexity of innovated securitisation products limited the ability of expert investors (bounded rational) to analyse disclosed data and assess the value and risks associated with products.\textsuperscript{260}

The extensive criticism in the last two years relating to the efficiency of disclosure in the context of the financial crisis has led many commentators to move away from the disclosure paradigm around which financial regulation has been centred. Interestingly it has been suggested that disclosure is insufficient with respect to retail investors who clearly lack the sophistication and possibly the willingness to access complex and lengthy documentations.\textsuperscript{261} At the same time however, the mitigated disclosure requirements for certain classes of investors has led sophisticated and qualified investors to suffer the highest losses in the subprime crisis.\textsuperscript{262} Evidence gathered from the last two years seems to point at the endorsement of more paternalistic solutions and mechanisms. Among them, the establishment of a supervisory body aimed at scrutinising \textit{ex ante} risky financial products is currently reflected both in the US and EU with future possible regulatory developments.\textsuperscript{263}

It is fair to say that the way events unfolded during the last decade truly jeopardised the overall paradigm of free-market approach to financial regulation. It is also evident that most large and global financial markets around the world had developed during the 1970s and 1980s along the guiding principles of neo-liberal

\textsuperscript{259} Ibid.

\textsuperscript{260} Supra Avgouleas 2009 (disclosure), p.16.

\textsuperscript{261} Ibid, p.33


\textsuperscript{263} Supra Avgouleas 2009 (disclosure), p.38.
ideology, under the influence of the dominating Anglo-American stock exchanges and of international organisations like the IMF.264

The task of designing a new infrastructure for financial regulation seems therefore to be an extremely controversial one as it involves politico-economic alternatives that reflect the different prioritisation of social goals (this dilemma exists both nationally and internationally). If financial regulation was, as it seems possible, to move towards a more paternalistic orientation, this may entail the adoption of measures which would simply prove to be draconian and obstructive of many financial arrangements.265 The case of public intervention is however a strong one as it emerges from the failure of different market mechanisms outlined in this section.

2.4 – Conclusion
The chapter identified the main theoretical underpinnings of the research and provided a background for the legal analysis of financial scandals. In doing so, themes were defined in the context of each strand of research. It was highlighted that with regards to corporate governance, the first theme is represented by the separation of ownership and control. This has been done firstly by looking at the historical development of corporations and then by enquiring into different patterns of ownership structures across different jurisdictions. The result of the examination revealed two predominant ownership models corresponding to the widely-held Anglo-American one, and to the closely-held continental European.

The second theme within the corporate governance debate addressed the issue of the corporate objective and it analysed the main relevant theories. It was observed that while shareholder value developed over the last three decades as the main guideline to drive corporate management, the crises over the last decade highlighted the pitfalls of the theory and the possible re-emergence of the alternative stakeholder theory. While this contributed to defining the main concerns underlying

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264 See generally Hellwig 2005. It is suggested that against a market-discipline system dominated by stock-market finance, a different model could emerge, which is the bank-based financial system that prevailed in the past in Germany or Japan.

265 See Schwarcz 2008 (protecting financial markets), p.13. It is observed that government’s restriction of certain transactions (for instance CDO) risks to inadvertently ban also beneficial transactions.
questions of accountability and directors’ duties, it also set the scene for further
development of this debate that will be conducted in this research.

The second part of the chapter concentrated on the corporate finance aspects
of the research and again recognised two themes. The first one drew a historical
perspective over different developments of financial markets, and introduced the
main resulting dichotomy between bank-based financial systems, and stock market-
based financial systems. The importance of this debate lies in the ensuing regulatory
concerns flowing from each of the above models. While this chapter developed a
theoretical approach to this problem, its practical relevance is reflected on the legal
analysis of structured finance conducted later in the thesis.

This discussion was complemented by the analysis of a second theme, which
examined the regulatory culture in place over the most influential financial centres,
and provided at the same time a critical assessment of some key features underlying
the regulatory edifice of the financial services industry. To this extent, three aspects
of the regulatory paradigm in place have been identified, namely self-regulation,
financial innovation and disclosure, and a critical assessment of each of them has
been provided.
Chapter 3 – Corporate governance issues: the control of managerial behaviours

3.1 – Introduction

In chapter two, attention was drawn to the identification of the corporate governance issues that underpinned the occurrence of corporate and financial crises over the last decade, and a theoretical background was provided. Following from that preliminary recognition, the aim of this chapter is to provide a legal analysis of corporate governance issues that have persisted over the last ten years and have more prominently characterised the recent global crisis. In particular, the chapter seeks to critically assess how the persistence of shareholder value ideology substantially influenced corporate mechanisms of decision-making and control within Anglo-American corporations. It is observed through this analysis that legal mechanisms – both statute-based and market-based – directed at controlling managerial behaviours, have repeatedly exposed operational flaws over the last ten years. On one hand, the enforceability of statute-based legal strategies (directors’ duties most prominently) has remained problematic and doubts therefore persist as to the extent to which directors can be held accountable. On the other hand, undisputed reliance on market mechanisms, like stock options, has proved rather illusory because this strategy has achieved the undesired objective of increasing boards’ “short-termisms” without effectively aligning their interests with shareholders’.

The chapter ultimately aims to provide a clearer perspective for the examination of case studies conducted later in the thesis and an easier recognition of key corporate law issues therein. The discussion is structured as follows: section 3.2 provides a background for the analysis; section 3.3 discusses the legal structure of delegation in connection with the ensuing issue of fiduciary duties and directors’ duties. Section 3.4 moves on to the second corporate governance issue, which is that of compensation arrangements, focusing in particular on stock options. Section 3.5 concludes the chapter by summing up the main themes analysed and the main critical reflections raised in connection with them.

1 The identified themes were firms’ ownership structure and the definition of the corporate goal.
3.2 – Background

After the recent crisis unfolded in 2008 in its full magnitude, a number of breakdowns in the legal system emerged as determining factors behind the numerous banking failures. Questions started to be raised with regards to the corporate governance system in place, and especially over issues of decision-making and control, where boards’ accountability and responsibility over dubious policies in place became a matter of concern within most financial institutions. Directors and managers, deceived by an illusion of ephemeral success, kept pocketing huge bonuses despite the sheer failure of policies ratified within their institutions, and also in spite of the general collapse of financial markets that brought about a broader economic downturn. Even though the events surrounding the recent global crisis are undoubtedly peculiar for the systemic effect they bear and for the global breadth of financial markets, it is interesting to note that the corporate governance failures herewith highlighted have not come unprecedented. It is correct to say that the wave of corporate scandals occurred between 2001 and 2003 manifested very similar concerns over corporate governance malfunctions.

After the recent crisis however, corporate governance failures have been recognised in a more comprehensive way and at different levels, and have more prominently been embedded in the review prepared by Lord Turner on the global credit crisis. Here a number of areas of concern were indicated as regards corporate governance and in particular attention was drawn to the need to improve risk-management procedures, to raise the general level of skills required from non-executive directors, and to enhance shareholders’ ability to constrain a firm’s risk-

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3 These will be highlighted in ch.5, in the context of the Enron and Parmalat accounts.


taking. The Turner Review was then followed by the Walker Review that made recommendations on five main areas of corporate governance.6

Following from the theoretical background provided in the previous chapter, this discussion analyses two fundamental legal strategies conceived, in different ways, to control managerial behaviour and discretion. Issues of corporate control have traditionally been at the heart of corporate governance debates and the fact that the same malfunctions underscored different scandals over a decade, urges to identify the root of the problem.

Control issues are here identified firstly with the problems arising in connection with fiduciary duties, and secondly with that of managerial compensations. It has been argued that in corporate systems characterised by dispersed ownership the delegation of managerial functions to directors is essential to achieve a sound and efficient operational framework. Under this paradigm however, it becomes paramount to ensure that once powers are delegated to the board, managerial activities are adequately monitored and that the distance between shareholders and directors is reduced through the employment of a number of legal tools.7 Traditionally, an essential mechanism to achieve this discipline resides in the fiduciary duties that bind directors to their function. In this sense, understanding the legal process of delegation and the extent to which the duties tie managers to specific interests and goals is of fundamental importance. It has also been stressed that defining in whose interest the company should be run is a necessary preliminary question to further understand the scope of directors’ duties within a legal system.

Beyond the statutory definition of fiduciary duties, of equal importance in the attempt of binding managerial actions to specific goals is traditionally the employment of compensation arrangement, mostly in the shape of year-end bonuses and stock options. These have again found widespread application in jurisdictions characterised by widely-held ownership, where the aim was to align managerial interests to shareholders’. This strategy has however fallen short of its aim as several flaws in its application have emerged even before the banking industry collapsed,

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6 Sir D. Walker “A review of corporate governance in UK banks and other financial industry entities”, 16 July 2009; recommendations were made specifically in the areas of: board size, composition and qualification; functioning of the board and evaluation of performances; role of institutional shareholders; governance of risk; remuneration.

manifesting some extreme consequences and an overall inefficiency of this tool to control and discipline managerial behaviours. The close examination of compensation arrangements will shed light on their intrinsic fallacy and on the reasons underlying their failure.

3.3 – Delegation and the issue of fiduciary duties

As broadly recognised within most, if not all jurisdictions, the governance of public corporation is today premised on the delegation of managerial powers to a specialised board. This allows the company’s affairs to be handled by those within the firm who possess the right abilities and skills to perform effective management and continuous decision-making, which on the other hand shareholders do not have. However, if delegation is a prerequisite of corporate efficiency, it also triggers risks generally associated with all agency relationships, whereby agents will tend to act in their own interest at the expense of the principal, reducing as a consequence his expected gains. It is observed that all agents have potentially a propensity for behaviours such as “shirking”, or generally for assuming positions of conflict of interest, whereby principals’ assets may be diverted to the agent’s use through unfair self-dealings. It is also suggested that conflicts of interest within such organisational schemes are thought to be endemic since managerial interests can only be indirectly and imperfectly linked to shareholders’ interests and to the firm’s profit maximisation. This entails that managers will inevitably tend to pursue different goals, aimed at increasing the benefits flowing from their office.

As a consequence, one of the corporate governance objectives has traditionally focused on the establishment of legal tools to control managerial discretion. Once managerial powers are vested in the board of directors, the main

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9 It needs to be pointed out that legally directors and managers are not shareholders’ agents, but they act as company’s agents. See Automatic Self-Cleansing Filter Syndicate Co Ltd v. Cunninghame [1906] 2CH34, CA.
12 Supra Parkinson 2002, p.53.
concern will be to have appropriate legal devices to align the board’s strategy to the corporate goal.\textsuperscript{13} Paramount among these control tools is that based on legal duties, which set standards for shaping management behaviour and which are complemented either by courts, or by external agencies. Fiduciary duties in particular, have traditionally represented the way in which managerial discretion can be channelled towards the interest of shareholders, responding therefore to an extent to the balance of powers resulting from the delegation to the board.\textsuperscript{14}

In order to fully appreciate the legal mechanism underlying fiduciary duties, it is necessary to further define the process whereby delegation of powers between principal/shareholder and agent/director occurs and assess the pitfalls that characterise this legal relationship. The central topic of discussion of modern company law is centred on the role of directors within the corporate structure. Under English law, a clear definition of directorship is absent and it can definitely be stressed that the office of director is a \textit{sui generis} one, since it embodies elements of the agency relationship as well as of trusteeship, whereby directors can have a very entrepreneurial function that goes well beyond the control by their principal.\textsuperscript{15} What characterises the role of directors in this context is the traditional approach to fiduciary liability found in equity that binds them to the company in a trustee-like function, where the underlying obligation requires high standards of honesty.\textsuperscript{16}

\textsuperscript{13} See B. Pettet “\textit{Company Law}”, Pearson Longman 2005, p.53,54. It is argued that these governance mechanisms vary according to firms’ ownership structure, since in contexts of closely-held ownership the issue of aligning managerial interests to shareholders’ will be almost absent, with the latter occupying often the post of directors or a position whereby direct monitoring is straightforward. It can be observed that the emergence of a control issue over boards’ activity is related to a situation of increased dispersion of ownership, where a “management-controlled” model prevails.

\textsuperscript{14} See E.L. Ribstein “The Structure of the Fiduciary Relationship”, \textit{Illinois Law and Economics Working Paper} No. LE03-003, 2003, p.9. It is observed that parties in a fiduciary relationship consent to forego their self-interest.


\textsuperscript{16} See Companies Act 2006, s. 170. The Companies Act 2006 has provided for a statutory statement of directors’ duties which replaced the old Common Law fiduciary duties. These are still present in the new codified version although some significant changes have occurred.
branch of law are observed *pro tanto* for the purpose of particular circumstances.\textsuperscript{17} If this configuration as trustees has historically well suited the role of directors as preservers of the company’s assets, from a different perspective it has failed to tackle difficulties arising out of the more dynamic entrepreneurial function that sees directors as risk-takers who are also expected to multiply shareholders’ investments.\textsuperscript{18} The challenge within this scheme in other words rests in the identification of appropriate limits to directors’ powers, and it resides in finding the right balance between conscious strategies based on incentives to pursue long-term policies on one hand, and entrepreneurial risk-taking on the other. This challenge has proven complicated to unravel within the legal structure of fiduciary duties, not least because of the intrinsically different type of risk that is at stake respectively for directors and shareholders.\textsuperscript{19}

This difficulty can be further illustrated by observing that a fiduciary relationship exists when a person has his interest served by another, but has not agreed the power and duties to be exercised and discharged for his benefit, nor has the general right to say how they have to be exercised for his benefit.\textsuperscript{20} The definition of fiduciary relationship is developed, as said, from the concept of trust and implies that the fiduciary, within the limit of his powers and duties, acts independently from the beneficiary’s (more broadly the principal’s) supervision and control.\textsuperscript{21} Within this independence lies indeed the peculiarity – and possibly the fallacy – of fiduciary office.\textsuperscript{22} This structure entails in fact a rather unbalanced relationship, since the risk-bearer who has ultimate right of share ownership transfers and delegates that right over his resources to an agent. It has already been noted that

\textsuperscript{17} See comment by Bowen LJ in *Imperial Hydropathic Hotel Co., Blackpool v. Hampson* (1882) 23 ChD 1.

\textsuperscript{18} Supra Pettet 2005, p.164.

\textsuperscript{19} Supra Parkinson 2002, p.132.


\textsuperscript{21} See L.S. Sealy “The Director as Trustee”, (1967) *CLJ* 83, p.89; see also *Bristol and West Building Society v. Mowthe* [1998] Ch 1, CA, 18. Unlike a trustee though, whose activity is traditionally fettered by laws directing him on the kind of investments he may make, directors’ discretion has been much broader and the risk-taking therein a matter of subjective judgment.

\textsuperscript{22} Supra Shapiro 1990.
agents are chosen with regards to their higher degree of specialisation and expertise, which principals would either be unwilling or unable to perform. As a result, the position as well as the skills possessed by agents can potentially bring about a monopoly of information that often principals are not in a position to access and verify readily. All in all, the concept of asymmetric information derives directly from the idea of trust, and this lays the foundation of the “agency problem” in general and more specifically of controlling managerial actions.

Flowing from fiduciary relationships, fiduciary duties stand as a mechanism aimed at mitigating directors’ discretionary power that can lead to abuses, without at the same time undermining the parties’ objectives. They are simply designed as a form of compensation for the owner’s inability to directly evaluate and discipline the controller’s performance, and consequently result in the fiduciary being requested to act unselfishly in foregoing personal gains from the relationship. The validity of fiduciary duties however has to be considered in light of the costs associated with them; the cost is justified only when the owner lacks cheaper ways to monitor and control the fiduciary. This would be the case for instance in the relationship between management and dispersed ownership in a public company, where shareholders’ cost of accessing information related to the day-to-day business would be too high, leaving therefore the ex-post judicial assessment of eventual conflicts of interest related to fiduciary duties as a viable control strategy.

The last consideration reiterates the proposition made in the previous chapter that different ownership structures and different degrees of separation between ownership and control imply firstly, a varying exposure to the agency problem, and secondly, different control strategies in place. It can thus be said that contexts of widely-held ownership and increased separation between management and

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23 It is suggested that an agency relationship and a fiduciary relationship both involve forms of entrustment. The difference between them would be that the former category is broader and the latter represents with its underlying duties, a monitoring device designed to limit agents’ misconducts. See L.E. Ribstein “Fancing Fiduciary Duties”, Illinois Program in Law, Behavior and Social Science, Working Paper No. LBSS11-01, 2011, p.4.

24 Supra Shapiro 1990, p.348.


26 Ibid, p.10.
shareholding accentuate the agency problem, and the consequential need to resort to fiduciary schemes in order to alleviate management’s discretional power.27

3.3.1 – The problem of directors’ duties and the enlightened shareholder value

As said in the introduction, various corporate and financial failures over the last ten years led to revisiting some corporate governance ethos that influenced, particularly in the UK and US, the balance of powers in major corporations. Scandals like Enron, WorldCom and Maxwell Communication had initially exposed among other things a breakdown in the board’s monitoring function; more recently, the failure of several financial institutions during the global crisis more clearly pointed at a failure of directors’ decision-making process.28

The board of directors is responsible for setting corporate strategies, for reviewing and overseeing their implementation and more importantly for assessing risk policies.29 The global financial crisis unveiled the gravity of failures in the area of general managerial practices, where insufficient due diligence, and imprudent business judgment led to catastrophic outcomes. This was evidenced by the fact that, in many cases, boards were not even aware of some strategic decisions, and had not implemented necessary controls to manage risks associated to those strategies.30 Beyond general board breakdowns, flaws in the functions of non-executive directors became more evident as due challenges to executives’ policies remained rare and ineffective, compromising therefore the overall accountability of boards’ operations. This became particularly evident with regards to negotiations of managerial compensations (as will be seen in next section) where specialised non-executive committees failed to understand the implication of certain pay arrangements. More

27 With ownership structures dominated by core shareholders or block-holders the controlling function over the delegated business can more easily be accomplished through a system of direct monitoring, because block-holders are normally well positioned to exert considerable influence over the board, and they often sit on the board. This governance system can be defined “insider control-oriented”, opposed to an “outside control-oriented” model. See B.R. Cheffins “Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies”, Oxford Journal of Legal Studies, Vol. 23, No.1 (2003), p.3,4.


29 Ibid.

30 Supra Kirkpatrick 2009, p.17.
specifically, the Northern Rock debacle revealed malfunctions in the process whereby non-executive members of the board should have ensured that the bank remained liquid and solvent; when needed, executives’ strategies were not challenged or restrained.\textsuperscript{31}

The different scandals occurred over the last decade in the UK and US have highlighted the shortcomings of a governance system dominated by managerial power and short-term strategies, where the traditional preponderance of shareholder value was reflected by the prevailing concern to keep executives stimulated in risk-taking, innovation, and in other creative entrepreneurial activities designed to enhance shareholders wealth maximisation, regardless of detrimental effects for other interests at stake.\textsuperscript{32} This was also due to a governance model that opposed rigorous liability rules, because under shareholder value propositions, market mechanisms (chiefly in the shape of hostile takeovers and year-end bonuses) would be sufficient to impose discipline and secure an acceptable level of managerial efficiency.\textsuperscript{33}

Even though shareholder value remains within Anglo-American jurisdictions the prominent approach to corporate governance, it is altogether evident that there is an increasing popularity around the stakeholder theory, which has been reflected even in the UK and US by legislative changes occurred during the 1990s.\textsuperscript{34} When concerns became more vigorous in the aftermath of the Enron-type scandals, a number of legislative moves were undertaken in both UK and US in order to correct traditional corporate governance axioms. While in the States the Enron-type failure generated alarms mainly with regards to the monitoring system – rather than on the governance system as a whole – which have been reflected by the promulgation of the Sarbanes-Oxley Act 2002, in the UK there has been a wave of government

\textsuperscript{31} Supra Arora 2011, p.6.

\textsuperscript{32} Supra Parkinson 2002, p.113,114.

\textsuperscript{33} Ibid. Market theorists postulated that the effect of implementing legal regulation on top of what is already provided by the market would be an inefficient distortion of managerial behaviour.

initiatives culminated with the work of the CLRSG\textsuperscript{35} that was established with a view to looking into issues of corporate accountability as well as addressing the question of the company’s objective. In the attempt to find a balance between the interests of all stakeholders in the corporation the Review focused on defining the central issue of in whose interest the company should be run, and in doing so it identified two possible approaches: a pluralist stakeholder model, or alternatively what eventually came to be referred to as enlightened shareholder value.\textsuperscript{36}

The latter was advocated as the best possible approach to guarantee and maintain wealth maximisation and competitiveness in the corporate sector, for all parties involved. The Review envisaged that a pluralist approach would have required a steep cultural and operational change within UK Company Law that would have been difficult to realise.\textsuperscript{37} The Review’s concerns about altering the UK’s business culture were reflecting broader politico-economic debates whereby the government’s main priority was to facilitate a “knowledge-driven economy” based on responsible risk-taking.\textsuperscript{38}

The recommendations provided by the CLRSG flowed into what has become the Companies Act 2006, which specifically endorsed a new approach towards directors’ duties as a reflection of the principles embedded in the enlightened shareholder value (ESV).\textsuperscript{39} This has come to be considered a “third way” between traditional stakeholder approach and shareholder value\textsuperscript{40}, whereby together with the best interest of shareholders, directors have to focus on achieving the success of the company by balancing the benefit of shareholders with the long-term consequences

\textsuperscript{35} The Company Law Review Steering Group was formed in 1998 following the implementation of a number of reports, among which the Cadbury Report, the Hampel Report and the Higgs Report.


\textsuperscript{37} Ibid, paragraph 5.1.31.

\textsuperscript{38} DTI \textit{“Our Competitive Future: Building the Knowledge Driven Economy”}, 1998, CM4176.

\textsuperscript{39} See Companies Act 2006, s.171-177.

\textsuperscript{40} A.R. Keay “Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom’s Enlightened Shareholder Value Approach”, 2007, \textit{Sydney Law Review}, Vol. 29:577 p.588-590. It has to be observed that at first the new legislation seems to move away from shareholder value principle, but a closer scrutiny shows that this is not really the case since directors decisions can only be impugned by shareholders.
Chapter 3 – Corporate governance issues: the control of managerial behaviours

of their decisions on other constituencies as well.\textsuperscript{41} Even though this does not constitute an outright move towards a stakeholder approach, it is altogether evident that for the first time directors face a wider range of issues and interests that should affect their decision-making process.\textsuperscript{42}

The central legal question to appraise is the extent to which this apparent shift can be envisaged as a solution to the problem of controlling managerial actions.

3.3.2 – The new Act
Under the reformed Companies Act 2006 (that for the first time codified rules traditionally developed by common law and equity), core duty is provided by s. 172, which, over-riding the old fiduciary principles, is conceived as a general duty to promote the success of the company. Even though the codification of the new duties cannot be chronologically configured as a cause of the corporate governance failures occurred during the global financial crisis\textsuperscript{43}, doubts on the realistic effectiveness of the duties have arisen in unsuspected times\textsuperscript{44}, and more recently criticism has surrounded the general viability of the norm to deal with events of such magnitude.\textsuperscript{45}

A first concern with regards to s.172 relates to its formulation, and the extent to which the provision is going to be effective in imposing a new duty on directors. It is argued that the section appears to be the codification of existing equitable principles of good faith\textsuperscript{46}, and recent post-2006 decisions have confirmed that beyond giving a more readily understanding of the provision’s scope, the duty still provides a subjective test whereby courts have to determine whether the director honestly believed that he was acting in a way most likely to promote the success of

\textsuperscript{41} See s.172 Companies Act 2006.

\textsuperscript{42} Supra Keay 2007, p.592.

\textsuperscript{43} The duties became operational in either October 2007 or October 2008, at a time when the financial life, not only in the UK, was already in turmoil. See Keay 2009, p.3.


\textsuperscript{45} Supra Arora 2011, p.9 and Keay 2009, p.6.

\textsuperscript{46} See for instance Aberdeen Railway Co. v. Blaikie Brothers (1854) 1 Macq 461; \textit{Scottish Co-operative Wholesale Society Ltd v. Meyer} [1959] AC 324, where Lord Denning emphasised that the duty of directors was to do their best to promote the firm’s business and to act in good faith towards this goal.
the company.\textsuperscript{47} While the Act does not give any reference as to how the success of the company should be measured, it has been suggested that this should be determined by the long-term increase in the value of shares and also by the board strategy together with the firm’s members.\textsuperscript{48} It is however counterpointed that long term remains a rather vague concept and it is not clarified the way in which directors should pursue it, whereas increase in share price, which is clearly a short-term signal of firms’ health, is a more visible and significant indicator of a company’s success.\textsuperscript{49} What this entails is that the pressure on management to reap short-term results is likely to remain higher than any long-term goals, mainly because of the persisting influence of stock markets on managerial behaviours.\textsuperscript{50}

Another argument points at the enforceability of the duty which as said encompasses a non-exhaustive list of interests of a broader range of stakeholders. At the same time however, the Act does not define how directors are expected to balance these often conflicting interests within their decision-making process. It is suggested in this respect that the duties’ effectiveness will be limited because constituencies other than shareholders would hardly find any remedy in the event of directors not having regard to their interests. The enforceability of the duties would in other words be impaired for other constituencies mentioned in the section, because only shareholders on behalf of the company have a right to bring proceedings.\textsuperscript{51} Moreover, while the section allows directors to have regard to the interests of other constituencies, such interests need at the same time not to prejudice shareholders wealth, which therefore remains the predominant managerial criteria.\textsuperscript{52}

What directors consider to be, in good faith, in the interest of the company, seems to be still the driving criteria to judge managerial actions, leaving executives

\textsuperscript{47} \textit{Re Southern Counties Fresh Foods Ltd,} [2008] EWHC 2810.

\textsuperscript{48} Supra Arora 2011, p.9.

\textsuperscript{49} Supra Cerioni 2008, p.3.


\textsuperscript{51} Supra Keay 2007, p.608.

\textsuperscript{52} Supra Cerioni 2008, p.3.
with almost unchallenged discretion.\textsuperscript{53} This implies that especially in the context of strategic business decisions\textsuperscript{54}, good faith risks to represent a comfortable defence for directors, unless their assertion of good faith is itself impugned.\textsuperscript{55} Despite this test remaining an essentially subjective one\textsuperscript{56}, concerns have in the past arisen as to its appropriateness in the commercial world.\textsuperscript{57} However, even though a dual level of good faith is envisaged (the subjective state of mind and the more objective genuine activity), a subjective honesty of purpose is all directors need in order to avoid challenges to their discretion.\textsuperscript{58}

The new Act has also provided a codification of the duties of diligence care and skill, based traditionally on common law and equitable concepts of honesty and loyalty.\textsuperscript{59} Designed to combat the shirking of directors and to hold them accountable for their incompetence, these principles had historically contributed to affirm rather low and subjective standards, unlike the more stringent fiduciary duties.\textsuperscript{60} They were enshrined in a number of cases where directors were only considered liable for gross negligence and were not required specific professional qualifications, expertise or to dedicate continuous attention to an activity that was still regarded as amateur.\textsuperscript{62}

\textsuperscript{53} A.R. Keay “Directors’ Duties”, Jordans 2009, p.112. In case of alleged breach, in examining director’s reasoning in the decision-making, it is unlikely that courts will second-guess director’s judgment, save if it was blatantly improper.


\textsuperscript{55} Supra Keay 2010, p.13.

\textsuperscript{56} As clearly stated in Regentcrest plc v. Cohen [2001] 2 BCLC 80.

\textsuperscript{57} Fletcher v. National Mutual Life Nominees Ltd [1990] 3 NZLR 97.


\textsuperscript{59} Companies Act 2006, s.174.

\textsuperscript{60} Prominent cases exposing courts’ low expectations were the Marquis of Bute’s Case [1892] 2 Ch 100, and Re Brazilian Rubber Plantation and Estates Ltd [1911] 1 Ch 425.

\textsuperscript{61} For instance Regal (Hastings) Ltd v. Gulliver [1967] 2 AC 134 (HL).

\textsuperscript{62} Traditionally case law established a low and rather subjective requirement of the “ordinary prudent man” that directors had to satisfy. See generally Overend & Garney v. Gibb (1872) LR 5 HL 480, HL; more specifically Re City Equitable Ltd [1925] Ch 407 on the duty of care and Dorchester Finance Co. Ltd v. Stebbing [1989] BCLC 498 that highlighted the subjectivity of the duty of skill.
Even though the rationale of the duty is that directors are expected to act with reasonable care and skill in taking risks, courts were reluctant to judge on the merit of business decisions and on directors’ competence because this was thought to be shareholders’ burden.\footnote{Supra Keay 2009, p.177.}

The courts’ approach to duties of care and skills started however to become more stringent in the late 1980s, further to the enactment of s. 214 of the Insolvency Act 1986\footnote{(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and (b) the general knowledge, skill and experience that that director has. (b) the general knowledge, skill and experience that that director has.}, that introduced a more objective test with the “wrongful trading” provision.\footnote{Groundbreaking cases in this sense were Norman v. Theodore Goddard [1992] BCC 14, where it was laid down that a director must possess the skill “that may reasonably be expected from a person undertaking those duties”; Re D’Jan of London Ltd [1993] BCC 646, where it was reaffirmed that the duty of care owed by a director at common law is accurately stated in s. 214(4) of the Insolvency Act 1986; or also Commonwealth Bank of Australia v. Friedrich (1991) 9 A.C.L.C 946 at 965, where it was argued that a more objective standard of care was expected because of the complexity of commercial transactions which implied a minimum level of understanding of company’s affairs and the ability to reach informed opinions.} This legal framework is what was recommended for the codification of the new s. 174, whereby a dual objective/subjective standard is applied.\footnote{Law Commission Consultation Paper No 261, 1998, paragraph 5.6.} The test in other words is subjective with regards to the personal characteristics of the director, and objective as regards what could reasonably be expected of a person with the same function, which includes the role of the individual director within a specific company and industry sector.\footnote{Ibid 5.7.} In complying with s. 174 directors have to satisfy both tests and courts are required to consider the functions the director had within the company, which is on paper a narrower analysis than the one proposed by the Law Commission, encompassing the circumstances of the company as well.\footnote{Supra Keay 2009. It is observed that the equivalent Australian provision (Corporations Act 2001, s.180(4)) extends the test to both director’s position in the company and to the company’s circumstances, as confirmed in ASIC v. Rich [2003] NSWSC 85.}

The above duty has become particularly relevant in the context of financial reporting and accounts, where directors have to discharge their duty of care skill and
diligence by disclosing relevant information. This was the main question in the recent Australian case *ASIC v. Healey* where the court had to establish whether directors of public companies are required to apply their own mind in the review of the financial statement proposed in the directors’ report, in order to determine that the information contained is consistent with directors’ knowledge of the company’s affairs. More specifically, the test here was whether directors had omitted something that should have been known to them. In the judgement, emphasis was laid on the need for a purely objective assessment of directors’ conduct, regardless of their status as executive or non-executive, which resulted in the expectation of financial competence and knowledge of the company’s operations. The decision had important implications also with regards to how directors should discharge their responsibilities by putting in place proper safeguards. As the defendants were relying on the professional advice received by auditors, the court emphasised that the auditors’ error was irrelevant to the question of whether the directors had discharged their duties of care. This, it was held, should have occurred through their final approval of the financial statements whereby they were acting as final filter.

The above decision also involved a stricter definition of how directors are to exercise independent judgment (s.173). The key aspect is the degree to which directors can delegate technical issues to external advisors, and while it is accepted that relying on advice is possible (sometimes necessary), the final judgment over the specific issue is held to be directors’ responsibility. This stance attracted corporate governance concerns because of the increased pressure on directors to keep track of

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69 This needs to be seen in connection with s.417 which requires a fair review of the development of the business of the company and its subsidiaries undertakings during the financial year.


72 In applying this principle the court followed the US authority in *Francis v. United Jersey Bank* 432 A(2d) 814 (1981).


74 This was already set out in *Re Barings Plc (No5) [2000]* 1BCLC 523, CA, even though in the context of disqualification.
their company’s business and because of the resulting risk that it would “empty Australia’s boardrooms”.75

Interestingly, the Insolvency Act 1986 also introduced an action for misfeasance (s.212) that could be available against directors and could be applied in case of a breach of duty of care.76 As a matter of fact, a number of recent banking failures have been recognised as possibly amounting to such a breach and prominent examples include the HBOS group as well as Northern Rock. As regards the latter for instance, evidence shows that Northern Rock directors had repeatedly neglected FSA’s warnings about liquidity risks as they considered their system of raising short-term finance sound. When the market worsened in 2007 and Northern Rock did not have adequate protection in terms of sufficient liquidity, the blame was clearly laid on the bank’s management for having failed to respond to changing circumstances in the market.77

The same action for breach of duty of care could arguably be brought also against non-executive directors who failed to discharge their duties to monitor executives’ performances, or also against remuneration committees whose remuneration practices resulted in awarding bonuses not based on performances.78

Despite the changes introduced with the new Companies Act, it seems realistic to say that outside the sphere of insolvency there has been very little (if none at all) room for litigation against directors. Courts in fact are mostly reluctant to second-guess the wisdom of company directors’ decisions and litigation against

75 Supra Lowry 2012, p.259.

76 In D’Jan [1993] B.C.C. 646 the court held that signing a form without reading it amounted to negligence and gave rise to misfeasance.

77 House of Commons Treasury Committee, The run on the Rock, January 2008, p.19. at http://www.parliament.the-stationery-office.com/pa/cm200708/cmselect/cmtreasy/56/56i.pdf. The Committee condemned the “high-risk, reckless business strategy of Northern Rock, with reliance on short-and-medium-term wholesale funding and an absence of sufficient insurance and a failure to arrange standby facility or cover that risk, meant that it was unable to cope with the liquidity pressures placed upon it by the freezing of international capital markets in August 2007. Given that the formulation of that strategy was a fundamental role of the board of Northern Rock, overseen by some directors who had been there since its demutualisation, the failure of that strategy must be attributed to the Board”.

directors of large public institutions remains a costly and remote remedy that is rarely advised to potential claimants.\(^79\)

All in all, the global financial crisis has contributed to defining the narrow scope of application of different statutory measures designed on paper to control managerial actions. At the same time however, the current crisis has even more clearly disillusioned free-market proponents by exposing how market mechanisms cannot be relied on as self-equilibrating factors.\(^80\) This only reinvigorates the ongoing debate as to whether directors and managers should be kept motivated to create wealth through a rather timid approach to effective rules (which underlies the main preoccupation of maintaining an attractive financial and business hub), or on the other hand more tightening and prescriptive rules are required in order to create a proper system of accountability.\(^81\)

Interesting proposal in this sense has been to extend the scope of the “wrongful trading” provision – particularly with regards to the imposition of a financial penalty on directors for debts suffered by the company that has gone into liquidation – beyond the boundaries of companies’ insolvent liquidation. This would allow the application of this important personal pecuniary sanction to the many directors of bailed out banks, who enjoyed government protection despite their institutions’ substantial failure.\(^82\) Aligning in other words nationalisation to liquidation as per s.214 Insolvency Act would provide a valuable leverage to extend directors’ personal liability and limit the “moral hazard” that ensued government intervention.\(^83\)

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\(^83\) Supra Arsalidou 2010, p.297,298.
Interim conclusions

From the brief analysis provided, it appears that major solutions to the problem of controlling managerial actions are not likely to be reached via directors’ duties. This conclusion is based on two further reflections. Firstly, politico-economic policies remain today geared to the assumption that entrepreneurship and risk-taking within the business community have to be facilitated. The enactment of tighter or more “proceduralised” liability rules would of course be detrimental in this sense, while the soft law approach to corporate governance currently in place allows the flexibility that has so far permeated the UK corporate environment. This stance was clear during the reform process and there are no signs after the crisis showing a change of direction. It also needs to be pointed out that the influence of supranational laws in this area is likely to remain limited, if nothing else because of the persistence of different politico-economic agendas that prevent an international consensus to be reached. What however could be envisaged is a tighter interpretation of liability rules endorsed by UK courts post-2008, following the example of other common law approaches (like in ASIC v. Healey for instance).

Secondly, it has been observed that the new provisions do not affect boards’ attitude towards short-termism and excessive risk-taking. Management in fact is still under pressure to pursue short-term values because of shareholders’ focus on quarterly reports and share prices as the main metric of corporate success.\(^84\) Moreover the overwhelming majority of institutional shareholding is today represented by hedge funds that on average hold their stock for less than eight months and have little interest in the company’s long-term success.\(^85\) This entails that boosting short-term profits through short-term strategies, such as investing in risky assets or taking on excessive debt, is likely to remain boards’ priority, unless specific regulatory measures are enacted.

The coincidence of corporate governance failures with the breakdown of shareholder value mechanisms has led over the last ten years to major theoretical debates. While the merits of alternative paradigms (mainly stakeholderism) have been considered by regulators in the context of law reforms, this has not led to the

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\(^{84}\) Supra Walker Review 2009, para.1.13.

enactment of substantive provisions in that direction. Despite the criticism in other words, shareholder value remains in the UK the predominant model for corporate management and this essentially entails reliance on market mechanisms for controlling and disciplining managerial behaviours.

In the aftermath of the global crisis this is by many perceived as inadequate. If the tenets of shareholder value are not challenged to their roots, regardless of the immediate availability of an alternative paradigm, more corporate scandals and crises may follow in the near future. This is the lesson learned after Enron and WorldCom, whose governance failures were replicated after less than ten years by the recent banking collapses.

The ESC paradigm put forward in chapter seven is conceived as a response to the above regulatory problem. The theory will propose specific measures with regards to corporate decision-making and control. These are based firstly on the recognition of a problem of competence\textsuperscript{86} in the decision-making process, and secondly on the need to represent broader societal groups in this phase.

3.4 – Compensation structures as alignment of interests

If directors’ duties epitomise the typical statutory measure designed to control managerial behaviours, compensation structures in general represent the most prominent market mechanism envisaged to reduce the gap between shareholders and managers and more broadly to solve the agency issue within widely-held corporations. Conventional wisdom among free-market scholars has been for the last twenty years that in order to spur managerial “effort”\textsuperscript{87}, executives should be tied to equity-based compensations, rather than to fixed ones. The latter would, according to the proposition, make managers excessively conservative, discouraging as a result their risk-taking entrepreneurial activity. Compensation arrangements based on bonuses or more prominently on stock options guarantee on the other hand a strong

\textsuperscript{86} The problem of competence could be exemplified by reference to the new Companies Act provision in s.417(3) whereby companies must include in the business review a description of the risks and uncertainties that the company is likely to face. Precedents from the financial crisis however trigger the question as to whether boards possess the understanding of the transactions they enter into and their long-term implications.

\textsuperscript{87} S.M. Sepe “Making Sense of Executive Compensation”, Arizona Legal Studies Discussion Paper No. 10-42, 2010, p.10. Effort is defined as what avoids opportunistic behaviours such as shirking, entrenchment strategies or the extraction of private benefits.
link between firm’s performance and managers’ remuneration, thereby aligning their interests to those of shareholders, which is effectively the chief proposition of shareholder value theory. 88 This theoretical stance stems directly from the “contractarian” view of the firm, premised on the tenets of shareholders’ centrality, private ordering, and liquid stock markets. 89 Reliance on stock markets (share value) in particular has created the assumption that compliance with their dictates underlies legitimate decision-making and accountable managerial processes. 90

Even though the global financial crisis has most definitely highlighted the excesses and the destructive effects of some compensation arrangements 91, doubts on the application of such incentive system started to arise at the dawn of its inception in the 1980s. It was then observed that in contexts of high concentration of managerial control, executives could effectively self-arrange compensation schemes and achieve predetermined results, exacerbating therefore, rather than solving the agency problem. 92 The wave of American scandals in the early 2000s and the more recent collapse of several financial institutions contributed to expose a substantial lack of effective control mechanisms in place over boards’ policies; this eventually played a central part in allowing an excessive level of risk-taking in the financial industry to be reached. 93


90 Ibid, p.45.


92 See E.S. Herman “Corporate Control, Corporate Power”, CUP, 1981 p.96. Confirmation of this scepticism was expressed at the end of the 1980s by the findings of Jensen and Murphy, who revealed that bonuses amounting to fifty per cent of executives’ salaries were awarded in ways which were not highly sensitive to performance. See also M.C. Jensen and K.J. Murphy “Performance Pay and Top-Management Incentives”, (1990) 98 Journal of Political Economy 225.

93 European Commission Green Paper “Corporate governance in financial institutions and remuneration policies”, Brussels, 2.6.2010, COM (2010) 284 final, p.2. This has been further highlighted by the Larosiere Report that emphasised the inadequacy of boards of directors and supervisory authorities in understanding the nature and the level of risk they were facing.
This problem can be better understood within the corporate governance analysis conducted in chapter two, where it was suggested that the dynamics of incentive systems are highly linked to the position of shareholders in most large widely-held corporations and to their interests which are pre-eminently governed by capital markets fluctuations.\textsuperscript{94} The increasing influence of financial markets over corporations (and over economies as a whole) and the varieties of sources of financial injections have brought about a departure from traditional shareholder-centred paradigms. The resulting trend has seen shareholders having little or no concern over the long-term objective of the firm they invested in, whereas main preoccupation has become the profit that can be reaped in the short-term, sometimes quarterly or even half-quarterly.\textsuperscript{95}

Shareholders’ interest and the general propositions flowing from shareholder value are thus central in understanding the rationale behind the incentive system in place. The problems associated with excessive remuneration packages have then been amplified by recent events in the banking industry\textsuperscript{96}, where executives took on board an uncontrollable level of risk because of the short-term share value that was being pursued as only performance criterion.\textsuperscript{97} This proved to be extremely dangerous, especially in the context of the financial services industry, where the interest of shareholders in seeing their profits maximised in the short term collides with depositors’ and creditors’ concern in the long-term viability of the firm and therefore with their favour for a rather low-level of risk-taking.\textsuperscript{98} Gearing the incentive system uniquely to the interest of shareholders can prove fatal because while they benefit from the undertaking of high risk in conditions of high leverage (which was the case for most institutions during the global crisis) as they reap the


\textsuperscript{95} See R. Khurana and A. Zelleke “You Can Cap the Pay but the Greed Will Go On”, \textit{The Washington Post}, February 8 2009.

\textsuperscript{96} Supra Peston bbc.co.uk, 12 January 2011.

\textsuperscript{97} Supra European Commission Green Paper 2010, p.8.

entire upside of these projects, their limited liability shields them against eventual downsides of the investments, which are borne mostly by debt-holders. 99

If traditionally the main concern around compensation arrangements was to find the appropriate alchemy to keep managers motivated and aligned to the corporate (effectively shareholders’) goal, a different problem emerged as a result of various scandals and crises over the last ten years: the excess of risk-taking strategies and the ensuing moral hazard. The focal question within executive compensations seems in other words to lie in the need to find the right balance between inducing effort on one hand, and restraining from too much risk on the other. 100 Analysing legal issues in connection with stock option plans can help identifying the central problem at stake.

3.4.1 – The problem of stock options

The dispersed ownership scenario prevailing across Anglo-American jurisdictions is traditionally associated with agency concerns related to the diverging interests of shareholding and management. The ensuing governance problem of keeping executives accountable to stockholders has been dealt with through a number of alignment mechanisms derived from shareholder value theory, most prominently stock options. 101

Even though the rationale behind these arrangements seems rather straightforward, their application has raised concerns from the outset of their boom in the 1990s, because of their long-term implications. On one hand, the strategy was

99 Supra Sepe 2010 p.5. This problem is often referred to as overinvestment and it leads to an increase in the cost of capital, and in turn to an inefficient allocation of debt capital and in general of social resources.

100 Ibid, p.9. See also S. Matchett “How to Know What to Pay the CEO”, The Australian, January 7 2011.

101 The threat of managerial behaviours such as shirking, entrenchment or the extraction of private benefits can be summed up in the words of Wall Street fictional character Gordon Gekko: “…Now, in the days of the free market when our country was a top industrial power, there was accountability to the stockholder. The Carnegies, the Mellons, the men that built this great industrial empire, made sure of it because it was their money at stake. Today, management has no stake in the company! All together, these men sitting up here own less than three percent of the company. And where does Mr. Cromwell put his million-dollar salary? Not in Teldar stock; he owns less than one percent. You own the company. That's right, you, the stockholder. And you are all being royally screwed over by these, these bureaucrats, with their luncheons, their hunting and fishing trips, their corporate jets and golden parachutes…”. “Wall Street”, directed by O. Stone, 1987.
thought to represent the best incentive to drive managerial actions and at the same time address the intrinsic dichotomy between the two corporate functions of providers of capital and providers of control. This for the simple assumption that, anchoring pay to firm’s performance (in terms of share value) would make managers motivated to maximise shareholders’ wealth.\textsuperscript{102} The employment of stock options was however coupled with an over-emphasised interpretation of the shareholder value maximisation ethos, which stressed the importance of managerial practices finalised at increasing productivity and return of free cash-flow for shareholders.\textsuperscript{103} It has been observed that the long-term implications of this theorem have resulted in capacious demands by shareholders, often beyond the firm’s productivity. This resulted in short-term pressures on executives who, through this pay regime, were encouraged to develop new risky strategies which in turn would provide them greater pay-offs. As will be shown, these strategies were aimed at inflating the company’s share value through leveraged speculations, earning manipulations, concealment of information.\textsuperscript{104}

Following spectacular scandals like Enron, and the recent banking ones\textsuperscript{105}, executives’ pay arrangements have increasingly attracted media attention and a closer analysis of their legal structures.\textsuperscript{106} Beyond the social outrage caused by their sensational amounts, the main points of concerns with stock options have been identified firstly with the short-termism they engender, and secondly with the excessive focus on shareholders’ interest to the detriment of other contributors of capital and other stakeholders.\textsuperscript{107}

\textsuperscript{102} Supra Sepe 2010, p.12.


\textsuperscript{104} Ibid. This argument finds corroboration in a number of business practices documented within corporate scandals such as Enron and Parmalat and more recently in the context of the banking failures.


\textsuperscript{106} L.A. Bebchuk “How to Fix Bankers’ Pay”, Harvard John M. Olin Centre for Law, Economics, and Business, Discussion Paper No. 677, 2010, p.2. Under the standard design of pay arrangements, executives have been able to cash out large sums of money based on short-term results. This in turn pushed executives to seek short-term gains, despite resulting in excessive risk and eventual implosion.

\textsuperscript{107} Ibid, p.1.
A close analysis of remuneration packages needs however to be centred on the legal hypothesis that underlie their negotiation. The main conjecture is that pay arrangements are the result of arm’s length contracting between executives and the board, which would as a result lead to an optimal remuneration, balancing risks and effort.\textsuperscript{108} This assumption however has been severely scrutinised and recent events have proven it misleading. This alone would lead to the conclusion that executives’ remuneration does not answer its ultimate scope of serving shareholders’ interest because these are not properly aligned with executives’.\textsuperscript{109} The main argument stems from the observation that most compensation practices are not compatible and understandable under the assumption of an optimal contracting theory\textsuperscript{110}, whereas they are easily explained by looking at managerial influence over the pay-setting process. This in turn distorts managerial incentives, designed as said, to increase firm’s value, and causes costs on shareholders which are even larger than inflated compensations \textit{per se}.\textsuperscript{111}

The first point to be made in order to understand the fallacy of the above hypothesis relates to the agency problem affecting boards’ performances as a whole and more specifically the dynamics within non-executive committees. Directors therein are, among other things, subject to reappointment and although in principle they are nominated by shareholders, in most cases they are proposed by the incumbent management with shareholders just approving them. The main incentive therefore will be for directors to develop and maintain a reputation as “managerial friendly”, whereas stiff negotiation over CEO’s pay arrangements would certainly hinder chances of being re-nominated.\textsuperscript{112} Moreover, it is practically very unlikely that the nomination committee of a company would look favourably at reappointing


\textsuperscript{109} Ibid.


\textsuperscript{111} Ibid. This alone hinders long term growth and productivity.

an individual who has taken a tough stance against the CEO, since this would create frictions in the day-to-day running of the firm.\(^{113}\)

Against this scenario, arguments supporting the view that market forces are sufficient to create constraint on the board and assure optimal contracting outcomes are rather scarce. It is broadly observed that the market for corporate control does not represent a significant threat for managers as it is obstructed by high transaction costs and by defence strategies – at least in the USA.\(^{114}\) The only barrier against managerial power towards compensation schemes can be identified with situations where pay packages are so clearly inflated to attract media attention and be covered by ridicule and scorn. This market reaction, defined as “outrage cost”, is anyway strictly related to the perception that these arrangements have on outsiders, and this actually brings about another facet of managerial power, namely the “camouflage”, which represents the desire to minimise outrage through legal devices that disguise and justify the degree of performance insensitivity of compensation schemes.\(^{115}\)

While referring to performance-based compensations, it is interesting to look back at the move towards equity-based compensation during the early 1990s, which was motivated by a desire to increase the link between management performance and pay. However, executives’ influence resulted in obtaining stock options without giving up corresponding amounts of cash compensation in the first instance. Moreover, several features of option plans consistently made them less linked to performance and therefore less beneficial for shareholders’ long-term interest.\(^{116}\)

Three main recurring features can be briefly signposted to exemplify this fallacy: firstly, the failure of option plans to filter out windfalls. This is probably the most central of all problems since stock option plans have persistently failed to detect price rises that are due to industry and market trends and therefore unrelated to managers’ performance. Secondly, while most stock options are “at the money”, which means that their exercise price is set to the grant date market price, it is

\(^{113}\) Ibid. It is suggested that although listing requirements generally attempt to give independent directors a greater role in directors’ nomination, this does not eliminate executives’ influence in the overall process because of the close relationship that is established between directors and executives.

\(^{114}\) Supra Bebchuk and Fried 2005.

\(^{115}\) Ibid.

\(^{116}\) Supra Bebchuk and Fried 2003.
suggested that under an optimally designed scheme, risk-averse managers would be provided with cost-effective incentives whereby the exercise price should depend on a number of factors more closely related to managerial performance. Thirdly, another critical problem for the optimal contracting hypothesis is represented by managers’ freedom to cash out their options once they are vested. This very common practice has effectively obliterated executives’ incentives, and therefore the scheme’s main aim, and has forced firms to restore incentives by giving new equity to managers. An obvious suggestion would be to preclude managers from cashing out their options for a certain period of time, as this would reduce short-term distortions and probably avoid situations where executives can use their inside information to unwind substantial amount of their stock just before bad news become public and determine a fall in the share price.\(^{117}\)

The above contracting patterns are not consistent with an arm’s length assumption, but are rather the result of strong managerial influence over non-executive directors and therefore over the pay arrangement process. It has been suggested that among other things, this phenomenon has lead to executives’ ability to extract rents to the detriment of other corporate constituencies. The ability to take large amounts of compensation based on short-term results provides in other words executives with an incentive to seek short-term gains, even when they come at the expense of long-term value. This has been particularly true in high-leveraged firms where the employment of stock options intensified incentives to resort to risky strategies because shareholders benefit from taking more risk when the level of outstanding debt is high enough to absorb losses from risky projects.\(^{118}\) Short-term strategies, as said, have become popular among executives because of shareholders’ focus on quarterly returns, and because of the availability of structured transactions that facilitate taking on high levels of leverage and gambling on toxic assets. Stock options essentially represented for executives a means to reap the benefits of these strategies while remaining insulated from their downsides.

The straightforward conclusion is that the mechanism designed to address agency problems in widely-held firms by aligning interests has actually created

\(^{117}\) Ibid. See also K. Murphy “Executive Compensation”, in Handbook of Labor Economics, by O. Ashenfelter and D. Card, North Holland 1999, Volume 3, p.2485.

\(^{118}\) Supra Sepe 2010, p.40.
opposite incentives and has become a very manifestation of the agency problem.\textsuperscript{119} Interestingly, similar conclusions have been reached from a different perspective by some business scholars, who strongly pointed out that executive’ compensations (bonuses in the specific analysis) – beyond their alleged unethical and immoral nature – have created the problem of encouraging people to take excessive risks and even to break the law at times. This is because they are awarded not when the company is doing well, but when it looks as if it is doing well; moreover, they reward short-term performances and people who are just lucky to be in the right place at the right time, with the performance element of the bonus becoming entirely subjective.\textsuperscript{120}

3.4.2 – Recent regulatory reactions

The widely recognised centrality of compensation arrangements among the causes of the global crisis, and more specifically as the drive that pushed executives to pursue short-term gains, has prompted regulators to look for adequate solutions to the problem.\textsuperscript{121} At international level, the Basel committee in 2009 required banking regulators to monitor compensation structures with a view to aligning them with good risk management;\textsuperscript{122} similarly G-20 leaders committed to implementing stronger international compensation standards aimed at ending practices resulting in excessive risk-taking.\textsuperscript{123} Despite a general consensus on the existence of the problem, there seems to be much less agreement on how to solve it.

\textsuperscript{119} Supra Bebchuk and Fried 2003.

\textsuperscript{120} S. Sanghera “Do bankers’ bonuses really work?”, The Times, January 21 2010. An interesting reference in the article is made to the book written by Professor B. Groysberg “Chasing Stars: The Myth of Talent and the Portability of Performance”, Princeton University Press, 2010, ch.3, where the author argues that exceptional performance is far less portable than is believed and bankers who leave one company for another are found to experience an immediate degradation in their performance.

\textsuperscript{121} See L.A. Bebchuk and J.M. Fried “Paying for Long-Term Performance”, Harvard John Olin Centre for Law, Economics and Business, Discussion Paper No. 658, 2010, p.1. It has also been acknowledged that excessive executive pay has been a common problem behind different crises over the last decade; see J.F. Reda “Re-evaluating Executive Pay to Mitigate Risk”, The Corporate Board, January/February 2010.

\textsuperscript{122} See Basel Committee on Banking Supervision, “Enhancement to the Basel II Framework”, 2009, p.84-94.

In the US the Dodd-Frank Act\textsuperscript{124} represented so far the clearest statement to prioritise investors’ protection and it flowed from a number of proposals by both SEC and Treasury.\textsuperscript{125} The corporate governance provisions within the Act influencing executives’ remuneration are enshrined in six sections. S. 951 introduced a “say-on-pay” requirement, similar to the existing UK one, whereby reporting companies must conduct a shareholder advisory vote on specific executive compensation at least every three years, without however the vote being binding on the board.\textsuperscript{126} The mandatory vote has encountered mixed reactions in the US, firstly because of the huge ensuing expenses connected with the review of more than ten-thousand US reporting firms\textsuperscript{127}; secondly, because drawing from the UK experience, empirical evidence shows that despite an increased pay-for-performance sensitivity, executives’ compensation has continued to rise overall and shareholders almost invariably approve the proposed package.\textsuperscript{128}

Of equal importance, s. 952 provides on the independence of the compensation committee, prohibiting stock exchanges from listing issuers that do not comply with requirements related to the independence of committee members. The main issue with this provision pertains to the definition of independence in connection with compensation committee members as each stock exchange is allowed to develop its own definition of independence.\textsuperscript{129} While proponents of this norm argued that the Act should make sure that compensation committees are free of

\begin{footnotesize}

\textsuperscript{125} Among US legislative proposals: Corporate Governance Reform Act 2009, to amend the Securities Exchange Act of 1934 to add requirements for board of directors committees regarding risk management and compensation policies, to require non-binding shareholder votes on executive compensation; Investor Protection Act 2009, to provide the SEC with additional authorities to protect investors from violations of the securities laws; Excessive Pay Shareholder Approval Act 2009, to require a supermajority shareholder vote to approve excessive compensation of any employee of a publicly-traded company.

\textsuperscript{126} Dodd-Frank, s.951.


\textsuperscript{129} For a debate on this see S.M. Bainbridge “A Question re Compensation Committees under Dodd-Frank 952”, September 14 2010, available at www.professorbainbridge.com.
\end{footnotesize}
conflicts of interest, despite the exceptions from the independence requirement provided by the Act, it has also been observed through empirical studies that committee independence is not necessarily correlated with firms’ performance or with improved CEO compensation practices.\textsuperscript{130}

The broad issue of pay disclosure is also dealt with within the Act which requires that each company’s annual proxy statement must contain a clear exposition of the relationship between executive compensation and the issuer’s financial performance, in order to provide investors with an easy way of comparing the two.\textsuperscript{131}

Another central provision has expanded the application of “claw-back” clauses, which were already in use within the Sarbanes-Oxley Act.\textsuperscript{132} Stock exchanges are instructed to require listed companies’ disclosure of company policies for clawing back incentive-based compensations paid to executive officers, in the event of a restatement of the firm’s financials, due to material non-compliance with any federal securities law financial reporting requirement.\textsuperscript{133} The Act moreover requires policies to provide claw-back clauses for excess compensations of executive officers, received during the three-year period prior to the date on which the issuer was obliged to issue the restatement.\textsuperscript{134}

S. 971 of the Act sets the SEC authority to adopt a proxy access rule, and at the same time authorises the SEC to exempt issuers from any proxy access rule, taking into account the disproportionate burden inflicted on small issuers.\textsuperscript{135}

Finally, according to s. 972, the SEC has to require reporting companies to disclose whether the same person holds the position of CEO and Chairman of the


\textsuperscript{131} Dodd-Frank, s.953. This provision has however been dubbed a “logistical nightmare” for the calculation of the ratios, supra Bainbridge 2010.

\textsuperscript{132} S.304, which required CEOs or CFOs to return to the corporation any bonus, incentive, or equity-based compensation received during the previous twelve months from the issue of the original financial statement, in case of an obligation to restate the financial statement due to “misconduct”.

\textsuperscript{133} Dodd-Frank, s.954.

\textsuperscript{134} Ibid. Excess is defined as the difference between what the executive was paid, and what he would have been paid had the financials been correct.

\textsuperscript{135} Dodd-Frank, s.971. It has been argued that the new rule favours activist investors who may use the new access rights to engage in private rent seeking. See Bainbridge 2010, p.11.
board. While the legislation does not endorse or prohibit either solution, it requires disclosure of the information together with the reasons for it. This, mainly because the evidence on the merits of separating the two functions is still mixed, even in the UK where such a split is the norm.\textsuperscript{136}

Despite being still in its infancy, the Act has been criticised for having failed to tackle the real problems underlying executives’ compensation. It has been argued that a central issue is the increased incentive to pursue risky strategies in high-leveraged firms where shareholders benefit from taking more risk than socially desirable because the level of outstanding debt is enough to absorb losses derived from risky projects. In these situations therefore, shareholders are likely to favour equity-based compensations ahead of fixed ones even though the latter would be preferable in the long term.\textsuperscript{137} Moreover, despite the apparent shareholder empowerment aimed within the Act (with the say-on-pay provision for instance) their effective power to displace the board is still limited and this poses a substantial obstacle to the adoption of efficient compensation, especially within the organisational structure of large firms.\textsuperscript{138}

It is also observed that the Act does not depart from a strict shareholder value approach, which inevitably does not take into due consideration the cost of externalities that executive compensation may cause on other stakeholders, particularly on fixed claimants.\textsuperscript{139}

Lastly, but of equal importance, there remains a problem that may not find adequate solution within the Act’s provisions, namely, that of executives using inside information to time their options and restricted stock grants, a practice that has been referred to as “springloading”.\textsuperscript{140} Even when the timing of equity grants is fixed in advance, executives may be able to influence corporate disclosure prior to

\textsuperscript{136} Supra Bainbridge 2010, p.12.

\textsuperscript{137} Supra Sepe 2010, p.40.


\textsuperscript{139} Supra Sepe 2010, p.42. See also Bebchuk 2010, p.12. A stakeholder concern has also been raised with specific regard to banks’ executives, where the necessity to link incentives to a broader range of capital contributors is more evident.

\textsuperscript{140} Supra Bebchuk and Fried 2010, p.22.
the equity award, manipulating the stock price around option grants, in order to boost their profits when the options are exercised.\textsuperscript{141} From a different perspective, executives’ manipulation of stock price can also be a matter of concern because of the freedom they have had to unwind their options. When free to decide when to sell their options, executives could use their inside information to time their sales, before bad news become public and the share value plummets.\textsuperscript{142} Similarly, executives can have an incentive to manipulate information in order to boost the stock price before unwinding their shares.\textsuperscript{143} While the above issues may be prevented by a prompt application of “claw-back” clauses in case of financial restatements, it is also suggested that further steps might be required in the shape of prescribed timings or schedules within which executives could unload their shares.\textsuperscript{144}

In the UK, concerns have arisen after the global financial crisis with regards to similar corporate governance issues. The Walker Review 2009\textsuperscript{145} has specifically addressed the problem of remuneration with a detailed analysis of flaws within the current system and with recommendations for future practice. Proposals in particular were divided into four specific areas, namely enhanced disclosure that might be appropriate for major banks and other institutions with systemic importance; secondly, “high-end” remuneration of executives of major banks and the related unlevel playing field they would create; thirdly, the harmonisation with the forthcoming FSA’s revised code and the G20 agreement; and finally and most controversially, the undue prescriptiveness of the recommended remuneration structure.\textsuperscript{146} Proposals in the UK were grounded on the existing normative structure, which is based on the Companies Act provisions on directors remuneration\textsuperscript{147}, on the

\begin{itemize}
\item \textsuperscript{141} Ibid, p.25. This practice is referred to as “gaming”.
\item \textsuperscript{142} Ibid, p.27. It is observed that during the last decade there have been numerous examples of insiders unloading shares before their firms stock price plunged. See M. Gimein “You Bought They Sold”, \textit{Fortune}, September 2 2002, p.64.
\item \textsuperscript{143} Supra Bebchuk and Fried 2010, p.28.
\item \textsuperscript{144} Ibid p.36. It is suggested that in order to prevent manipulation from executives, a limitation on hedging and derivative transactions on their stock positions could contribute to limiting the above issue.
\item \textsuperscript{145} Supra Walker Review 2009, chapter 7.
\item \textsuperscript{146} Ibid.
\item \textsuperscript{147} See Companies Act 2006, sections 420, 421, 422.
\end{itemize}
Combined Code issued by the Financial Reporting Council\textsuperscript{148}, and on the listing rules in the FSA Handbook. More recently, the FSA issued a Code on remuneration practices consisting chiefly of general requirements for firms to promote effective risk management.\textsuperscript{149}

Among the review’s main proposals, the enhanced role of remuneration committees to encompass firm-wide remuneration policies is central in guaranteeing appropriate oversight on the risk dimension relevant to performance conditions, deferment, and claw-back clauses.\textsuperscript{150} In particular, it is suggested that non-executive directors through remuneration committees should have the responsibility and the power to counterbalance the CEO’s ability to arrange incentive structures for “high-end” employees that could have an impact on the firm’s risk profile.\textsuperscript{151}

Like in the US, disclosure is perceived at the very heart of the proposal, especially with regards to the afore mentioned category of “high-end” employees, in relation to which the remuneration committee should specifically report on performance objectives and risk adjustments reflected on compensation structures as well as on the principles underlying the performance objectives. It is also suggested that disclosure of total remuneration cost for all employees of the above category should be in the form of band of remuneration, with the indication of main elements of salary, bonus, long-term awards and pension contributions.\textsuperscript{152} As regards the entities to which this disclosure is meant to apply, the review specifically refers to listed UK banks and comparable unlisted entities, with a proposal to extend its application to foreign listed UK banks. Debates have also arisen as to whether similar disclosure requirements should apply beyond financial entities, in order to encompass a broader array of firms with systemic importance or also firms whose activities fall in the public interest sphere.\textsuperscript{153}

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\textsuperscript{148} This mainly deals with the remuneration committee and the number of non executive directors in it. See \url{http://www.frc.org.uk/corporate/ukcgcode.cfm}.

\textsuperscript{149} See FSA “\textit{FSA draft code on remuneration practices}”, 18 March 2009.

\textsuperscript{150} Supra Walker Review 2009, 7.7.

\textsuperscript{151} Ibid, 7.9 and 7.10.

\textsuperscript{152} Ibid, 7.11 and 7.15.

\textsuperscript{153} Ibid, 7.16.
Of more importance in the context of the disclosure of executives remuneration is the question of the type of implementation that the resulting obligation is likely to have. If general recommendations issued normally within corporate governance codes are traditionally linked to a “comply-or-explain” basis, soft law mechanisms are not envisaged as optimal solutions here and specific disclosure obligations should definitely not be optional ones. Proposals indeed are for these provisions to fall under the new statutory power available to the Treasury and therefore to be based on hard law regulation.\textsuperscript{154}

Like in the US, primary risk adjustments mechanisms to align awards with long-term performance have been recognised in the deferral of incentive payments and in the use of “claw-back” in case of misstatement or misconduct; this structure is recommended to be incorporated in the FSA Remuneration Code and therefore will be likely to require firms’ conformity to remuneration arrangements on a “comply-or-explain” basis.\textsuperscript{155} Similarly to SEC proposals, “high-end” employees will be expected to maintain “skin in the game” in the shape of shareholding, or through retention of vested stock options which should not be accelerated on cessation of employment.\textsuperscript{156}

Of importance within the broader corporate governance debate is also the review’s recommendation on the role of the remuneration committee within the board of directors. It is suggested that even though resolutions from the remuneration committee are purely advisory (unlike the audit committee report, which is binding) and do not require an immediate response from the company, it would be advisable to introduce a super majority trigger on the remuneration committee report according to which if the non-binding resolution attracts less than seventy-five per cent of total votes cast, the chairman of the committee should stand for re-election in the following year, irrespective of the appointment term.\textsuperscript{157}

The interesting and altogether controversial side of these proposals is related to the question of how much government intrusion should be allowed in the

\textsuperscript{154} Ibid, 7.17.

\textsuperscript{155} Ibid, 7.23 and 7.31.

\textsuperscript{156} Ibid, 7.35.

\textsuperscript{157} Ibid, 7.38, 7.40 and 7.41.
regulation of pay packages and the extent to which self-regulation should be preserved against a tighter regulatory action. It has been debated that proposals to increase regulation and disclosure on corporate boards could harm the free-market system in place, both in the US and in the UK. These concerns have followed a similar development across the Atlantic and the preoccupation of undue prescriptiveness over the structure of remuneration expressed in the UK within The Walker Review has found similar reflections in the US where it was pointed out that regulation could not possibly encompass the broad spectrum of all the US public companies. At the same time however, there is a call for a clear restriction on pay practices that have in recent years incentivised the creation and the sale of complex, exotic and obscure financial products, with little or no underlying value, which effectively destroyed shareholder value. The question then lies on whether a tighter regulatory system on one hand or a principle-based one on the other could be more efficient in allowing companies to grow and thrive and at the same time in restraining pay practices that led to excessive executive pays and short-termism.

Recommendations from the Walker Review, coupled with EU developments, resulted in the FSA Revised Remuneration Code in 2010. This applied to a much wider array of firms than before, including banks and investment firms, and established different tiers of firms for different levels of compliance with the Code, whereby tighter requirements attach to staff with substantial influence on the firm’s risk profile. Through a related statutory reform, the FSA has powers in respect of disclosure of executive pay, and it can enforce measures to prohibit specific types of remunerations or contractual provisions that are not consistent with effective risk management.

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159 Ibid. It is suggested that as far as the USA market is concerned, the answer may lie in the ability of shareholders and companies to join together and provide adequate self-regulatory solutions. On the other hand it is also observed that a similar solution might be more feasible in the UK because of the smaller shareholder base.


161 Supra FSA 2010 10/20, 1.15.

162 Financial Services Act 2010, s.4,6.
Finally and more interestingly, at EU level, the Capital Requirement Directive III (CRD III)\(^\text{163}\) encompasses new measures on bankers’ bonuses that would be, if fully implemented by each member state, among the strictest in the world.\(^\text{164}\) By agreeing that high bonuses gave bankers in the past incentives to take undue risks without certainty of good results, policymakers concurred in capping bonuses at thirty per cent of salaries, rising to as much as twenty per cent in case of high-band salaries. Under this framework, banks would also have to defer forty to sixty percent of bonus payments for at least three years and at least half of the money would have to be paid in shares or other instruments linked to performance. The measures within this new framework could potentially put a stop to bonuses either matching or exceeding salaries and could also attach bonuses to actual performances thanks to “claw-back” provisions.\(^\text{165}\) In addition, the legislation should specifically regulate banks that have received state aid, by empowering national supervisors to determine whether bonuses (or also pension-like bonuses) can be cashed.\(^\text{166}\)

As foreseeable, the full extent of these changes may severely compromise the “bonus culture” in place in the City, where full implementation of the above guidelines\(^\text{167}\) would bring about a reshuffle of compensation practices so far carried out. The threat of managers’ relocation to non-European banks, not affected by the new restrictions, is likely to weigh substantially on UK policy-making.\(^\text{168}\) This leads to a consideration on the need to reach a degree of international convergence in

\(^\text{163}\) Available at: [http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm#crd](http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm#crd).

\(^\text{164}\) See B. Masters, M. Murphy, N. Tait “EU sets new pay practices in stone”, *Financial Times*, 1 July 2010.


\(^\text{166}\) Supra Peston, bbc.co.uk 12 January 2011. It appears that this is not yet in place: [http://www.guardian.co.uk/business/2012/feb/08/rbs-stephen-hester-bonus-row](http://www.guardian.co.uk/business/2012/feb/08/rbs-stephen-hester-bonus-row).


\(^\text{168}\) See BBC News, “Bankers’ bonuses to face dramatic change in Europe”, bbc.co.uk, 12 December 2010.
eventual new statute-based regulations in order to avoid jurisdiction shopping. In the context of international financial markets this problem seems all the more problematic, given the persistence of very divergent interests at stake in different jurisdictions and at the same time because of the truly globalised character of the industry.

**Interim conclusions**

The steep increase in executives’ pay experienced in Anglo-American jurisdictions over the last three decades spurred a mix of legal, business and ethical concerns. While some of them are reflected in recent regulatory initiatives, it is altogether clear that new regulations are still substantially grounded on the undisputed acceptance of shareholder value. This assumption leads to three fundamental questions: firstly, do shareholders under new rules have the legal power to challenge excessive remuneration packages? Secondly, do shareholders have interests in pursuing long-term strategies and therefore in ostracising risk-driven compensations? Thirdly, should shareholders still be regarded as “owners” or residual claimant and thus remain in a privileged corporate governance position? While these three questions set the scene for more controversial debate, a brief reflection provides a critical perspective on recent regulatory changes.

With regards to the first question, the application of “say-on-pay” provisions has raised suspicion as to its effective shareholders’ empowerment, especially in the US where the power to displace the board is still limited. In the UK, the Stewardship Code 2010 and the Corporate Governance Code 2010, both operating on a comply-or-explain basis, have pushed for a wider shareholder participation in corporate governance. The former set out principles aimed at placing monitoring responsibility on shareholders, whereby institutional investors should establish

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171 Ibid, p.24. Among them, risk-based approach to executive pay; sustainability; alignment of interests; re-evaluation of performances; income inequality.

172 Supra Bainbridge 2010, p.13.
guidelines and act collectively. The CG Code also envisaged enhanced shareholder power specifically with regards to pay-setting procedures. These changes lead to a rather tentative answer to the question set out above, largely because they are reflected in soft-law provisions. While shareholders’ legal position may have changed to a degree, this is still not sufficient to trigger definite shifts in their activism.

The second question should be premised on a reflection on contemporary shareholding in Anglo-American markets. It has been observed that highly fragmented ownership and foreign investments are not conducive to enhanced monitoring, and shareholders’ interests in such conditions may not coincide with long-term wealth because of the amount of time they hold shares and the scope of their investments. The increased interaction with capital markets has ultimately made shareholders more reliant on the short-term value mirrored by stock markets. This point partially answers the previous question, as it ponders on whether shareholders, assuming their legal right, may have the economic interest to interfere with the pay-setting process and with ensuing strategies.

The third point brings back to the theoretical conflict between shareholder value and stakeholder theory. The global financial crisis demonstrated the centrality of a broad range of constituencies beyond shareholders who have direct interests in the outcome of corporate decision-making. The new regulations make no reference however to a change in focus with regards to the objective of corporate management, which remains strongly anchored to the interest of shareholders ahead of other constituencies. This entailed that a fundamental reconsideration of remuneration practices has not been undertaken, whereas a timid attempt to regulate and disclose existing ones has been made, mainly under the assumption that shareholders are equipped to restrain excessive pay. While the maximisation of share prices is clearly no longer synonymous of corporate success, it remains today a valid reason for executives to receive outrageous compensations on top of very rich salaries.

176 Supra Keay 2011, p.11.
Beyond the suitability of new regulatory measures to tackle the excesses of recent pay arrangements, the underlying issue is to establish whether stock options represent a viable legal tool to control managerial behaviour. The analysis provided in the chapter points at a negative answer, which is corroborated by the events of the last decade. Following from this assertion, the thesis’ paradigm is oriented towards the recognition of a broader range of societal groups to be taken under consideration in the management of large public firms. This implies an entirely different approach to the problem of alignment of interests and corporate control, whereby internal ex ante mechanisms, thanks to a different board structure and composition, are designed to tackle these problems.

3.5 – Conclusion

The chapter provided the legal analysis of two fundamentally different strategies (statute-based and market-based) designed to control managerial behaviours: directorial duties and stock options. This contributed to assess the effective pressure that they exerted on boards of directors and management. A fair evaluation of the above strategies, in connection with the events considered as case studies, points at the straightforward conclusion that both control mechanisms failed during the various crises. Market measures like stock options and bonuses have proven inadequate to control managerial actions and align executives to the long-term success of the company. This became even more evident during the global crisis, when banks characterised by very high degree of equity-based compensations (prime example were Lehman Brothers and Bear Stearns) collapsed as a consequence of risky and leveraged speculations.\(^\text{177}\) In a less dramatic and spectacular way, statutory mechanisms also fell short to contributing, either ex post or as ex ante procedural means, to influence directorial behaviours and to hold them accountable.\(^\text{178}\)

What can be observed from the analysis is that in both cases the control of managerial behaviours stemmed from a shareholder value approach to corporate governance mechanisms, which permeated each of the two control strategies,

\(^\text{177}\) D. Benson “The EU’s proposed rules on pay are misguided”, Financial Times, 10 October 2010.

\(^\text{178}\) Supra Arsalidou 2010, p.284.
especially in the analysed context of Anglo-American corporations. If nothing else, the picture resulting from the global financial crisis exposed yet again the shortcomings of shareholder value and of its corollaries, mainly because the crisis showed very clearly the centrality of a much broader spectrum of stakeholders’ interests which have been affected after 2008. This brings back to questioning the core values and theories underlying the above governance mechanisms: should the driving criteria of corporate management remain shareholder value?

Statutory measures in the shape of duties are still within the new Companies Act anchored substantially to a predominant shareholder value approach, which as seen, is only veiled as enlightened because stakeholders’ concerns within it remain confined to largely unenforceable duties. Market-based mechanisms like stock options are the offspring of a “contractarian” view of the firm, premised among other things on shareholder exclusivity, and new regulatory initiatives have so far not departed from the axiom of linking managerial performances to criteria other that share value.

The resulting key question is thus how the control of managerial actions in large corporations can be achieved; how decision-making and risk-management processes can be successfully established in order to help preventing future crises. The lack of accountability and the dubious balance of powers within Anglo-American corporations lead to envisaging more fundamental changes in the regulation of corporations. The thesis’ proposed paradigm offers a clear departure from the ethos of shareholder value and suggests for this purpose a division of public firms in two tiers, whereby tier-one firms would attract a greater degree of public scrutiny. This would affect ex ante the decision-making process, solving at the same time two orders of problems: the problem of competence that has affected boards over the past years; and the problem of representing in this delicate phase a broader

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179 If Stock options and bonuses are directly the offspring of a “contractarian” approach to corporate governance, based on shareholder value, directors’ duties can be geared to either shareholders or to other stakeholders, according to the corporate law model adopted in each jurisdiction and to the judiciary’s approach to relevant cases.


181 Supra Moore 2010, p.12.
range of societal interests that are inevitably touched by the life of large public firms.\textsuperscript{182}

\textsuperscript{182} A specific explanation of how this is achieved is provided in ch.7.
Chapter 4 – Corporate finance issues: financial innovation, securitisation and rating agencies

4.1 – Introduction
The identification of corporate finance themes within financial scandals led, in chapter two, to focus on two main enquiries. Firstly, different patterns of financial development were analysed as a first theme underlying the explanation of financial scandals, and a line of demarcation was drawn between capital market finance on one hand and bank finance on the other. This differentiation retains centrality within this chapter because the legal issues discussed herein are concerned with capital market finance transactions and more broadly with the regulatory framework pertaining to stock market operations. The second theme identified in chapter two introduced the discussion on the role played by regulation in the context of crises, and focused on specific regulatory patterns that have been endorsed within the financial services industry over the last three decades. The enquiry pointed more specifically at three regulatory features (self-regulation, financial innovation, and disclosure paradigm), which in the context of the present chapter provide the background for the analysis of the more specific issues. Thus, the aim of this chapter is to investigate the mechanics of two fundamental legal issues that in different ways underscored the excesses of the past decade and flowed into the most spectacular financial crisis since the Great Crash of 1929. The examination focuses on securitisation and credit rating agencies which are intertwined processes of financial markets and represent key stages of many transactions carried out at global level.

Financial innovation and the development of more complicated securitised products have been recognised as central causes behind the global financial crisis and their employment and sophistication were further fuelled in the years preceding the crisis due to persisting macroeconomic imbalances between western economies and BRIC ones.¹ Even though similar transactions had been in use for over a decade, what became increasingly problematic before the crisis was the interconnectedness of securitised exposures – often synthetic – among globalised financial institutions.

¹ These are identified with Brasil, Russia, India, China.
which in turn propelled an increased and uncontrolled level of leverage. A critical question that has been posed in the aftermath of the global crash is whether the new model of credit intermediation resulting from financial innovation is inherently risky, or whether provided a different regulatory framework it can still deliver benefits.

As will be explained in the next section, securitisation has long been praised for creating greater liquidity for end-investors, while at the same time abating risks for originators who would transfer their credit risk to investors, reducing therefore the need to raise capital. The perverse use of the transaction, combined with credit derivatives, resulted however in securitised credit being either bought by the propriety trading desk of another bank (that would retain part of the credit via derivatives), or used as collateral to raise short-term liquidity. This of course created a very complex chain of relationships, between different institutions, mostly characterised by highly leveraged balance sheet, only requiring little capital to support that function.

At the end of that transaction chain stood credit rating agencies (CRAs), performing a critical and fundamental role in determining the value of assets purchased by investors. The function of rating agencies started to be scrutinised after the Enron scandal and generally speaking their slow reaction to detect deteriorating credit risk has been criticised over the last ten years. If on one hand this may have depended on the obscurity of certain transactions that inherently create difficulties in representing the real value of underlying securities, on the other hand it has been

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2 A. Turner “The Financial Crisis and the Future of Financial Regulation”, *The Economist’s Inaugural City Lecture*, 21 January 2009. These developments were designed to satisfy higher demands for yield, and they were premised on the belief that by “slicing and dicing, structuring and hedging, using sophisticated mathematical models to manage risk”, value could be created by offering a combination of risk and return that appealed investors more than what was available from the simple purchase of the underlying credit exposure.

3 This refers to the originate-and-distribute model which will be explained in the next section.

4 Supra Turner 2009.


6 Ibid. It is observed that most banks’ practices were really “acquire-and-arbitrage” rather than originate-and-distribute.
observed that CRAs have engaged in commercially conflicting activities, resulting mainly in their involvement in advising the issuer on how to structure transactions.\(^7\)

The sort of “regulatory paradox”\(^8\) surrounding the role of these largely unregulated private entities in ordering financial markets has become a central concern of international financial regulation. Especially at European level, the introduction of a pan-European regulatory agency (ESMA)\(^9\) may bring about a more consistent regulation and supervision of financial markets and of its actors, most prominently CRAs.

The chapter provides the analysis of securitisation as main structured finance device, whereby the background of the transaction is considered, together with its more recent developments that eventually gave way to more complex schemes such as CDO and CDS (section 4.2). Secondly, the chapter addresses the issue and the regulatory concerns related to CRAs by offering an examination of their recent failures in connection with the most recent developments of EU and US legislation in the area (section 4.3). A conclusion, summing up of the main themes of the chapter, is provided in section 4.4.

4.2 – The development of securitisation as main structured finance device

The assignment of receivable has traditionally represented in common law a means for trading companies and finance houses to raise funds readily and to predict the cash-flow with some degree of certainty and independently from eventual defaults by debtors.\(^10\) This was traditionally achieved through the employment of factoring agreements whereby a factor would purchase receivables for a discounted sum or for a periodic commission, providing therefore necessary funds for the assignor to continue trading without having to rely on its receivables to be serviced.\(^11\)

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\(^7\) This involvement would compromise the uninterested assessment made by the agencies. See IOSCO “Code of Conduct Fundamentals for Credit Rating Agencies”, December 2004.


\(^9\) Regulation EU No. 1095/2010 Establishing a European Supervisory Authority (European Securities and Markets Authority).


In essence, securitisation developed as a more sophisticated form of factoring, one of the main developments being that assets are sold to a special purpose vehicle (SPV or SPE) that funds the operation by issuing bonds on the stock market, secured on the receivables. This fairly linear process started to be more extensively employed in the US housing market in the 1970s, when two government-sponsored agencies – “Fannie Mae” and “Freddie Mac” – began acquiring home mortgages from lending institutions and issuing securities backed by pools of those mortgages. Subsequently investment banks as well embraced this financing model, and set up trading departments to specifically handle these securities. When banks entered the securitisation market for their home loans new frontiers opened up with wider classes of assets being involved in the transaction and a broader category of originators participating in the market.12

4.2.1 – The securitisation structure

The fundamental structure of a securitisation transaction is aimed at providing finance by selling assets, by transforming a loan as a financial relationship into a tradable bond and therefore into a transaction.13 To achieve this, the originator (which can be not only a bank but also a financial institution, a corporation, or a government agency) sells its receivables to a SPV in return for the purchase price of the receivables (chart 4.1). Although the vehicle is sponsored by the originating company, it qualifies for the purpose of the transaction as a totally independent company and not as originator’s subsidiary.14 The SPV is anyway likely to be an almost non-substantive shell entity, whose only function is to raise money through the bond issue; complementary functions, in particular the servicing one, are mostly still carried out by the originator that will maintain existing relationships with borrowers.15 The SPV is also likely to be thinly capitalised, with its shares held by a

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15 Supra Fabozzi and Kotari 2007, p.4.
trust or by a charitable foundation, mainly for tax purposes and also to avoid consolidation of its assets with the originator’s.

The SPV can be either a company or a trust. In case of trust, a trustee is appointed over the assets held in the SPV and beneficiaries’ rights in the trust are passed to investors once their investments have been received. In case of a company, the SPV remains owner of the assets, and investors’ rights result in personal claims against the company. When the SPV is a company, it is frequent to have also a trustee, holding the money received from investors and the assets received from the originator, acting therefore as a custodian as well as a manager of all the property involved in the transaction.

The reason for transferring receivables to the SPV resides in the necessity to ensure that the originator has no proprietary right in them and that they are put beyond his reach in the event of originator’s insolvency. The insulation of SPV’s assets is legally achieved through a “true sale” of receivables from the originator, which at this stage of the transaction serves the purpose of avoiding the main risks of “recharacterisation” and substantive consolidation. The latter refers to the threat of potential claim from originators’ creditors, in the context of insolvency, to seek consolidation of the assets of the two companies. This risk mainly concerns US courts, where assets and liabilities of an entity affiliated to the insolvent one can be

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17 Ibid.

18 Ibid, p.1202. In this way investors know that their rights to the receivables have been transferred to the SPV. This entails that unlike in regular corporate bond issues, where the value of bonds is premised on the value of the whole corporation, bonds issued within securitisation transactions are valued only from the assets sold to the SPV.

19 Ibid, p.1203.

20 Supra Wood 2007, ch.8. From a legal perspective the treatment of a transaction as true sale is determined upon three main concepts: 1) liability for the assets which should pass to the buyer, 2) exclusive control over the assets that should be with the buyer, 3) non-revocability of the sale in case of buyer’s insolvency.

merged to create a single common estate for the benefit of creditors. The outcome of such occurrence would of course be highly detrimental for investors who above all would see their rights frustrated. The other afore-mentioned risk involves the possible recharacterisation of the true sale of receivables as secured financing, for accounting, tax and above all insolvency considerations. If the sale was to be legally recharacterised as a security, the assets would remain on the originator’s balance sheet, as well as their underlying liabilities, hampering therefore the function of the transaction.

The whole purpose of issuing asset-backed securities through the SPV is in other words to limit investors’ exposure to a specific class of assets, as opposed to the entirety of the issuer’s business (which is the case of corporate bonds). Creating therefore the bankruptcy remoteness between originator and issuing vehicle guarantees that even the eventual insolvency of the originator will not affect investors’ claims directed against the pool of receivables.

In order to ensure that receivables are sufficient to repay investors, a number of credit enhancement mechanisms are in place, namely third party guarantees to the SPV, a subordinated loan from the originator, over-collateralisation, or else the vehicle may retain part of the receivables’ purchase price until the notes are repaid.

Securities issued by the SPV are then rated by credit rating agencies, and at this stage of the transaction bonds receive a higher rating than would otherwise be obtainable by the originator directly through a bond issue, chiefly because of the insulation of the former from the originator’s assets and business.

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24 Supra Wood 2007, ch.8.

25 Supra Fabozzi and Kotari 2007. The essence of bankruptcy remoteness lies in the legal preference that asset-backed investors enjoy over traditional investors, as well as in the structural preference that refers to the order of mutual rights among different classes of investors.

26 Supra Wood 2007, ch.6.
Profits obtained from the receivables are then transferred by the SPV (that thus accomplishes its special purpose function) to the originator in the form of servicing fees, or else at a high rate of interest on a subordinated loan.\textsuperscript{27}

\textsuperscript{27}Ibid. The profit extraction at this final stage should not prejudice the off-balance sheet treatment or the true sale for the purpose of capital adequacy, nor should it lead to risks of recharacterisation.
4.2.2 – The advantages and the pitfalls of securitisation

Over the last two decades securitisation has blossomed, both among financial institutions that could obviate the maturity mismatch intrinsic of the lending business (especially in the context of mortgages) and also bypass capital adequacy requirements, and among corporations and government agencies wanting to get most of the profits of a certain cash-flow up front. To fully appreciate the advantages of securitisation however, an initial examination needs to look at the regulatory incentives provided by the first enactment of the Basel Accord of 1988.28 The Accord and the ensuing harmonised capital regulation provided the major incentive for the development of the “originate-and-distribute” model, and for the consequential mass-employment of structured finance29 as a means to reduce transaction costs.30 The way in which loans and other risk assets weighted on balance sheets became in other words critical in credit preferences and in the way banks started to manage risk accumulation by separating this process from that of credit origination, and by intensifying therefore balance sheet management.31

This new concept allowed banks in particular to operate under a new model: they could lend to a wide pool of borrowers without necessarily having to hold those loans to term on their balance sheets; moreover they could separate assets from the risks associated with the company. Loans became the subject of negotiations among banks and other financial institutions, such as investment funds, which were all keen to get involved in the debt finance market where they could originate loans, sell the relating risks to a wide range of investors and remain insulated from potential

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29 S. Criado and A. Van Rixtel “Structured Finance and the Financial Turmoil of 2007-2008: An Introductory Overview”, Banco De Espana, No. 0808, 2008, p.11. Structured finance can be as a whole strongly identified with securitisation technology, as it broadly speaking relates to a group of financial instruments and mechanisms designed to accomplish the repackaging of cash-flows to transform the risk, return and liquidity of a certain portfolio. This is achieved by pooling assets and by selling them to investors, whereby several classes of securities are issued, with distinct risk and yield attached to them, depending on the underlying assets.

30 The 1988 Accord was designed firstly to reduce systemic risk by requiring banks to hold a minimum amount of capital against risk and secondly to limit regulatory competition and arbitrage by providing a level playing field for international banks. See Basel Committee on Banking Supervision, “International Convergence of Capital Measurement and Capital Standards” (1988).

31 Supra Arner 2009, p.120.
defaults. The legal mechanisms through which this twofold purpose could be achieved – namely the compliance with capital requirements and the risk shifting off-balance sheet – can indeed be identified with securitisation technique.

Beyond regulatory incentives, the main economic advantage of securitisation lies in the possibility of turning a pool of illiquid assets such as mortgages into tradable bonds; this in turns creates liquidity and a more accessible and diversified financial system. Originators can access a cheaper and more immediate source of capital (as compared to bank finance or to the bond market) without the necessary intermediation of banks and therefore improve their gearing ratio. From a different perspective, society at large can benefit from a broader access to consumer finance through the securitisation of mortgages, car loans, and credit card receivables.

The accounting advantages of securitisation are another hot topic that strongly came to prominence in connection with the wave of corporate scandals at the start of the decade. Originators’ balance sheet can substantially improve since they can raise money without the loan appearing on the balance sheet (hence off-balance sheet financing) and that therefore allows keeping the surplus from the sold receivables as profit. In other words, while improving its financial ratio, the originator can also improve the return on capital because it has removed assets and liabilities from its balance sheet while still retaining relating profits.

From a strategic perspective, securitisation provides originators with a corporate finance tool that liberates them from the tight terms of general loan agreements employed by most banks. This for the simple reason that the bargaining

32 Ibid p.121.

33 Ibid. This process encouraged the prolific transfer of credit risk to hedge funds, which were “lightly regulated”, and also the creation of special investment conduits designed to maximise returns from capital and accounting arbitrage. These behavioural patterns have been embraced over the last decade by most of the major banks that have been committed in the use of structured finance and risk management and have arguably played a significant role in the Basel process.

34 Supra Criado and Van Rixtel 2008 p.15,16.

35 Supra Wood 2007, ch.6.

36 Ibid.
power of investors purchasing bonds is much less influential than that of a dominant bank that is in a position to negotiate and enforce restrictive covenants.\textsuperscript{37}

Finally, besides the regulatory benefits aforementioned, securitisation also avoids restrictions related to loan documentation (such as negative pledge borrowing restrictions, or cross defaults) because the transaction is effectively a sale and the security is granted by the SPV.\textsuperscript{38}

Against the above benefits, the disadvantages of securitisation have all come to prominence after 2007 as they have been highlighted among the reasons underlying the global financial crisis. Although many of the transactional problems relate to the more recent development of structured products like CDO and CDS\textsuperscript{39}, certain aspects of the transaction can be generally red-flagged. The off-balance sheet character can affect the originator’s credit and ability to issue its own unsecured bonds, since it will have already transferred its best receivables. Investors moreover will tend to buy secured bonds.\textsuperscript{40}

The off-balance sheet structure can potentially lead to the more problematic issue of the originator’s disincentive to monitor the quality of the receivables it originates, since they become property – as well as burden – of some other entity further down the transaction chain.\textsuperscript{41} It is worth observing that during the years prior to the crisis this became particularly evident as demand for securitised products increased dramatically leading originators and credit rating agencies to conduct little due diligence on underlying assets, and overall the exuberance that permeated the

\textsuperscript{37} For a broader discussion on the difference between bank finance and capital market finance, see P.R. Wood “International Loans, Bonds, Guarantees, Legal Opinions”, Sweet and Maxwell London 2007, p.193.

\textsuperscript{38} Supra Wood 2007 (Project Finance, Securitisation, Subordinated Debt), ch.6. It is usually forbidden for banks to grant security over their assets as a form of depositor protection.

\textsuperscript{39} These will be analysed in the next section.


\textsuperscript{41} Ibid p.12.
economic environment led to a decline in the level of transparency of transactions, as well as in their supervision.\textsuperscript{42}

\textbf{4.2.3 – Financial innovation: From securitisation to CDO and CDS}

In order to understand the dynamics that fuelled the last wave of financial innovation, a brief insight into the development of the financial sector highlights the role played by stock exchanges in shaping transactional models. From the start of the 1980s the evolution of capital markets has been extremely rapid and has brought about a clear departure from more traditional commercial law schemes (from which linear securitisation structures could be said to stem). This has resulted in market practices and trends underpinning exclusively from industries’ necessities and drive to enhance their value as reflected on the stock market.\textsuperscript{43} Moreover, this pattern of growth achieved by the most developed Anglo-American markets had come to represent before 2008 an ideal benchmark of general economic growth even for continental European welfare economies that started to endorse a shift in their patterns of financial development in order to achieve global competitiveness.\textsuperscript{44} Within this context, financial innovation became the main tool for corporations and banks to fund their operations and to be competitive on a global scale.

This process can be said to have originated from the Neo-Liberal cultural tide that from the 1970s led to increased deregulation and self-regulation in certain areas of financial services.\textsuperscript{45} More recently, these theorems have found fertile soil in the uncontrolled employment of new structured finance schemes, and in the general euphoria that pervaded financial markets, characterised by excessive liquidity, low

\textsuperscript{42} Ibid. See also Hudson 2009, p.1199. The case study on Northern Rock and Lehman Brothers will more closely analyse the implication of securitisation during the global crisis.

\textsuperscript{43} See The Economist “A Short History of Modern Finance”, October 18 2008.


\textsuperscript{45} See C.R. Morris “The Trillion Dollar Meltdown. Easy Money, High Rollers, and the Great Credit Crash”, Public Affairs New York 2008, p.xiv. It is suggested that the conditions for a prolonged financial market boom were set at the start of the 1970s with the Great Inflation; then in the ‘80s the Chicago school ideology was endorsed in Washington, resulting among other things in financial deregulation; this gave way between the ‘80s and ‘90s to the birth of structured finance, to the expansion of derivatives market, and to the “mathematisation” of trading that flowed together to contribute to the credit bubble.
interest rates and a willingness to innovate in order to satisfy high demands. The resulting economic environment represented an ideal setting for banks in particular, which speculated on a vast scale by taking full advantage of the implicit guarantee provided by national central banks. Financial innovation was carried out in the shape of alternative investment schemes and new structured techniques designed to move assets and liabilities off-balance sheet and to lay off credit risk, thereby creating what has come to be referred to as “shadow banking”.\(^{46}\)

In the context of the recent global meltdown, the role played by new structured products is central to understanding the mechanisms through which banks were able to reach such high levels of leverage and risky exposures. The employment of derivatives combined with more traditional securitisation had already been critical in the context of Enron, but products like CDO and CDS have more recently come to prominence for the level of obscurity they entail, which is arguably what triggered market failures.\(^{47}\)

The former structure describes collateralised securities, such as for instance residential mortgage-backed securities, which are subject of a securitisation, so represents in essence a securitisation of securitisation (chart 4.2).\(^ {48}\) CDS can be more closely associated with derivatives and can be defined as a type of protection against default, whereby the seller of a CDS agrees to pay the buyer if a credit event occurs, and the buyer agrees to pay a stream of payments equivalent to the payments that would be made by the borrower (chart 4.3).\(^ {49}\) Since the seller of the CDS receives payments that resemble a loan, the CDS can be regarded as a form of synthetic loan, and a mechanism to acquire credit risk of an unrelated party. Arguably, the over-exposure to these products in the broad context of the present financial crisis is what


\(^{48}\) See supra Criado and Van Rixtel 2008 p.12.

triggered in particular the downfall of the insurance giant AIG.\textsuperscript{50} What in hindsight appears clearly as a risky transaction, received global support in the past years through the Basel Accords as said, and more generally through a combination of debt capital market technology, regulatory incentives, excessive low interest rates and global investor demand.\textsuperscript{51}

\textsuperscript{50} For an account of AIG downfall, see J.B. Stewart “A reporter at large. Eight days, the battle to save the American financial system”, \textit{The New Yorker}, September 21 2009

\textsuperscript{51} Supra Arner 2009 p.140.
A first distinction that sheds light on the basic difference between traditional securitisation schemes and more innovative ones (also referred to generally as synthetic securitisation) is that in the former assets are sold by the originator to the SPV and removed from the balance sheet, whereas in the latter the underlying assets remain on the originator’s balance sheet and only the credit risk related to the underlying assets is transferred to the SPV through the purchase of credit derivatives.
over those assets.  

Credit risk represents in fact the major concern for financial institutions and the development of credit derivatives, in particular CDOs and CDSs, realised the goal of transferring credit risk to another party without actually selling the underlying asset.  

The transfer can be carried out in different ways, with the originator (referred to in this context as protection buyer) having the option of issuing credit-linked notes to the SPV, or directly to investors; alternatively the protection buyer can enter into a credit derivative transaction (like a CDS) with a protection seller, pursuant to which the latter agrees, in return for certain payments, that upon the occurrence of a credit event related to the portfolio of assets, the protection seller will pay an amount to the protection buyer.  

Within the above schemes, the use of SPVs is not as central as it is for ordinary securitisations. The credit risk of the pool of assets can be transferred directly to the protection seller or to a SPV; the latter solution being advantageous because the notes issued by the SPV under a collateralised structure are rated independently of the rating of the originator, and therefore can normally enjoy a higher rating. Not employing the SPV on the other hand can save costs related to the setting up and administration of the vehicle, the drawback being that the credit notes would be linked to the originator’s creditworthiness. This problem however, is resolved in the context of synthetic transactions, through the collateralisation of credit-linked notes.

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52 Supra Criado Van Rixtel 2008 p.37.


55 Ibid.

56 Ibid.
CDOs
Collateralised debt obligations\textsuperscript{57} represent an application of securitisation technology combined with credit derivatives, which allows the creation of a security without the actual sale of the pool of underlying loans to the SPV. These securities are based on the packaging of various risk assets (such as risky mortgages, loans, bonds) into a new security (a CDO). In other words, a group of debt contracts are grouped in a SPV. CDOs liabilities are then divided and sliced into tranches of different credit quality and of different subordination\textsuperscript{58}, so investors in such securities bear the ultimate risk exposure to the underlying assets.\textsuperscript{59} CDOs can be structured as “cash flow”, in which case the SPV purchases a portfolio of outstanding debt issued by a range of companies, and in turn finances the purchase by issuing financial instruments, which are then rated by rating agencies depending on seniority. Alternatively, in a “synthetic” CDO the SPV does not actually purchase bonds, but

\textsuperscript{57} Initially the term in use was Collateralised Bond Obligation or Collateralised Loan Obligation; CDO then became more suitable to encompass the wider array of underlying assets. See supra Lucas, Goodman, Fabozzi, 2006.

\textsuperscript{58} Ibid. Typically a CDO would have a tranche structure with more than 70% of most secured AAA tranches enjoying great amount of subordination, followed by mezzanine tranches and at the bottom of the capital structure by around 8/10% of the most levered, unrated equity tranches, which absorb all losses and at the same time attract “junk bond-type” high yields.

\textsuperscript{59} Supra Criado Van Rixtel 2008, p.37.
enters into a number of CDS contracts with a third party in order to create a synthetic exposure to the outstanding debt issued by a range of companies. In this case, the SPV will then issue financial instruments backed by CDS rather than actual bonds.\textsuperscript{60}

While the benefits of credit derivatives have appeared in all their might since their emergence two decades ago, when they broadened investment opportunities for banks and corporations alike, it seems now that arguments pointing at the pitfalls of such instruments are prevailing. Nevertheless, arguments sustaining the advantages of employing CDOs are still widespread and they are based primarily on the less expensive way to participate in the bond market they offer to investors. This is possible because synthetic CDOs create new instruments instead of using assets on bank’s balance sheet, thereby completing the market by providing new financial instruments at lower prices.\textsuperscript{61} Behind this structure anyway stood rating agencies that developed methodologies for the rating of CDOs, resulting in the combination of the tranches being worth more than the cost of the underlying assets.\textsuperscript{62}

Some of the drawbacks of CDOs are common to credit derivatives as a whole, and CDSs in particular, especially when the SPV rather than the bank holds loans and bonds. This drastically reduces bank’s monitoring incentives since even risks associated with huge exposures (like for instance the billion of dollars lent to Enron by banks like JP Morgan Chase or Citigroup\textsuperscript{63}) can be mitigated by using credit derivatives as a protection in the event of borrowers’ default. This protection has a drastic effect in neutralising banks’ incentives to carry out general corporate governance and monitoring controls over borrowers that as a result are subject to less financial discipline.\textsuperscript{64}


\textsuperscript{61} Ibid. It is suggested that in a synthetic CDO there is no regulatory rationale since banks do not offload their loans. They are regarded as pure arbitrage (rather than regulatory arbitrage) because the new tranches they create are typically priced at higher yields than other similarly rated fixed income investments.


\textsuperscript{64} Supra Partnoy and Skeel Jr 2007, p.6.7.
Moreover, it has also been suggested that the structure of CDOs can potentially motivate sophisticated investors (such as hedge funds) to manipulate the pricing of collaterals in order to shift risks among the various tranches of the resulting security. This leads to the main problem within CDOs, which is unique to this product, namely the costly mispricing of credit. Transaction costs associated with CDOs are in fact very high and there are reasons to believe that the potential benefits above outlined may not be economically possible and real. It seems in other words that because the methodologies applied for rating CDOs are complex, arbitrary and opaque, they create opportunities for rating arbitrage without that adding any actual value. This became very evident during the 2008 crisis, where synthetic CDOs deriving from existing mortgage-backed securities had clearly no social benefit, but were rather the clone of those securities into imaginary units that mimicked the originals. They in other words were not financing the ownership of any additional homes or allocating capital more efficiently, but were simply inflating the volume of mortgage-backed securities that eventually lost value when the bubble burst.

The composition of the asset pool also plays a part in creating a much more complicated security to value than that resulting from an ordinary securitisation structure. While the latter would be based on pools of large numbers of relatively homogeneous assets, the former is characterised by pools of few numbers of relatively heterogeneous assets.

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66 Supra Partnoy and Skeel Jr 2007 p.31,32.

67 F. Salmon “A Formula for Disaster”, Wired, March 2009, p.79. It is observed that anything could be bundled into a triple-A bond, even when none of the components were worth a triple-A.

68 G. Soros “America must face up to the dangers of derivatives”, Financial Times, April 22 2010. George Soros was on the occasion commenting on transactions concerning the Goldman Sachs civil suit brought by the SEC.

69 Supra Criado Van Rixtel 2008 p.38. The first scenario could be exemplified with a pool of many residential mortgages of a few cities; while the second with small numbers of specific tranches from various mortgage backed securities.
CDSs

If CDOs stem to a certain extent from the legal structure of securitisation, credit default swaps represent a clearer departure from that scheme and fall drastically into credit derivatives contracts. A CDS can be described as a private contract whereby parties bet on a debt issuer’s event, such as default, insolvency, restructuring. If the borrower defaults for instance, the lender will lose money on the loan, but will make money on the swap; whereas if the borrower does not default, the lender will make a payment to a third party, reducing its profit on the loan. The rationale behind these contracts – whose consideration closely resembles that of insurance contracts – is to provide hedging against a particular investment or exposure, but also to create opportunities for speculation and arbitrage.70

The virtues of such financial instruments have long been highlighted within some political circles as foundation and prominent feature of the American economy and the globalised world of financial markets has promptly followed the American way in the employment of these devices.71 Indeed derivatives in general and CDSs in particular have certainly highly contributed to boost the market in the last two decades and have provided banks and corporations with a number of business options. First of all, the hedging function that traditionally banks accomplish by negotiating syndicated loans with other lenders can more easily and cheaply be realised through CDS contracts which provide a quicker method for laying-off risks.72 CDSs also enable banks to lend at lower risk, increasing therefore liquidity in the banking sector and expanding on the other hand corporate access to bank capital.73

Another advantage of CDSs can be identified with what is referred to as benefit of standardisation, which stems from the relatively newness of the market

70 See supra Partnoy and Skeel Jr 2007, p.5,6.


72 Supra Partnoy and Skeel Jr 2007, p.6. It is observed that credit derivatives served as a shock absorber during the corporate crisis of 2001 and 2002, when many of the lenders to companies like Enron and WorldCom had hedged their risk, avoiding therefore the corporate scandals to affect the banking industry.

73 Ibid p.8.
and from the activity of the International Swap and Derivatives Association (ISDA), that has substantially reduced transaction costs associated with such deals. Finally, a further benefit is the informational value that CDSs provide to other market participants. That is to say, the price of CDS transactions can perform a signalling function as it is disclosed to the market, providing therefore an additional source of market-based information about a company’s financial status.

Against these benefits, derivatives as a whole have recently manifested their dark side and the perils that lie behind recent innovations, namely low quality of monitoring and oversight, incentives to short-term investment strategies and overall systemic risk. It has been said earlier in the context of CDOs that derivatives can hinder the incentive to perform monitoring functions on the part of banks; this has become evident during the recent banking crisis as the quality of due diligence performed by originators plummeted dramatically.

An even more threatening danger associated with CDS schemes is that they can lead to perverse incentives to destroy firms’ value, especially on the part of hedge funds that can make their short position worth more if a firm for instance files for insolvency. In other words, a lender that has purchased a CDS may have an incentive to use the leverage of the loan to force a default, even if that imposes costs and undermines the value of the borrowing firm. All this is made even more problematic because of the low level of regulation that surrounds entities like hedge funds and the level of their anti-monitoring behaviour.

The above point can be easily correlated with the more general opacity of the CDS market which is largely structured “over-the-counter” and therefore remains unregulated with details of particular contracts often not being properly disclosed. The most straightforward consequence of this is that firms cannot be sure of how

74 Ibid p.9.
75 Ibid p.10.
76 Such scenario is exemplified in the case of Tower Automotive, where a hedge fund refusal to make concessions for another loan forced the borrower to file for Chapter 11. See H. Sender “Hedge-Fund Lending to Distressed Firms Makes for Gray Rules and Rough Play”, Wall Street Journal, July 18, 2005; even more prominent in this sense is the manipulation of a synthetic CDO structured by Goldman Sachs, SEC v. Goldman Sachs 10-cv-3229, 2010 United States District Court, Southern District of New York.
77 Supra Partnoy and Skeel Jr 2007 p.23.
much risk they are taking and with whom they are actually dealing. This means for instance that there is no way for investors, creditors or other parties to know whether a lender has hedged its position with credit derivatives and adjust their corporate behaviour accordingly.\textsuperscript{78} This leads to the broader issue of self-regulation that characterises this section of the industry and that inevitably leads firms to protect their own interest even if that undermines the market as a whole; the disincentive of market players to promote better disclosure is clearly symptomatic of a willingness not to divulge their specialised knowledge in the field.\textsuperscript{79}

Finally, but perhaps more importantly, CDSs raise concerns for the systemic risk they bear and for the type of crisis they can trigger. The level of interconnectedness of the contracts and the highly leveraged bets that they contain can in fact translate a small market change into an international bubble. That is arguably what happened at the outset of the 2008 crisis.

4.2.4 – Securitisation legal issues
Beyond the analysed legal issues, arising in connection with specific transactional schemes, more general concerns need to be highlighted as regards regulatory and structural problems of securitisation.

A first definition needs to be made in order to identify the regulatory framework surrounding securitisation. The legal environment within which structured finance operates is that of capital market finance (as opposed to bank finance\textsuperscript{80}), and more specifically securitisation classifies as a debt capital market technique whereby the resulting securities issued to investors are bonds secured over a certain category of assets. Issuance of these securities would normally have to comply in the UK with the rigid requirements of the Prospectus Rules and the

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\textsuperscript{78} Ibid p.25.

\textsuperscript{79} Ibid.

\textsuperscript{80} From a regulatory perspective, this distinction refers to the predominantly “arm’s length contracting” character that dominates banks finance, where the financing relationship is governed by restrictive covenants enshrined in a number of clauses (such as condition precedent, representations, warranties and so on) through which banks are often capable of exerting corporate governance constraints and financial monitoring on corporations. Capital market finance does not present the same type of relationship between lenders and borrowers, who resort to capital markets as a means, \textit{inter alia}, to achieve disintermediation. See Wood 2007 (International Loans) ch.6.
Disclosure Rules, which provide mandatory obligations on the part of issuers.\textsuperscript{81} At the same time however, the Rules lay dawn a number of exceptions by virtue of which certain categories of issues are exempted.\textsuperscript{82} It needs to be observed that most structured finance transactions (especially CDOs) involve investors that qualify as sophisticated and therefore avoid the regulatory requirements above outlined.\textsuperscript{83} Moreover, most CDO securities are issued in private placements that virtually escape regulation.\textsuperscript{84} The ultimate lack of regulation disciplining both the way structured finance evolved (new structured products were mostly designed by market players, according to their needs) during the last fifteen years and the actual supervision and disclosure of issued products led, prior to the 2008 crash, to unsustainable levels of leverage and risky exposure among financial institutions, that even advanced regulators and investors could not predict.

Another legal problem that has been recognised among the defects of securitisation technique is the moral hazard that the originate-and-distribute model seems to bring about. The argument proposes that by allowing mortgage lenders for instance to sell their loans before maturity, the credit consequences of these loans do not have to be borne by those who actually originated the mortgages.\textsuperscript{85} Arguably, this led to a dramatic fall in underwriting standards exacerbated by lenders’ incentive to originate high volume of loans in order to make more money.\textsuperscript{86}

This technical issue depends mainly on the practice that allows originators not to retain risks of loss in the transaction. A critical feature of securitisation is in fact the recourse clause, which represents the option the originator has to guarantee

\textsuperscript{81} E. Ferran “Principles of Corporate Finance Law”, OUP 2008, p.422. The Rules enacted by the FSMA 2000 were later amended in 2005 to transpose more recent EC Directives.

\textsuperscript{82} For instance Financial Services Market Act 2000 s.85(5,6) outlines exceptions from mandatory Prospectus requirements, which most interestingly apply to sophisticated investors and private placements (similar exemptions are in place in the US too).

\textsuperscript{83} Supra Munoz 2010, p.381.


\textsuperscript{86} Ibid. It is argued that there are also other explanations as to why the level of underwriting fell.
the pool of receivables against debtors’ default. Selling receivables on a recourse basis implies that the originator will retain risks (or part of them) related to debtors’ financial distress, with the consequence of having to repurchase defaulted debts. Modern securitisation practice has however taken full advantage of the option not to employ this clause, and as already argued, it has almost become a means to layoff the risk attached to certain assets.

Another problem strictly linked to the way in which transactional schemes have evolved, is the over-reliance on mathematical models. It has been said that the process of “financialisation” occurred between the ‘80s and ‘90s gave way to the birth of structured finance and to the expansion of derivatives markets. This was accompanied by the application of mathematical models in structured transactions. The relatively simple structure of securitisation transactions was expanded over the years to encompass a wide range of new contractual schemes whose complexity and exoticness stemmed from quantitative models rather than from pure commercial rationale. If on one hand mathematical models are important in structured finance because they allow predicting the cash-flow from underlying financial assets to pay securities issued by the SPV, on the other hand they can be unrealistic and misleading, resulting in incorrect valuations. Arguably, some of these mathematical models coupled with highly complex assets and obscure means to originate them, have exacerbated the level of complexity in financial markets, leading eventually to market failure.

Finally, but equally important, there are a number of corporate governance concerns that surround the setting up and management of issuing vehicles. If in practice SPVs are shell entities, they retain some importance as they issue securities to investors and are formally the ultimate decision-makers of the transaction,

87 Supra Good 2004, p.747.
90 Supra Schwarz 2008 (the future of securitisation), p.11. A simple example of flawed models would be the incorrect assumption that the US housing market would not depreciate in value as actually happened since 2007.
91 Supra Schwarz 2009 (regulating complexity), p.216.
involving therefore a governance structure and appointed directors. Moreover, according to how the transaction is structured, it may involve collateral/asset managers who are responsible for selecting assets and substituting them as the transaction progresses, and more importantly, in Anglo-Saxon jurisdictions, securitisations often include the appointment of trustees who balance the difficult position of bondholders. Because of the intrinsic differences between common law jurisdictions and their civil law counterparts, and also because of the different evolution of securitisation markets therein, the types of vehicles employed remain diverse, as well as their administration.

A related problem with SPVs governance is that of establishing where fiduciary duties lie, especially in the context of crucial decisions taken by directors, such as restructuring or liquidation of assets. The underlying question would be to whom duties are owed, since SPVs are thinly capitalised or “orphan vehicles”, with nominal capital held by charities, and are financed with debt secured over the assets. If shareholding in this context appears to be irrelevant, fiduciary duties are still owed to shareholders and there is no duty to consider bondholders interest until the company becomes insolvent. In other words, if promoting the company’s

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92 In the US for instance, to avoid recharacterisation, the transaction is structured in two steps, the first being a true sale between originator and SPV (without recourse), the second a transfer to a trustee for the benefit of investors. See Wood 2007, ch.8.

93 Supra Munoz 2010, p.370.

94 Ibid, p.372. Among different vehicles and related administration, there can be: corporate vehicles vs. trust-type vehicles or funds; they can be set up with or without external management. It is overall observed that the absence of trust law in civil law countries hinders the role of trustees; moreover, different models create difficulties in defining and comparing SPV’s functions across jurisdictions. The management role in Anglo-Saxon countries is usually performed by a collateral manager, whereas in civil law countries by management companies; the control role by security or indenture trustees in Anglo-Saxon countries while by management companies in civil law jurisdictions.


96 Supra Munoz 2010, p.377.

97 A stage prior to the commencement of insolvency is recognised as twilight zone, whereby directors have to consider creditors’ position. See D. Milman “Two Cases of Interest for Company Directors Operating in the Twilight Zone”, Insolvency Intelligence 25, 2008, and “Strategies for Regulating Managerial Performances in the “Twilight Zone” – Familiar Dilemmas: New Considerations”, JBL 493, 2004; directors however are in a position to ignore the downside risk of certain projects, even as insolvency approaches, because of incentives towards risk-taking. See P.L. Davies “Directors’
success (under s.172 Companies Act 2006) would imply, in securitisations, the benefit of creditors, the problem would still remain because of the lack of enforceability of this duty; creditors as said, would have an action only once the company is insolvent and the administrator acts on behalf of creditors.  

4.2.5 – Recent regulatory initiatives

Regulatory concerns reignited after the 2007-08 global crisis have been in the first instance difficult to recognise and then to implement. This for two main reasons, firstly because of the global dimension of the crisis, and secondly because of its systemic origin. Mapping these sometimes controversial developments in the context of research work is altogether difficult because of the constant changes that are taking place in the regulation of financial markets post-crisis.

US

The Dodd-Frank Act was the quickest and most comprehensive response to the financial meltdown and it represented a controversial stance with regards to certain legal issues. The Act purported to protect American public from losing their savings as well as investors from the dangers of unregulated markets. In particular, as far as securitisation and financial innovation are concerned, the Act addressed critical issues on a) the regulation of derivatives markets by seeking to reduce counterparty risks in “OTC” contracts; and b) the role of credit rating agencies in the securitisation process whereby a mitigation of the conflict of interest was sought. The resulting regulatory framework revolved around the broader objectives of

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Creditor-Regarding Duties in Respect of Credit Decision Taken in the Vicinity of Insolvency”, EBOLR 7:301, 2006.

98 See s.214 Insolvency Act 1986.


limiting risks flowing from certain transactions and from the shadow banking system, and limiting damages caused by the failure of large financial institutions.\textsuperscript{102}

As the main priority of the Act was to reduce risks associated with certain products, derivative contracts are required to be traded through a clearing house in order to backstop parties’ performance on the contract.\textsuperscript{103} This entails that it is now unlawful to engage in derivatives transactions unless they are submitted for clearing to an organisation registered under the Act.\textsuperscript{104} Exception to this relates to the event of parties employing derivatives contracts to hedge or mitigate risks, in which case transactions remain legal and enforceable on OTC markets.\textsuperscript{105} The Act leaves however to the regulator the definition of commercial risk, clarifying in s.723 that financial firms cannot rely on this hedging exemption to escape clearing requirements.\textsuperscript{106}

The controversy generated by this provision is associated with some specific problems that have remained unresolved. It is observed that the effectiveness of the rule against speculative OTC transactions will largely depend on the powers vested in the Commodity Futures Trading Commission (CFTC) which is granted authority to define “commercial risk” and determine the extent of the requirement, by also verifying which organisations are qualified as DCOs.\textsuperscript{107} The provision’s efficacy will ultimately depend on the effectiveness of a relatively small public agency, faced with the significant lobbying power of Wall Street investment banks, keen to maintain their grip on an extremely profitable business.\textsuperscript{108}

\textsuperscript{102} Supra Skeel 2010, p.3.4.

\textsuperscript{103} Dodd-Frank Act, Title VII, s.723(a)(2). This imposes a clearing requirement to all speculative derivative contracts, effectively turning back the clock to before the enactment of the CFMA 2000. See also L.A. Stout L.A. “The Legal Origin of the 2008 Credit Crisis”, Working paper February 2011, available at http://ssrn.com/abstract=1770082 p.27.

\textsuperscript{104} S.723(a); s.721 and 725 define “derivatives clearing organizations” (DCO) as either recognised future exchanges or performing similarly the trade-guarantee and private-enforcement function, assuming as a consequence liability for the trade among other things.

\textsuperscript{105} Supra Stout 2011, p.28.

\textsuperscript{106} Ibid.

\textsuperscript{107} Supra Stout 2011, p.29.

\textsuperscript{108} Ibid p.30.
The role played by clearing houses within the Act raises other concerns. Firstly, there has been little effort in the US to coordinate cross-border transactions involving multiple clearing houses. Lack of consistency in the way transactions are regulated through clearing houses across different jurisdictions may compromise the objective of limiting interconnectivity risks. A second concern revolves around a more conceptual issue. As the provision purports to shift counterparty risks to clearing houses, it is not quite clear whether and how these organisations will be able to withstand the risks associated with a wide range of swap transactions. While clearing houses will be subject of regulatory oversight, specifically with regards to their capital, the question over their solvability remains open.

The Act also introduced the so called “Volcker rule”, which is effectively a reminder of New Deal legislation that separated commercial from investment banking activities. The provision addresses the Act’s aim of reducing systemic risk by prohibiting commercial banks from engaging in proprietary trading (defined as trading in securities and other financial instruments as principal for the entity’s own account, for the purpose of selling in the near term or of profiting from short-term price movements). While this has been recognised as one of the driving activities of investment banks through their hedge funds before the crisis, the absence of an equivalent measure at EU level may create competitive disadvantage for US institutions and regulatory arbitrage.

With more specific reference to the securitisation process, the Dodd-Frank addressed some specific issues. Firstly, s. 941 tackles to a limited extent one of the legal problems highlighted in the previous section, namely the risk-retention of originators involved in the originate-to-distribute process. The Act requires an economic interest to be retained from the securitised assets, at least five percent, with

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109 Supra Greene 2011, p.46.

110 S.619, prohibits a banking entity from “engaging in proprietary trading or acquiring or retaining any equity, partnership, or other ownership interest or in sponsoring a hedge fund or a private equity fund”. The rule is subject to certain exceptions and is also extended to systemically important non-bank financial institutions. See C.K. Whitehead “The Volcker Rule and Evolving Financial Markets”, 701 Harvard Business Law Review, Vol.1, 2011.

111 Supra Green 2011, p.41.
the exception of certain classes of securitisations defined in the Act. Secondly, s. 621 prohibits any underwriter, placement agent, or sponsor of an ABS from engaging in transactions prior to one year after the closing of the sale of the ABS, in case this involved any material conflict of interest with respect to investors in a transaction arising out of this activity. This rule was specifically directed at limiting conflicts of interest in connection with the structuring of synthetic products, whereby sponsors were selling products to their customers while betting against those same products. Doubts however surround the practical application that this provision is going to receive, because ascertaining whether engagement in the transaction is for investment purposes or for the purpose of creating a financial product may be difficult. While US regulators have not provided clear guidance as to how this judgment is to be made, it has been pointed out that investors should be enabled to make their own assessment through existing disclosure standards.

Finally, in the attempt to limit systemic risk in the financial system, the Act set a threshold for bank holding companies ($50bn in assets) and the systemic importance of non-bank institutions will also be assessed whereby these firms are required to keep a larger buffer of capital. It has been observed that this measure could lead to the unintended consequence of tying banks to excessive capital requirements, which, it is argued, should be determined by market forces rather than by governments. Similar arguments point at the problematic recognition of systemically important firms, which also raises issues of moral hazard because of the implicit guarantee against failure.

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112 S.941. Details of risk retention requirements are left to federal agencies which have the authority to totally or partially exempt securitisations as they deem appropriate.

113 S.621. The rule is subject to three exceptions.


115 D. Lucking “The death of synthetic ABS?”, Allen and Overy, October 2011.

116 Supra Skeel, 2010, p.4. Banks are intended as deposit-based institutions whereby within the group or network one is subject to banking regulation; other firms include investment banks, insurance companies.


118 Ibid, p.479.
EU
Some of the regulatory initiatives undertaken at European level will be specifically discussed in the context of CRA. Generally speaking there has been a move towards the centralisation of supervisory activities, which attempted to close the gap between regulatory activities, enacted at EU level, and supervisory functions, remained traditionally within national competences.\textsuperscript{119} To this extent, the establishment of new pan-European supervisory authorities (ESAs) plays a fundamental role in carrying out this shift.\textsuperscript{120} Among the new authorities, ESMA\textsuperscript{121} represents with some of its powers the first opportunity for rule-making and supervision to converge into a single body.\textsuperscript{122} Beyond the establishment of a common supervisory culture, ESMA’s role resides in contributing to the creation of a single EU rulebook aimed at removing differences in national transposition of EU law and at ensuring therefore their uniform application.\textsuperscript{123}

Broadly speaking, ESMA’s powers can be recognised as: soft-law powers, whereby it produces guidelines and recommendations; rule-making powers, whereby the Authority’s effort is directed at creating a single rule-book through draft standards adopted by the Commission; intervention powers, which allow intervention in defined circumstances, in order to settle disputes between authorities (this power is directed both at national authorities and at market actors); day-do-day supervisory powers, which remain exceptional because of the general principle of home country control in matters of supervision.\textsuperscript{124} Moreover, subject to various

\textsuperscript{119} E. Ferran “Understanding the New Institutional Architecture of EU Financial Market Supervision”, \textit{University of Cambridge, Legal Studies Research Paper Series}, No.29/2011, p.4. It needs to be observed that traditionally regulation and supervision at EU level are not fully synchronised.

\textsuperscript{120} Ibid, p.3. The European Banking Authority, European Securities and Markets Authority, European Insurance and Occupational Pensions Authority.

\textsuperscript{121} European Securities and Market Authority, EU Regulation No. 1095/2010 OJ 2010 L331/84.


requirements, a range of specific powers are assigned to ESMA\textsuperscript{125}, among which: the ability to address binding decisions to competent authorities, and overrule national bodies in emergency situations, in cases of breach of EU law.\textsuperscript{126} The Authority can also temporarily prohibit or restrict particular products and services that threaten the integrity and stability of financial markets\textsuperscript{127}, and has powers over cross-border actors with systemic implications and pan-EU reach.\textsuperscript{128}

As discussed later in the chapter, one of ESMA’s functions will be the direct supervision of CRAs. This is a clear manifestation of increased powers compared to the previous model centred on CESR, and also an example of day-to-day supervisory powers which supersede member states authorities.\textsuperscript{129}

Of great importance is also the harmonisation of OTC trading in the EU. Similarly to what is established in the US, the Commission has proposed the regulation of over-the-counter derivatives through central counterparties and trade repositories.\textsuperscript{130} While the definition of derivatives which are eligible for clearing would be provided under MiFID\textsuperscript{131}, ESMA will be at the heart of a newly designed supervisory architecture, whereby its role would be to decide whether derivatives meet criteria established under MiFID and thus impose clearing obligations for OTC derivatives applying to both financial and non-financial counterparties, in the EU area, entering into contracts with third country entities.\textsuperscript{132} At the time of writing, the

\textsuperscript{125} Ibid, p.1881.

\textsuperscript{126} Supra Regulation 1095/2010, art.17,18,19. ESMA’s direct supervision arises under three circumstances prescribed in the mentioned articles: breach of EU law, emergency situations, disagreement between supervisors.

\textsuperscript{127} Ibid art.9(5).

\textsuperscript{128} Ibid art.22,23,24.


\textsuperscript{131} Directive 2004/39/EC.

Chapter 4 – Corporate finance issues: financial innovation, securitisation and rating agencies

Proposal for a European Market Infrastructure Regulation (EMIR) has been approved and is to be implemented by member states by the end of 2012.133

More specific provisions on the regulation of securitisation have been included in the CRD II134, which dealt with transactions directed at transferring credit risk with the aim to improve risk management, by inter alia removing misalignment between the interests of firms that repackage loans and firms that invest in the resulting securities.135 This was done by requiring originators/sponsors to retain on an ongoing basis an economic interest of five percent in the credit risk related to the securitised assets.136 Exception to this rule would be the case of securitised exposures which are claims on parties of distinct solvency or claims guaranteed by such parties.137

The effect of the above rule entails that investment decisions may only be taken after thorough due diligence, which mandate investors to obtain adequate information and to monitor on an on-going basis the acquired exposures.138 It has been argued that the above provisions may trigger competitive disadvantages for EU institutions because both originators’ refinancing costs and investors’ expenses may rise considerably.139

In order to supplement the above framework, CRD III140 introduced, with regards to securitisation, capital requirements for assets held by banks for short-term resale, and for complex re-securitisations. The intention here is to double current

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134 Directive 2009/111/EC.

135 Ibid, art.10.

136 Ibid, art.122a.

137 Ibid, art.122a(3,6,7). Non-compliance with this rule prevents originators from excluding the securitised exposure in the calculation of capital requirements. Originators are also bound to disclose to investors the level of retained economic interest.

138 Ibid, art.122a(5). Failure to comply with the above may result in national supervisors applying a risk-weight of up to 1,250% for the investment position.


140 Directive 2010/76/EU.
trading book capital requirements by adapting them to those for equivalent securities on the banking book, and tighten the standards for internal models used by banks to calculate market risk.\textsuperscript{141} It is again suggested that the increased capital requirements on certain products will hinder the profitability of a number of transactions (like CDO for instance), and this may have the positive effect of changing banks’ investment focus.\textsuperscript{142}

In line with the above initiatives, Basel III sought to strengthen regulation, supervision and risk-management in the banking sector. By recognising shortcomings of the previous version of the Accord, Basel III rectified specific issues with regards to liquidity, leverage and capital reserves.\textsuperscript{143} This was done through a number of measures both at micro and macro-prudential level.\textsuperscript{144}

While the capital adequacy regime under Basel I and II created regulatory incentives to move assets off-balance sheet, with its tougher capital controls Basel III may increase incentives for regulatory arbitrage.\textsuperscript{145} Moreover, some banks are said to have already devised new hybrid products that would escape the new capital requirements.\textsuperscript{146} These concerns emerged firstly from the new approach to liquidity ratios, encompassing short-term obligations (30 days) and long-term funding obligations (12 months) into a set of formulas that has been criticised for its standard-scenario assumption.\textsuperscript{147} As regards the approach to capital\textsuperscript{148}, the new rules

\textsuperscript{141} Ibid, table 1.
\textsuperscript{142} Supra Muelbert and Wilhelm 2011, p.205.
\textsuperscript{145} J. Plender “Basel III is priming big banks to work the system”, \textit{Financial Times}, 21 September 2010.
\textsuperscript{146} Supra O’Riordan 2011, p.203.
\textsuperscript{147} Ibid p.204. It is argued that the observation periods are standardised regardless of each bank’s business model and risk profile.
\textsuperscript{148} Ibid p.205. Under the current proposal, Tier 3 capital, permitted under the previous framework to offset market risk, will be completely disallowed; tier 1 is designed for items that can absorb losses
have also increased capital requirements for certain types of transactions that under the previous definition had created higher levels of risk and are likely to raise issues of counterparty risks, such as: derivatives, repos, securitisation and related transactions.\textsuperscript{149}

The long period of implementation of the new Accord and the doubts surrounding its effectiveness\textsuperscript{150} prompted concerns with regards to its global reception.\textsuperscript{151} Moreover, as incentives to regulatory arbitrage are likely to increase as a consequence of the new capital ratios, tightening the grip over the shadow banking sector may prove more problematic.

\textbf{UK}

The UK independent Commission on Banking issued in 2011 a final report that advocated structural reforms of the banking sector, with a view to reducing systemic risk and the moral hazard resulting from the implicit government subsidy.\textsuperscript{152} These changes are largely based on loss-absorbency principles and revolve around the ring-fencing of domestic retail banking from international wholesale/investment activities.\textsuperscript{153}

Banks in the ring-fence would need to have capital cushion of up to 20\% with the inclusion of debt alongside equity, in order to provide debt-holders with the same interest against downside risk.\textsuperscript{154} It has also been recommended that in case of

under a going concern assumption; tier 2 is defined as capital that can be used to offset losses as a going concern.

\textsuperscript{149} Ibid p.206.

\textsuperscript{150} D. Miles “Bank of England study says Basel III too weak”, \textit{Financial Times}, 27 January 2011. It was suggested here that a capital ratio twice as large as the agreed one would just constitute an optimal position for the banking sector.


\textsuperscript{153} Ibid p.11. This implies that between one sixth and one third of banking activities would be in the ring-fence and insulated from external shocks; further protection will come from the independence of ring-fenced entities that will have their own boards with a majority of non-executive directors.

\textsuperscript{154} Ibid p.13. Largest banks should have at least 17\% of equity and bonds and a further loss-absorbing buffer of 3\%; this could include “bail-in bonds” – or long-term loss unsecured debt – and contingent capital or “cocos”, as well as equity and other capital.
insolvency, insured depositors should rank ahead of bondholders as this would deter providers of wholesale funding and give credit to debt-bearing losses in resolution.\textsuperscript{155}

While the reforms will have far-reaching effects on most British banks because of the amount of assets that will be held in the ring-fence (which will be isolated from excessive leverage and risk resulting from a wide range of services\textsuperscript{156}), individual institutions will be allowed to adapt the rules to suit their own models. This degree of flexibility was advocated especially in relation to large banking groups whereby costs of transition to new business models would be too high, with risks of asset/liability mismatch.\textsuperscript{157}

The compromise envisaged by the Commission has been positively received insofar as it allows pursuing the fundamental aim of limiting the implicit government subsidy associated with the structure of universal banking. Criticism however pointed at the possible increase in risk-taking within activities in the ring-fence, where bankers will rely on government bail-out. The costs of the proposed reform (amounting to £7bn) and the increased cost of lending that British banks would face is another cause of concern.\textsuperscript{158} It has been argued though that similar measures would have prevented RBS to merge with ABN Amro in 2007 and would have overall mitigated the effect of the global crisis.\textsuperscript{159}

\textit{Interim conclusions}

The analysis of securitisation and financial innovation exposed the urgency to regulate more closely the originate-to-distribute process that over the past two decades became a common financial strategy among corporations and financial institutions.

\textsuperscript{155} Ibid.

\textsuperscript{156} Ibid p.10. The ring-fence is designed to be insulated from the exposure of the global financial market, and the interconnectedness that would complicate resolution.

\textsuperscript{157} Ibid, p.11. It is advocated that domestic retail banking should be inside the ring-fence, global investment banking should be outside, while straightforward banking services to large domestic non-financial companies can be in or out.

\textsuperscript{158} P. Jenkins, S. Goff, M. Murphy “Sweeping change proposed for UK banks”, \textit{Financial Times}, September 12 2012.

\textsuperscript{159} Ibid.
The brief overview of regulation enacted in the wake of the global crisis shows that some measures reflected the willingness to reduce excessive risk-taking in the securitisation process. Timid examples in this sense are the need to maintain an economic interest in the securitised assets provided both in the Dodd-Frank and in the CRD II, where a five per cent is mandated. Similarly, in the US steps have been taken in order to mitigate the effects of financial innovation by attempting to reintroduce a classification between hedging and speculative derivatives, similar to the old common law one.

The overall assessment of the current regulatory framework cannot however lead to optimism. In the US criticism has pointed in particular at the system of *ad hoc* intervention by regulatory agencies that are not bound by rule-of-law constraints, leaving them with discretion as regards their intervention (the case for instance of resolution of financial institutions in distress).\(^{160}\) Also in the case of derivatives trading, doubts have been raised as to the effective powers the agency (CFTC) has over regulated firms. At EU level, the political strife between member states may not allow the purported centralisation of supervisory activities, which is essential for harmonisation purposes. The relationship between new ESAs and national authorities (not only national regulators, but also national courts, or police forces for instance\(^{161}\)) may therefore result in complex relationships because of different political agendas. The regulation of securitisation has also remained fragmented, with initiatives mainly in the context of capital requirement directives.

The thesis’ legal analysis points at the need for a transaction-based regulatory approach that so far has not been wholeheartedly envisaged by regulators. The general acknowledgment that excessive risk-taking and leverage resulted from the unbridled process of financial innovation leads here to thinking that beyond systemic concerns (macro-prudential regulation), securitisation should be regulated from a transactional perspective. This would imply a preliminary definition of the transaction and its economic aims, which at present are still blurred because of the broad functions it has encompassed. The *ex-ante* regulation of transactional models

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\(^{160}\) Supra Skeel Jr 2010, p. 7.

deemed economically viable would then provide the anticipatory measure for regulators to pre-empt market trends and financial innovation.

It is also recognised that the above approach would need to be accompanied by a more general breakdown of the axiom of private ordering in the area of financial law. The development of structured finance transactions has in fact been facilitated over the years by this underlying common law principle whereby market players were free to design transactions according to their commercial needs.

Whether financial innovation – and the consequential interconnectedness and complexity – can deliver any economic and social value is still a matter of controversy. While the development of structured products and derivatives has been advocated by Alan Greenspan as foundation and prominent feature of the American economy (and of the globalised world of financial markets), the risks inherent to these products have been highlighted by both George Soros and Warren Buffet who described them as “weapons of mass destructions”. In more unsuspected times, concerns had already been raised by Lord Browne-Wilkinson in a decision where he strongly emphasised the dangers and risks associated with transactions involving off-balance sheet liabilities and property rights of which the parties to the transaction could not be aware.

It has been seen that some new policies indicate a willingness to limit the effects of complexity and interconnectedness flowing from product innovation, at the cost of creating a “chilling effect” on market liquidity. This leads in turn to revisiting the axiom prevailing over the last thirty years that all financial activities


\[164\] See Westdeutschche Landesbank Girozentrale v. Islington London Borough Council, 1996, 1 AC 669.

\[165\] Such long-term effect is feared as a consequence of the new Basel III rules whose capital requirements are likely to raise the cost of securitisation for investment banks, mainly because of the way in which some securitisation exposure will be risk-weighted under the new process. See Standard & Poor “Tougher Capital Requirements under Basel III could Raise the Cost of Securitisation”, November 17 2010, available at http://www2.standardandpoors.com/spf/pdf/media/TougherCapitalRequirementsUnderBaselIIICouldRaiseTheCostsOfSecuritization.pdf.

\[166\] Supra Turner 2011, p.25.
are socially useful and that the size of the financial sector is the main indicator of policy success.\textsuperscript{167}

The proposals advocated in the thesis under the ESC paradigm are grounded on the wider function financial markets should encompass on a broader range of societal constituencies, far beyond market players. This entails firstly, that size, development and innovation of markets would not constitute policy criteria for reform. Secondly, that regulation should have a sovereign dimension in the way regulators represent democratically different interests at stake, and ultimately protect them by insulating them from the perils of global interconnectedness. Thirdly, that product innovation, far from being banned altogether, should be reconciled with general societal needs.

4.3 – The role of credit rating agencies as gatekeepers

As introduced in the previous section, the role of CRAs over stock market finance, and in particular in the securitisation market, became indispensable mainly because of the complexity of new products which required specialised knowledge in the way they were structured. This led regulators to rely on ratings for the evaluation of most securities with the result that in the past hardly any deal could be finalised without CRAs’ approval.\textsuperscript{168} Their role became increasingly critical, especially in the context of structured finance, because of the intrinsic asymmetry between investors on one hand and issuers on the other, that rating agencies were supposed to mitigate.\textsuperscript{169} This however did not happen, mainly because CRAs have not remained unaligned from the parties involved in the transaction, which should have been the essence of their gatekeeper role.

Gatekeepers’ failure has been broadly identified among the main factors behind corporate and financial scandals over the last decade; Enron and Parmalat clearly highlighted this particular aspect of the broader corporate governance failure, and it was then suggested that the US corporate crises of 2001-02 were to be

\textsuperscript{167} Ibid p.26.

\textsuperscript{168} Supra Munoz 2010, p.371. Agencies’ influence has been reflected at different stages of transactions, not only in the rating of securities, but also in the confirmation to the parties that certain transactions would not necessitate revision of the rating.

\textsuperscript{169} Ibid p.374. This should have occurred through the processing of complicated information from the arranger into simplified outputs (ratings) for investors, indicating probability of default.
understood as a breakdown in the performance and reliability of accounting and audit services.\textsuperscript{170} Even though CRAs had already played a prominent part in the genesis of those scandals, they have more recently emerged as key players contributing significantly to the failures underlying the global financial crisis.

CRAs can be defined as independent providers of credit opinions\textsuperscript{171}, and their role in the market has become increasingly central as their ratings are used by investors, borrowers, issuers, governments, for a variety of reasons. Their position, and the over-reliance of market players on their ratings, substantiated by the huge scale of total outstanding rated debt, has clearly directed regulatory concerns towards CRAs’ operations, once the subprime crisis exploded in 2007.\textsuperscript{172} In order to understand the centrality of rating agencies in the context of the global crisis, a brief analysis of their business model and of the regulatory environment within which they have operated is of paramount importance.

\subsection*{4.3.1 – CRAs’ business model}

The most important aspect of the rating market is that it is mainly dominated by three most recognised entities (Standard & Poor’s, Moody’s Investors Service and Fitch Ratings) which have so far virtually operated in an oligopolistic environment. All three have been increasingly relying on a business model based on “issuer pays”, opposed to the alternative “investor pays” which would rely primarily on subscription revenues by investors. This is mainly due to the rapid growth experienced in the number and volume of structured finance transactions which became more recently reflected in CRA’s revenues.\textsuperscript{173}

\begin{footnotesize}
\begin{enumerate}
\item Credit opinions can be defined as the assessment regarding the creditworthiness of an entity, a credit commitment, a debt financial instrument, or an issuer of such obligations. See F. Amtenbrink and J. de Haan “Regulating Credit Rating Agencies in the European Union: A Critical First Assessment of the European Commission Proposal”, Common Market Law Review, Vol.46, No. 6, 2009; see also Regulation (EC) No 1060/2009 of the European Parliament and of the Council on Credit Rating Agencies, Art.3(a).
\item ESME’s report to the European Commission “Role of Credit Rating Agencies”, June 2008, p.3, available at \url{http://ec.europa.eu/internal_market/securities/esme/index_en.htm}.
\item CRA’s earn approximately 50\% of their earnings from structured finance ratings. See CESR “The role of credit rating agencies in structured finance – consultation paper”, February 2008, p.12
\end{enumerate}
\end{footnotesize}
Chapter 4 – Corporate finance issues: financial innovation, securitisation and rating agencies

It is suggested that the role of rating agencies within financial markets changed dramatically in the 1990s when the steep increase in bond issues revolutionised CRAs’ business which had until that time remained rather stagnant.\footnote{F. Partnoy “How and Why Credit Rating Agencies Are Not Like Other Gatekeepers”, University of San Diego, School of Law, Legal Studies Research Paper Series, No. 07-46, 2006. One major shift was that agencies had previously based their revenues on investors’ subscription fees for their periodical ratings and analysis, rather than on fees charged to issuers directly.} These changes were also rooted in the process of financial disintermediation that saw investors lending directly to borrowers on the stock market; the consequential need for informational intermediaries to play the role historically covered by banks was then taken by CRAs which started assessing the creditworthiness of debt securities.\footnote{C.M. Bruner “States, Markets, and Gatekeepers: Public-Private Regulatory Regimes in an Era of Economic Globalization”, Michigan Journal of International Law, Vol.30:125, 2008, p.134.} If the rising importance of structured finance and securitisation within financial markets triggered the shift in the rating business,\footnote{It should be observed that structured finance issuers pay the bulk of the fee upfront with an annual surveillance fee, whereas more traditional corporate bonds would have two or three CRAs rating their debt and an annual fee would be paid to each of them. See supra ESME’s report 2009} this also contributed on the other hand to reshaping the relationship between agencies and investment banks, which lies at the heart of the conflict of interests signalled as one of the main flaws in CRAs’ business (this will be further discussed below).\footnote{See J.C. Coffee “What Went Wrong? An Initial Enquiry into the Causes of the 2008 Financial Crisis”, Journal of Corporate Law Studies, Vol.9, part1, 2009.}

It is also important to clarify at this stage that the boom of structured finance products generated a broad differentiation between corporate bonds on one hand and structured ones on the other, which gave rise to fundamentally different issues to be taken into account in the process of rating and in the methodologies applied. This is arguably one aspect of the business that CRAs have underestimated claiming repeatedly that the rating of different products is actually similar.\footnote{Supra ESME’s report 2009 p.4-5; see also Regulation (EC) No 1060/2009 L302/5 (40).} Conversely, there are a number of differences that can be highlighted in this respect, and essentially refer to the single-asset character of corporate debts as opposed to structured finance securities which are usually obligations of a special purpose vehicle with a pool of assets.\footnote{Ibid.} This in turn implies a different business risk and
financial risk (which are diversified in a pool of assets) entailed in the rating process, but above all the rating of structured finance is much more model-driven than corporate debt and this involves a substantial level of complexity as well as the employment of a range of variables to be taken into account.\(^{180}\) Also, in structured finance CRAs do not usually carry out any due diligence on the underlying SPV assets as they rely on assurances provided by originators and sponsoring banks. This lack of due diligence has been pointed out as one of the main features of the current global crisis.\(^{181}\)

As briefly outlined, conflicts of interests have been indicated as one of the major flaws of CRAs business and regulatory model. If a similar argument can be made with regards to other gatekeepers, it has been suggested that for a number of reasons rating agencies present peculiarities that make their business model more problematic and conducive to conflicts of interests than other gatekeepers.\(^{182}\)

The “issuer pays” model has to be seen in conjunction with a number of other features: first of all, rating agencies provide unsolicited ratings together with ancillary consulting services related to the products they rate. This creates a further exacerbation of the conflict of interest because of the way in which issuers structure their transactions, which is highly dependent on the pre-rating assessment provided by the agencies. Ancillary services are offered for additional fees and provide issuers with an understanding of how a particular corporate transaction may affect future ratings. The straightforward implication is that once an agency indicates what rating it would give following a certain transaction, it would afterwards be under pressure to stick to the pre-assessment rating. Equally, issuers may feel compelled to use the agency’s consulting services because if they did not, that would have a negative impact on the rating.\(^{183}\)

A peculiarity of CRAs is centred on how they have in the past escaped pressure to eliminate the above conflicts of interest and also how regulation in the area has failed to curb the possibility for rating agencies to offer a range of

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\(^{180}\) Ibid.

\(^{181}\) Ibid.

\(^{182}\) Supra Partnoy 2006, p.61.

\(^{183}\) Ibid, p.71.
consulting services, which on the other hand have been specifically restricted with regards to accounting firms as well as research analysts and investment banks in the years post-Enron.\textsuperscript{184}

The conflict of interest problem has raised even deeper concerns because of the role played by agencies in the context of structured finance and particularly in the CDO market. Without stressing again the criticism over the perils underlying the rationale of these transactions, which is primarily centred on arbitrage, it is worth emphasising how CRAs have played a significant role in the development of the CDO market and more specifically in devising rating criteria for the evaluation of the underlying obligors’ tranches. Moreover, the agencies developed methodologies for the rating of CDOs that resulted in the combination of tranches being worth more than the cost of the underlying assets, this entailing a substantial difference between the price investors pay for CDO tranches and the actual cost of underlying assets.\textsuperscript{185} It is suggested that this arbitrage has arisen mainly because the methodologies applied by rating agencies are complex, arbitrary and opaque and therefore create opportunities for “rating arbitrage”, without that adding any actual value.\textsuperscript{186} In the context of the global financial crisis, it is interesting to stress how investment banks structuring CDO transactions were carrying out the complex calculations leading to arbitrage opportunities. The process of rating CDO tranches in other words became a mathematical game that bank managers knew how to play and win, by twisting inputs, assumptions, and the underlying assets, in order to produce a CDO that appeared to add value while in reality it did not.\textsuperscript{187}

4.3.2 – The regulatory “paradox” of CRA

Of equal importance is the understanding of the regulatory environment under which CRAs have until recently operated and that has arguably allowed them to perpetuate

\begin{itemize}
  \item \textsuperscript{185} Supra Partnoy 2006, p.74.
  \item \textsuperscript{186} Ibid, p.75.
  \item \textsuperscript{187} Ibid, p.80. Because of the above argument, it is observed that CRAs have functioned more like “gate-openers” than gatekeepers with respect to structured finance, where unlike other gatekeepers they have created a multi-trillion dollar market, based on their errors and limitations.
\end{itemize}
the *modus operandi* above described. The role of rating agencies has to be appreciated in light of the deregulation shift that has taken place over the last three decades and that has accompanied the erosion of discipline in capital market activities. It has been suggested that the function performed by CRAs in capital markets epitomises the diminished position of governments within them and the “hybridisation” of certain regulatory activities which have come to be conducted by private or semi-private entities, sometimes in consort with state agencies.\(^{188}\) Clear sign of this trend can be recognised in the way in which rating agencies have been elected as stewards of capital markets through the formal regulatory process of Basel II which induced an excessive reliance on credit ratings and on quantitative risk models often developed by the agencies themselves.\(^{189}\) This overreliance was not only based on the fact that CRAs possess valuable information (often in fact they do not possess any information beyond what is already available before the financial instrument is issued\(^{190}\)), but because they grant issuers “regulatory licences”.\(^{191}\)

Rating agencies have gone even beyond that as they have become virtually controllers of markets since almost all debt issues/securitisations are transacted under the advice and eventual blessing of CRAs.\(^{192}\) Whether this appraisal constitutes an independent, objective and reliable judgment on issuers’ creditworthiness is subject of discussion and is at the heart of the new regulatory edifice both in the EU and US.

Despite having played a major role in capital markets – mainly through the risk-weighting of banks’ assets for regulatory capital purposes (which is embedded as the first pillar of Basel II) – rating agencies have until very recently not been specifically regulated. At EU level CRAs have been directly or indirectly covered by

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\(^{189}\) See Supra Arner 2009 p.132.

\(^{190}\) Supra Schwarcz 2002.

\(^{191}\) F. Partnoy “Rethinking Regulation of Credit Rating Agencies: An Institutional Investor Perspective”, *University of San Diego, Legal Studies Research Paper* No. 09-014, 2009. This is specifically the case in the USA as it will be seen with the regulatory recognition of NRSROs.

\(^{192}\) Supra Flood 2005.
three financial services Directives\textsuperscript{193} and before the recent initiative undertaken with the Regulation 1060/2009, the EU Commission concluded that no further legislation was needed in the area and it felt confident that the pre-eminently self-regulatory structure governing CRAs (mainly based on the IOSCO Code of Conduct) could satisfy eventual concerns.\textsuperscript{194} Within the above regulatory environment, CESR (The Committee of European Securities Regulators) came to play an oversight role which was never anyway close to the supervisory powers entrusted to the SEC (Securities and Exchange Commission) in the US.\textsuperscript{195}

In the USA the SEC categorised in 1975 the “nationally recognised statistical rating organisation” (NRSRO) in order to give regulatory status to bond ratings for the setting of minimum capital requirements. Effectively that initiative provided CRAs with the regulatory power to determine what would and what would not be appropriate for financial institutions to hold to meet capital requirements.\textsuperscript{196}

Further controversy related to agencies’ operations is that pertaining to their insulation from legal liability. Again this can be pointed out as another differentiating element from other gatekeepers, since auditors and securities analysts have all been dragged into costly litigations following the corporate frauds of 2001-02, and also the ensuing Sarbanes-Oxley Act 2002 was implemented, among other things, with a view to regulate their activities more tightly.\textsuperscript{197} CRAs however have insisted in claiming that their function is to provide mere opinions, in a way that would resemble the position of financial publishers.\textsuperscript{198} Opinions are indeed protected under American law by the First Amendment and this is of course one of the reasons


\textsuperscript{194} Supra ESME’s report 2009 p.7.

\textsuperscript{195} Ibid p.8.

\textsuperscript{196} See “Statement of Lawrence J. White for the Committee on Banking, Housing, and Urban Affairs”, US Senate, 26 September 2007.

\textsuperscript{197} Supra Partnoy 2006, p.66.

\textsuperscript{198} See Report of the Staff to the Senate Committee on Government Affairs “Financial Oversight of Enron: The SEC and Private Sector Watchdogs”, October 2005, page 105. Under Rule 436(g)(1) of the Securities Act 1933, 17 C.F.R. §230.436(g)(1), an exemption of liability for CRAs is provided whereby “nationally recognised statistical rating organisations” are generally shielded from liability under the securities laws for all conducts except fraud.
why CRAs have managed to escape to a substantial degree litigation claims, despite the argument being anyway only partially valid because agencies’ financial statements reveal a rather different picture, that of a business that is much more profitable than publishing.199

What also weakens the publishing argument is the position upheld by the US Supreme Court that “commercial speech” can be regulated to the extent that it is false or misleading200, whereas it has not ruled directly as to whether gatekeepers should be entitled to First Amendment protection for the opinions they express. Although the Supreme Court position here remains quite unclear201, there is evidence of more recent litigation among lower courts, where a differentiation has been made between situations where rating agencies were merely acting as journalists or information gatherers, and those where they were playing a more substantial role in the overall transaction.202 A prominent example of this approach is provided by the litigation that followed the Enron fraud, where in Newby v. Enron Corp.203 the plaintiff sought to recover $200 million lost in a complex transaction it entered into with Enron in 2000, and in order to do so it sued S&P, Moody’s and Fitch, alleging that they were liable for negligent misrepresentation as, in rating Enron’s debt in the investment grade category, they failed to exercise reasonable care or competence in obtaining and communicating accurate information about Enron’s creditworthiness. The court however ultimately dismissed the claim, partly because of weak factual allegations brought by the plaintiff, but also on the ground that any First Amendment protection for CRAs in the case was “qualified” and not absolute.204


200 This was established in Central Hudson Gas & Electric Corp. v. Public Service Commission, 447 US 557 (1980).

201 In Dun & Bradstreet Inc. v. Greenmoss Builders Inc., 472 US 749 (1985) the Court referred to the First Amendment protection as unnecessary in case of market driven nature of the speech; however, in Lowe v. SEC, 472 US 181,210 n.58 (1985) it was noted that it was difficult to see why the expression of opinion about a marketable security should not also be protected.

202 In County of Orange v. McGraw-Hill Cos., 245 BR 151, 157 (CD Cal. 1999) the First Amendment was said to protect S&P’s publication of its ratings.


204 Ibid.
It can be overall said that as far as American courts are concerned, rating agencies are held liable only upon the occurrence of particular circumstances, where the agency is involved in structuring the transaction and not only in gathering information, but also depending on the complexity of the transaction and on the level of sophistication of the investor. It can be observed that, again unlike other gatekeepers, CRAs have more successfully obtained a degree of First Amendment protection because of the way they have more clearly disclaimed the value of their opinions, which – unlike equity analysts who clearly recommend a “buy”, “hold” or “sell” – are not qualified as investment advice.205

Drawing a consistent comparison with English judicial tradition on this matter is difficult because of the more limited litigation that has developed in the area. However, as far as English court are concerned with regards to CRAs’ legal liability, it seems fair to point out that the lobbying power of the parties involved has somewhat hindered the courts from developing a doctrine where tort claims of misrepresentation or negligence could be recognised, let alone being successfully brought by investors.206 Under English law moreover, courts employ a “proximity” test in order to establish whether a duty of care arises for potential plaintiffs.207 This has mainly applied to auditors valuing securities whereby their opinions are relied upon in a decision to buy or not. The situation is exemplified in Arneson v. Arneson208 where an accounting firm was held liable for having undervalued – through a signed report – shares sold by an employee to the company, which subsequently were sold by the company at six times the purchase price. The court held that the accounting firm assumed the possibility of being held liable for negligence when the report was signed, which at the same time created “proximity” between the accounting firm and the plaintiff.209 An opposite outcome is however

205 Supra Partnoy 2006, p.88.
209 Ibid.
found in *Caparo Industries v. Dickman*\(^{210}\) where the court refused to establish a duty of care owed by the auditors to future potential shareholders.\(^{211}\)

The main problem in constructing rating agencies’ liability lies essentially in the difficulty of establishing “proximity” between the parties that justifies reliance, duty of care and foreseeable damages.\(^{212}\) As suggested above, the rationale for the “proximity” requirement is to be found in policy considerations, whereby configuring liability in contract or tort for CRAs would entail potential claims from millions of investors that would simply put agencies out of business.\(^{213}\)

### 4.3.3 – The current EU and US framework

The flaws in rating agencies’ operations outlined in the previous sections, combined with evidence of an inadequate regulatory framework under which they have so far functioned, have been recently confirmed by events in the context of the global crisis.\(^{214}\) Episodes surrounding the downfall of Lehman Brothers and other financial institutions in the wake of the 2008 crisis reiterated themes already associated in the past with the Enron and Parmalat scandals, and have ultimately served as a platform for discussing developments in the regulation of CRAs. The lesson to be learned seems to be that the regulatory failures surrounding gatekeepers over the last decade can be understood as a progressive erosion of capital markets discipline, where key regulatory and supervisory roles were delegated to private agencies, leading to a self-regulatory model whereby market incentives pushed firms to resist regulation.\(^{215}\) This resulted in CRAs’ inability to accurately appraise the value of securities, both because of the inherent conflicts of interest affecting their operations and for the

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\(^{211}\) Ibid. The case involved the purchase of a company by another, which had relied on the valuation of the latter’s auditors.

\(^{212}\) Supra Munoz 2010 (The Law of Transnational Securitisation), p.266.

\(^{213}\) Ibid, p.267.


\(^{215}\) Supra Coffee 2009, p.21.
opaqueness of structured transactions that resulted from the unrestrained process of financial innovation.

The concerns and the challenges above outlined have since 2007 prompted regulatory reactions with regards to possible ways to address the malfunctions exposed in the years prior to the crisis. If rating agencies had in fact been criticised in the past for giving their approval to dubious bonds, their failings in the context of the housing bubble have been far greater. The authority that CRAs have so far enjoyed seems to have now been put under scrutiny and new legislations implemented in the US and EU have clearly moved towards that direction. As these new pieces of legislation are briefly discussed in this section, especially with regards to their implication on the functioning of corporate and financial markets, it is interesting to note that further changes to the regulation and functioning of rating agencies are being currently studied with a view to set more drastic limitations to the excesses and the arbitrage opportunities occurred before the crisis.

Moreover, even more drastically, among the measures to prevent risk-taking in the financial sector, EU and US authorities have contemplated the setting up of a public rating agency as a solution to the lack of competition between the “big three” and as a way to address the distortion of their ratings caused by private interests. In the EU, a rating from the public rating agency would become mandatory, for each debt finance product issued; moreover, a public rating agency would perfectly complement ESMA in the supervision of the registration process of rating agencies.

EU

The first post-crisis initiative at EU level was the enactment of Regulation 1060/2009 on credit rating agencies. The general perception after its implementation is that major impacts on CRAs’ activities may occur through the application of strict standards of integrity, quality and transparency, coupled with the supervision of

216 See J. Gapper “Time to rein in the rating agencies”, Financial Times, April 28 2010.
217 See E. Moya “EU plans to create watchdog to curb credit rating agencies”, guardian.co.uk, Wednesday 2 June 2010.
public authorities. The Regulation puts in place a common regulatory regime for the issuance of credit ratings – based to a large extent on the existing IOSCO code of conduct, but with a binding effect – primarily with the aim to restore market confidence and create increased investor protection following the global financial meltdown. This is achieved in the first instance through a process of registration whereby all rating agencies that would like their ratings to be used in the EU territory will have to submit an application for registration to ESMA (previously CESR), with the competent national authority assessing and examining the application.\(^{219}\) Further to the amending Regulation 2011\(^{220}\) ESMA is competent for the ultimate decision on applications of credit rating agencies for registration, and this authority is complemented by investigative and supervisory powers which are no longer held by member states’ authorities.\(^{221}\) These powers however do not extend to actually interfering with the content and the methodologies of credit ratings.\(^{222}\)

Since the registration process virtually creates a system of common passport for CRAs registered in the EU and willing to offer their service within the EU\(^{223}\), global rating activities may have to relocate in order to be able to trade in foreign financial instruments for the benefit of European investors. This, if nothing else, calls for the adoption of a system of equivalence that in the context of globalised financial markets seems to be more than appropriate.\(^{224}\) This is achieved through a process that allows third-country ratings to be certified providing a number of conditions are met.\(^{225}\)

\(^{219}\) Regulation (EC) No 1060/2009, Art.14, 15. This has been amended by Regulation No 513/2011 whereby the registration process has been streamlined with ESMA taking over national authorities’ competence.


\(^{221}\) Regulation 513/2011 amending art.24-25. ESMA’s powers over CRAs are centred on the day-to-day supervision which substantiate in powers to request information and to investigate, and if necessary to sanction agencies; ESMA’s powers can eventually lead to revoke registrations, stop agencies from issuing ratings, and imposing fines and penalties.

\(^{222}\) Ibid Art.23. Under the amending Regulation however, Art.21 provides an assessment by ESMA of compliance with rating methodologies.

\(^{223}\) Ibid Art.4.

\(^{224}\) Ibid (15) and Art.5.

\(^{225}\) Ibid Art.4(3); supra Schammo 2011, p.1889.
The independence and the avoidance of conflicts of interest are among the main areas of concern within the Regulation as they seek to ensure quality and objectivity of credit ratings. This is achieved primarily through a general duty on CRAs to ensure that the issuance of credit rating is not affected by any actual or potential conflict of interest. In doing so, CRAs have to comply with more specific requirements set out in the Annex I, sections A and B of the Regulation, which refer mainly to the independence of CRAs’ employees and to their compensation which should be based chiefly on quality, accuracy, thoroughness and integrity. In particular, key independence requirements are set with regards to: the management of CRAs, which must have a supervisory board for ensuring independence; the services provided, which should be limited to credit rating and related operations, but with strict exclusion of consultancy or advisory services; the monitoring of credit ratings, which consists in an obligation on CRAs to verify the quality and reliability of the sources underlying the ratings; and finally the record of all activities. Some of the obligations above discussed are strongly associated with enhanced transparency and disclosure that CRAs have to provide to the public. Disclosure in particular relates within the scope of the Regulation to the methodologies, models and assumptions employed in the rating process. This is especially emphasised with regards to unsolicited ratings and more importantly to the specific requirements that are necessary for the rating of structured products, namely securitisations and CDOs. Beyond this, CRAs have to publish annual transparency reports detailing among other things, matters of conflict of interest, ancillary services, and financial information of the agency.

A very central point within the Regulation is that concerning the supervisory powers and the enforcement inherent to the new framework. As pointed out, ESMA represents the convergence of supervisory functions into a centralised EU body with

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226 Ibid Art.6.
227 Ibid Annex I s.A.
228 Ibid Annex I s.B.
229 Ibid Art.8.
230 Ibid Annex I s.D.
231 Ibid Annex I s.E.
powers previously vested in national authorities. Articles 21 to 25 of the Regulation lay out ESMA’s supervisory and investigative powers\(^\text{232}\), and more prominently the power to impose fines and penalties.\(^\text{233}\) The interesting and controversial development is represented by the already cited establishment of a more centralised system of supervision of CRAs at EU level through the new European supervisory authority (ESMA).\(^\text{234}\) The new authority is entrusted with extensive and direct supervisory powers over rating agencies registered in the EU, including European subsidiaries of the likes of Moody’s, S&P and Fitch.\(^\text{235}\) Powers are as said substantial and include requesting information, launching investigations, performing on-site inspections.\(^\text{236}\) Moreover, issuers of structured products will also be subject to tighter disclosure requirements as they have to provide all interested CRAs with access to information they give to their own CRA, in order to enable them to issue unsolicited ratings.\(^\text{237}\)

Generally speaking these changes are likely to bring about a simpler and more direct supervisory environment within the EU\(^\text{238}\), as the role and powers of ESMA represent a definite step towards the establishment of a single EU rulebook applicable to all financial institutions in the single market.\(^\text{239}\) To this extent, differences in the way EU law is transposed should be removed in order to harmonise the core set of standards to be applied; similarly, a common supervisory

\(^{232}\) Ibid Art.23,24,36.

\(^{233}\) Supra Schammo 2011, p.1890. It is observed that national authorities will continue to be involved because of the delegated tasks by ESMA and also as members of the EU body.


\(^{235}\) It is suggested that until present the EU financial market intervention was asymmetric because supervision and enforcement were vested in Member States; the regime brought about with ESMA centralises supervisory powers which are conferred upon the new authority. See N. Moloney “The European Securities and Markets Authority and Institutional Design for the EU Financial Market – A Tale of Two Competences: Part (1) Rule-Making”, *European Business Organization Law Review*, 12:41-86, 2011, p.49.


\(^{238}\) Ibid. This because CRAs will operate under a centralised EU supervision of all CRAs instead of various national authorities.

\(^{239}\) Supra Regulation No.1095/2010, Art.6.2.
culture should be adopted across member states, whereby behaviours by national supervisory authorities considered to be diverging from EU legislation should be appropriately addressed.240 Also, in case of emergency situations where national authorities alone lack the power to rapidly face cross-border crisis, ESMA has, subject to certain requirements, the power to require national supervisors to jointly take specific actions241, in order to guarantee integrity and stability within the EU financial system.242

From a more general perspective, the importance of a pan-European securities regulator has been already emphasised in the previous discussion on securitisation. The way in which the “cooperation” with national authorities will function is likely to determine the effectiveness of the enforcement powers available to ESMA.243

US
In the USA, the SEC started at the end of 2008 a process to change its credit rating rules which flowed into the final rule released in 2009. The main concern at the heart of this reform was the examination of the state of the three dominating NRSROs and the aim to increase transparency and accountability of the whole rating market; these new rules came to complement the already existing Act of 2006.244

As far as the 2006 Act is concerned, it created a voluntary system of registration whereby SEC would grant NRSRO status and consequential regulatory benefits to agencies complying with prescribed requirements. In this respect, the Act replaced the previous procedure by granting the SEC statutory authority to oversee

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240 Ibid, Art.6.2.2. The national supervisory authority would be called to comply with the recommendation (for the action addressed to the national authority) within one month.

241 Ibid art.17,18,19. ESMA’s direct supervision arises under three circumstances prescribed in these articles: breach of EU law, emergency situations, disagreement between supervisors.

242 Ibid Art.6.2.3.


245 Credit Rating Agency Reform Act 2006.
the credit rating industry, with a view to “improve rating quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry.” 246 This purpose is achieved within the Act through certain key features, namely through the disclosure of detailed information to the SEC at the time of registration; the periodic update of registration information and the filing of financial statements; the maintenance of procedures to prevent the misuse of material non-public information and the management of conflicts of interest; and the prohibition of unfair, coercive or abusive practices. 247 It is observed that compliance with the above obligations on the part of CRAs provides the SEC with a degree of information that allows scrutiny of NRSROs and their accountability. To this extent, the SEC is conferred powers to deny, suspend or revoke the registration, to require NRSROs to make public the documents submitted to the SEC, and most importantly to take actions should NRSROs issue credit rating in material contravention of the procedures which it has notified. 248

The new credit rating rules in force since February 2009 aim to tighten record-keeping procedures and to overall curb the conflict of interest problem. With regards to the former issue, this is obtained by requiring NRSROs to firstly, retain records of all rating actions related to a current rating; secondly, to document the rationale for any material difference between the credit rating implied by quantitative models used and the final credit rating issued if the model is a substantial component of the rating process; and thirdly, to retain records of any complaints regarding performances of a credit analyst in determining or maintaining a credit rating. 249

The conflict of interest problem is tackled by prohibiting NRSROs from firstly issuing a rating where the agency has made recommendations to the issuer in respect of the structure of the financial instrument that is to be rated or in respect of the issuer’s activity; secondly, by restricting personnel of NRSROs who are responsible for determining ratings, from participating in any fee discussions and

246 See Consultation by the Commission services on Credit Rating Agencies (CRAs), Brussels, 31 July 2008, IP/08/1224, Appendix I, p.23.

247 Ibid.

248 Ibid.

negotiations; thirdly, by prohibiting credit analysts who participated in determining the rating from receiving gifts from the rated issuer.\textsuperscript{250}

Under the SEC new rules, NRSROs are also subject to enhanced disclosure obligations since they have to provide the SEC with an unaudited report of the number of credit rating actions occurred during the fiscal year, in each class of rating; moreover, there are also provisions in place related to providing performance measurement statistics and rating methodologies.\textsuperscript{251}

Following interesting recommendations issued by the Financial Stability Board\textsuperscript{252}, the Dodd-Frank has stricken references to credit rating agencies in Federal statutes by replacing them with references to “standards of creditworthiness” which are to be determined by each Federal agency.\textsuperscript{253} While this approach could potentially limit the regulatory power enjoyed by the main CRAs, it could also lead to duplications by various regulators who reference ratings without necessary coordination and according to different standards.\textsuperscript{254}

**Interim conclusions**

The enactment of the above legislations in the EU and US has not completely settled the need to find a new regulatory model disciplining financial markets generally and rating agencies more specifically. Since CRAs have been found to be at the very heart of the global financial crisis, with their poor and flawed rating process being responsible for the decline in confidence which eventually paralysed markets\textsuperscript{255}, new solutions are being evaluated in order to create long-term answers to the problems discussed. If the legislations briefly examined certainly tackle some of the issues that

\begin{itemize}
\item \textsuperscript{250} Ibid, p.38-51.
\item \textsuperscript{251} Ibid p.35.
\item \textsuperscript{252} Financial Stability Board \textit{“Principles for Reducing Reliance on CRA Ratings”}, October 2010, at www.financialstabilityboard.org/publications/r_101027.pdf. The report recommends removal or replacement of CRA ratings from standards, laws and regulations, and the design of a framework that incentivises independent credit assessment.
\item \textsuperscript{253} Dodd-Frank, s.939,939A.
\item \textsuperscript{254} Supra Greene 2011, p.56.
\item \textsuperscript{255} See J.P. Hunt \textit{“Credit Rating Agencies and the “Worldwide Credit Crisis”: The Limits of Reputation, the Inefficiency of Reform, and a Proposal for Improvement”}, 2009 Columbia Business Law Review, 109.
\end{itemize}
have underscored CRAs’ failure, there is still criticism as to how they will affect agencies’ structures and operations.

A first concern points at the fact that CRAs still retain the character of private entities exerting huge regulatory influence in international financial markets, through the performance of functions that prima facie should be retained by states.\textsuperscript{256} This argument is grounded on the debate surrounding the theoretical tension between state-based and market-based forms of regulatory authority, where only the former are founded on political legitimacy.\textsuperscript{257} Gatekeepers and more specifically CRAs epitomise the difficulty of finding public legitimacy and accountability in private entities that function like governments, either on the premise of regulatory licences granted by the state (like for rating agencies), or more broadly because of the dynamics of the global economy that exceed the grasp of single states.\textsuperscript{258}

A second concern reflects the freedom CRAs preserve with respect to devising rating methodologies (whereby obligations, both in the US at EU only relate to disclosure). It is widely accepted that models designed by the agencies played a central role especially in structured transactions, where issuers’ preferences became “rating-driven”.\textsuperscript{259} Through these methodologies, agencies managed to award AAA to CDOs even when the underlying assets had been valued BBB. As the design of new structured products relied heavily on the inputs provided by CRAs, the innovation process exerted by agencies can strongly be linked to the excessive importance that mathematical models acquired in structured finance. This problem has clearly been left outside the scope of recent regulation both in the US and EU.

A third criticism points at the partially unresolved problem of conflicts of interest between agencies and rated firms. While in the EU, the Regulation restricts to some degree consultancy and advisory services provided by the agencies to rated

\textsuperscript{256} See Supra Flood 2005.

\textsuperscript{257} Supra Bruner 2008, p.126.

\textsuperscript{258} Ibid, p.128.

\textsuperscript{259} A. Johnston “Corporate Governance is the Problem, not the Solution: A Critical Appraisal of the European Regulation on Credit Rating Agencies”, \textit{Journal of Corporate Law Studies} 2011, Vol.11, part 2, p.409.
entities\textsuperscript{260}, it still permits other ancillary services which are deemed to not compromise the independence of the rating.

Finally, ESMA certainly represents a step towards more direct and harmonised supervision of CRAs. The Authority also breaks down the self-regulatory environment under which agencies had previously prospered, as its powers flow from an indirect democratic legitimisation (because national authorities are its members). However, the fact that ESMA’s powers stem from each member state’s authority brings about doubts as to the effective exercise of these powers, because member states will continue to have different agendas on how to they intend to supervise financial markets. This would result in ESMA being a collective actor rather than a coherent supervisory authority, whose functions would be further jeopardised by its institutional setting and by the underlying question over its delegated powers.\textsuperscript{261}

More general criticism towards new regulations needs to point at the undisputed acceptance of neo-liberal theorems recognised in hindsight as what triggered the excesses of the last decade and the chain of events that led to the 2008 crisis.\textsuperscript{262} Beyond regulatory intervention in fact, a challenge to the Anglo-American model of financial capitalism is seen as the necessary presuppose to soundly reform the way in which financial markets work.\textsuperscript{263}

The thesis’ proposals stem from the above criticism and revolve around renewed regulatory functions of the state in financial markets, especially with respect to powers traditionally delegated to CRAs. This would achieve a double purpose: firstly, it would encompass a more democratic legitimisation of financial regulation as a broader spectrum of societal interests would be regarded in the regulatory process; secondly, it would pre-empt market-driven practices – pre-eminently those

\footnotesize{\textsuperscript{260} Regulation 1060/2009, Annex I s.B.}

\footnotesize{\textsuperscript{261} Supra Schanno 2011, p.1905-1911. Constitutional concerns emerged with regards to certain ESMA’s powers over which the EU may not have power to delegate; the power to sanction individual firms is such example as it normally is associated to statehood.}

\footnotesize{\textsuperscript{262} See A. Turner “Reforming Finance: Are We Being Radical Enough?”, 2011 \textit{Clare Distinguished Lecture In Economics and Public Policy}, FSA, 18 February 2011.}

\footnotesize{\textsuperscript{263} Ibid p.2.}
exercised by CRAs – because a state regulator/supervisor would be empowered to anticipate trends or to screen them \textit{ex ante}.

4.4 – Conclusion
The chapter explored what, after the crisis, has become the most central feature of capital market finance. Securitisation and rating agencies have been singled out as the process (often referred to as originate-and-distribute) by virtue of which huge and unquantifiable level of risk-taking had been reached. Even though this financial process has come to encompass a wide range of transactions, the chapter reflected the main differentiating features that characterise innovated products such as CDO and CDS, and the different legal risks they create. A critical analysis of recently implemented measures assessed the impact they will have on structured finance in the future, and the need for further reforms.

The analysis of CRAs, with regards to both their operative structures and the most recent reforms to their regulation, contributes to providing a picture of the difficulties faced in the regulation of debt capital market finance. The self-regulatory status of the agencies and their regulatory power can be said to have exacerbated the uncertainty and the volatility of global financial markets.

Critical considerations of most recent legislations are linked to the thesis’ proposals which point at a rather drastic change in the regulation of the above mechanisms. These would be premised on the intervention of a specifically established public body. This institution would be designed to first of all perform the “gatekeeping” functions so far entrusted in the rating agencies, and it would also embrace a substantial role in redefining \textit{ex ante} the contractual schemes of structured finance arrangements.

The chapter’s analysis and the considerations brought forward more generally point at the measure in which debt stock market finance has become a culprit of modern financial crises. This contention is grounded on the broader criticism of the theories that underpinned its excessive development\textsuperscript{264}, and of the resulting politico-economic models dominated by large financial markets.\textsuperscript{265} To this

\textsuperscript{264} See H. Minsky and M.H. Wolfson “Minsky’s Theory of Financial Crisis in a Global Context”, \textit{Journal of Economic Issues}, June 1, 2002.

\textsuperscript{265} See A. Turner “Reforming Finance: Are We Being Radical Enough?”, 2011 \textit{Clare Distinguished Lecture In Economics and Public Policy}, FSA, 18 February 2011.
extent, the thesis’ proposals challenge the observance of free-market, neo-liberal theorems and point at a drastic departure from the Anglo-American model of financial capitalism as the necessary preliminary step to reform financial markets.
Chapter 5 – Beyond Enron and Parmalat: the legal engineering that made the frauds possible

5.1 – Introduction
This first chapter of part III is concerned with the corporate scandals that invested North America first and then Europe between 2001 and 2003: Enron and Parmalat. The role of case studies in this thesis is to provide a representation of the legal issues discussed thus far. The purpose if twofold: firstly, to illustrate the legal issues identified as common denominators of modern financial crises, therefore corroborating their initial selection; secondly, to substantiate the proposals formulated in this research.

The chain of events occurred at the start of the twenty-first century represented a wake-up call for the then booming Anglo-American corporate world. At a time when the neo-liberal ethos reflected in the “new economy” were also the driving force behind the management of large public corporations in the US and UK, the sequence of corporate and financial failures - such as Enron, WorldCom, Adelphia Communication and Tyco, among the most astonishing - contributed to cast doubts on the real merits and effectiveness of the American corporate governance system. As the above scandals were immediately branded as accounting manipulations, a piece of legislation was promptly enacted in the USA to correct what were then perceived as main (to some the only) malfunctions of the corporate system. Despite this apparent legislative correction though, uncertainty started to creep on the whole workability and efficiency of a governance system grounded on dispersed ownership, deep and liquid capital markets, and external market-based control mechanisms. At the same time, scandals like Enron and WorldCom served as catalyst to reconsider the merit of American corporate governance, vis-a-vis the

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3 Sarbanes-Oxley Act 2002, (Pub.L. 107-204 116 Stat.745) also known as “Public Company Accounting Reform and Investor Protection Act”.

continental European one, epitomised by rather opposite tenets.\(^4\) Certain European business circles felt somewhat vindicated by the freefall of the American economy and pointed at block-holding, family-oriented corporate models as a valid alternative of business organisation.

These sentiments however were not to endure long, as shortly after the Enron collapse exposed its full magnitude, an altogether similar event shook the core of Italian (and perhaps European) industry, with the dairy giant Parmalat falling under the weight of nearly $13 billion debt.

This chapter provides an account of two of the major financial scandals of the last decade, and reflects on the main legal issues emerged as common denominators of those disasters. The research follows a parallel path, focusing firstly on the corporate structures characterising each corporation, and secondly investigating the financial strategies in place, which initially propelled the life of those corporations and then eventually led to their ultimate failure. The financial aspect of the account leads to reflections involving a broader analysis on the long-term reliability of financial mechanisms in place. This is all the more evident since very similar concerns underpinned the collapse of the banking industry during the 2008 global financial crisis.

The chapter is introduced by a short socio-legal enquiry into the genesis of corporate scandals (section 5.2). This is followed by the account of the Enron bankruptcy (5.3) and by the Parmalat one (5.4). Section 5.5, provides a critical reflection on the above events, with particular reference to the legal issues that have remained unresolved until present day. Section 5.6 concludes the chapter.

5.2 – Reasons behind corporate scandals: why and how they have been committed
The first problem to analyse when dealing with financial collapses is to understand the fraudulent purposes that underpinned the actions that led to scandals. This is all the more instrumental to the discussion since scandals are here examined from the lens of corporate governance classifications and from the perspective of legal arrangements therein.

\(^4\) A detailed discussion on different corporate governance models is provided in Ch.2.
It has been suggested that different types of scandals occurred in Europe and in the USA and they varied with regards to the style of manipulations and the people behind them. The difference goes back to firms’ ownership structure, which is usually very divergent across the Atlantic, and consequently it relates to agency problems therein.\(^5\) It is fair to say that Enron epitomises earning manipulations carried out by managers, while the Parmalat scandal is a clear example of the exploitation of private benefits of control from shareholders. These two situations stem from different corporate scenarios, whereby various constituencies within the firm can commit frauds and pursue personal enrichments. Within a dispersed ownership background, typical of large Anglo-American corporations, the separation of ownership and control is clear and it brings about a delegation of managing functions to the board of directors. The theories\(^6\) that have attempted to explain the consequential agency problem – the clash of interests arising from the delegation of management functions to the board and the consequential dichotomy within corporations between managing and monitoring – have mainly focused on the mechanisms in place to mitigate the effects of the above separation between security holders and managers. It can be observed that in the US this problem has been often challenged by tying managerial interests to shareholders’. This has been achieved chiefly through compensation schemes that awarded equity instead of cash, often though in excessive measure that encouraged managers to follow the path of short-term policies, aimed at maximising the firm’s stock price.\(^7\)

The same agency problem in European corporate governance is manifested by the recurring presence of a controlling shareholder or a shareholders group. Under these circumstances the agency problem is tackled in a more “rudimental” way, since there is no need to establish mechanisms of balance of powers: controlling shareholders will rather rely on a system of “command and control”, on direct monitoring of managers and eventually on their replacement.\(^8\)

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8 Supra Coffee 2005, p.10,11.
Looking then at the reasons behind corporate frauds, greed has to be singled out as the driving force that prompted certain behaviours, regardless of the corporate context. In an attempt to understand the nature of frauds it has been suggested that personal gain is the most common reason.\textsuperscript{9} In particular researchers have observed that within corporate frauds, managers’ lust for power and the belief that their approach to the world is one played by their rules, all constituted an explanation to fraudulent behaviours.\textsuperscript{10} A certain industry culture could also be pointed at as a factor inducing to frauds especially by considering the perception of certain executives that there are little and weak financial and regulatory systems that prevent fraud strategies. The audit function, to name one, has seldom been perceived as a threat and chief executives and chairmen alike have frequently ignored controls and more generally standards of behaviours in that respect.\textsuperscript{11}

Generally speaking there may be a number of possibilities that trigger deviance from standard behaviours, namely the pressure to achieve corporate goals, the organisation’s ideology and practices, risk-taking, or the anxiety to reap some sort of rewards. All these factors, it could be argued, lead to the development of a “corporate mind” which is completely attuned to the corporate environment and to the concerns and conducts that are expectable and acceptable from peers and superiors.\textsuperscript{12}

Turning then the attention to practical cases, from Enron and Parmalat to more recent ones, it can be observed how different fraudulent schemes reached similar results. Each scheme in fact was designed to serve the needs of those in control of the business: managers at Enron sought to inflate earnings to maximise the

\textsuperscript{9} See A. Doig “\textit{Fraud}”, Willan Publishing 2006, ch.5.

\textsuperscript{10} It is worth pointing out that there is literature that proposes a further explanation to criminal behaviours arising from business conducts. It suggests that the unlawful behaviour is often a by-product of business activity and as such appears as intrinsic and \textit{prima facie} legitimate business strategy, a response to the pressure arising from the corporate environment. This trend finds to an extent confirmation with what is said later about Parmalat, where some of the fraudulent strategies were designed to keep the company afloat and avoid or delay business failures. See S. Wilson “Collaring the Crime and Criminal?: Jury Psychology and some Criminological Perspectives on Fraud and the Criminal Law”, \textit{Journal of Criminal Law} 70(1) 75-92, 2006; D. Nelken “White Collar Crime” in “The Oxford Handbook of Criminology”, by M. Maguire et al., 1994.

\textsuperscript{11} Supra Doig 2006 p.91.

\textsuperscript{12} Ibid p.94,95.
share value, while in Italy the controlling owner endeavoured to hide diversion of assets into his personal accounts from minority shareholders and creditors. Northern Rock and Lehman Brothers, examined in the next chapter, involve a broader issue because the scandals were the result of a huge market bubble that led banks’ executives to ride recklessly the wave of market euphoria, by giving low-quality loans which had little or no chance of being repaid. This was however again achieved through the employment of the same financial mechanisms that marked the present case study of Enron and Parmalat, and for this reason it is worth reflecting on how a fundamental component of financial scandals has reiterated after almost a decade with little or no legislative correction.

5.3 – The Enron bankruptcy
The Enron collapse represented a remarkable event from many points of view. It was probably the biggest bankruptcy in history, its proportions and consequences being unprecedented. What is even more striking however, is the impact it had on the American capitalist system as a whole and more specifically on that corporate governance system that was considered a sophisticated and safe operational platform for corporations worldwide.

In the 1990s, when American stocks were leading the world and index peaked at record heights, Enron was at the zenith of its growth and was repetitively acclaimed as one of the most innovative firms on the market by the Wall Street financial press. Enron stock prices continued a spectacular rise until late 2001, when a series of revelations concerning accounting frauds and executives

13 Supra Coffee 2005, p.3.


15 It was the biggest bankruptcy in the US history, costing 4,000 employees their jobs, and leaving an estimated $23 billion in liabilities, both debt outstanding and guaranteed loans, with a stock price falling from over $90 to $0.61. See “The 15 Largest Bankruptcies 1980 – Present”, www.BankruptcyData.com.

16 The Anglo-American “outsider model” of corporate governance, coupled with global capital markets was supposed to be the most competitive model, especially when compared to the “insider” system of European countries. See H.B. Hansmann and R. Kraakman “The End of History for Corporate Law” 89 Georgetown Law Journal 439 (2001).

17 See N. Stein “The World’s most admired companies. How do you make the most admired list? Innovate, innovate, innovate!”, Fortune magazine, October 2, 2000.
misconducts led the way to the historical fall of the seventh largest corporation of the
United States and six-time winner of Fortune Magazine’s award. Enron’s downfall
was coincidentally followed by other scandals, among which WorldCom, Tyco and
Adelphia, which presented similar patterns in the way the frauds had been committed
through accounting irregularities.\textsuperscript{18}

The immediate consequence to the above scenario was a loss of confidence in
the stock market, especially from those groups who suffered the heavier losses after
the scandal, like employees, whose pension schemes were tied to the share value of
the company. As said, the reaction was prompt from American authorities, since the
Congress enacted a new piece of legislation, known as Sarbanes-Oxley Act\textsuperscript{19}, just
few months after Enron filed for bankruptcy.\textsuperscript{20} The accounting irregularities and
more specifically the process by which accounting and audit firms should have
exercised their controlling functions represented the core of the new regulation,
which was generally speaking designed to prevent new corporate governance failures
also by imposing tighter obligations on senior executives.

In analysing the Enron scandal it is possible to single out two aspects of the
corporate failure: on one hand the corporate governance failure, especially with
regards to the role of gatekeepers who, in their different functions, did not prevent
the making of the frauds and sometimes even contributed to the structuring of
fraudulent transactions. On the other hand, irrational and risky managerial strategies
(corroborated by a deficient governance structure) led to the serial application of
financial transaction that eventually led to collapse. A brief account of the rise and
fall of the Texas corporation will help defining the legal issues underlying this
financial scandal.

5.3.1 – The background

Enron was formed in 1985 through the merger of two gas companies, Houston
Natural Gas and InterNorth, which gave way to the USA’s largest gas pipeline

\begin{footnotes}
\item[18] See J. Armour and J.A. McCahery “After Enron: Improving Corporate Law and Modernising
Securities Regulations in Europe and the US”, \textit{Amsterdam Centre for Law and Economics}, Working

\item[19] Public Company Accounting Reform and Investor Protection Act 2002, known as Sarbanes-Oxley
Act.

\item[20] Supra Armour and McCahery, 2006.
\end{footnotes}
system. It is worth pointing out that in Enron’s steep rise in the energy market, the concept of deregulation was paramount to success. Kenneth Lay, founder, Chief Executive Officer and then Chairman of the company had always been keen on that ideology and through his lobbying power in Washington he participated in the crusade for deregulation laws to be passed, in order to “liberate businessmen from the rules of regulation of government”. The newly deregulated energy market proved in fact vital for Enron’s trading activity to prosper.

Since its beginnings Enron was characterised by an innovative and intrepid managerial style, which in the early 1990s was complemented by the hiring of Jeff Skilling, as Chief Operating Officer first and then as CEO. Under Skilling’s leadership Enron developed the new idea of working as a “Gas Bank”, operating as intermediary between suppliers and end-users in the gas market. In particular the main innovation brought about in the energy market was the use of risk management products and long-term contracting structures which resulted in combining financial contracts and contracts for the physical delivery of goods traded. In the 1990s it became also clear that the focus of Enron business was rather in the trading operations of financial securities based on energy commodities, than in the trading of physical assets. Moreover, the growth during this period was related to and dependant on acquisitions in the energy market and on substantial capital investments which often took years to deliver significant earnings. The management however, strongly believed in the future success of the company and in the cash flow that it would eventually generate.

A key aspect of Enron strategy and of its governance structure was the vast use of Special Purpose Vehicles (SPV or SPE) made by the management. SPVs were structured as separate entities to which Enron would contribute assets, in order for the SPV to borrow from capital markets, issuing securities to investors backed by the underlying assets contributed by Enron. Such schemes would guarantee an investment grade credit rating that was vital for Enron to maintain trading

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operations.\textsuperscript{23} These transactions, coupled with a very peculiar corporate governance structure, gave way to the financial engineering that led the Houston group to bankruptcy.

The accounting problems came to light in 2001 as Enron had to restate its financial statements for the period 1997–2000 to reflect the consolidation of some previously unconsolidated SPVs. This event generated concerns from the specialised press about the company and its financial problems, since the firm’s debt ratio had not reflected the situation of the unconsolidated SPVs.\textsuperscript{24} Although Enron’s profits started declining by the end of the 1990s, the general public became aware of the firm’s financial difficulties only in 2001, when Enron’s share price dropped to less than a dollar in November. It is safe to state that the firm’s decline was a quick one, regardless of the public perception, for two main reasons. Firstly, the long-term contracts that Enron concluded with its counterparts entailed an element of trust that Enron could perform its obligations throughout the term of the contract; once Enron’s credit rating declined, its counterparts refused to trade, simply withdrawing their cash balances held with Enron and requiring cash collateral. These actions created further financial pressure as well as a liquidity crisis. Secondly, what also enhanced Enron’s vertical decline was the exposure to contingent liabilities related to its off-balance sheet SPVs. Once the credit problems appeared in their magnitude, Enron’s ability to obtain credit and support its trading vanished completely and brought the business to a halt.\textsuperscript{25}

5.3.2 – The governance failure
The corporate governance structure in place at Enron represents the first element of the scandal to be analysed in order to understand the ensuing collapse. From different perspectives the roots of the debacle lie in multiple governance failures, both internal and external as it will be observed. On paper the Enron board was a perfect one – especially when compared to some continental counterparts, like the

\textsuperscript{23} Ibid p.9. This closely resembles the structure of securitisation transactions, even though it is notably argued that the transactions in place at Enron are not classifiable as securitisation. See S.L. Schwarcz “Securitization Post-Enron”, Duke Law School Research Paper No. 38, 2003, p.9,10.

\textsuperscript{24} Supra Gillian and Martin 2002, p.11.

\textsuperscript{25} Ibid, p.8,9.
Parmalat board – composed by fourteen members, of whom only two were insiders; most of the outsiders had relevant business experience in the fields of finance and accountancy, and in management roles in other boards. Moreover, most of the directors owned stock in significant amount as they all received stock options as part of their compensation schemes. It is also pointed out that the audit committee had a state of the art charter which made it the “overseer of the company’s reporting process and internal controls with direct access to financial, legal, and other staff and consultants of the company, and the power to retain other accountants, lawyers, or consultants as it thought advisable”. In other words, Enron’s board structure appeared to be at the leading edge of best governance practice, as confirmed by the review of best corporate boards where the Chief Executive Magazine included Enron among the five top boards in the US.

However, in the aftermath of the scandal, it was reported by the Enron Special Investigation Committee that the board had been inefficient in its main duties, particularly with regards to the audit committee. The acclaimed independence of its directors was in fact repeatedly compromised by conflicts of interest arising as a consequence of side-payments and by bonds of long service and familiarity. A peculiarity of the Enron governance which serves as an explanation to the above mentioned conflicts of interest is the sui generis structure that allowed the Chief Financial Officer Andrew Fastow to run independent entities that entered into risky and volatile transactions worth billions of dollars. Other senior officers were also allowed to profit from self-dealing transactions, without the supervision or the full

26 The two insiders were the Chairman and former CEO Kenneth Lay and the CEO Jeffrey Skilling.


28 Supra Gillian and Martin 2002, p.22. The board subcommittees included audit and compliance, compensation and management development, executive, finance, and nominating and corporate governance.


30 Supra Gillian and Martin 2002, p.23. See also S. Shapiro “Collaring the Crime, not the Criminal: Reconsidering the Concept of White Collar Crime”, American Sociology Review, 1990 Vol.55 (346 – 365). Directors as trustees or fiduciaries are not only custodians of property since they may be entrusted with discreitional powers such as to imply the allocation of corporate assets and resources. Some agents are in a position to exercise these powers for their personal benefit, by self-dealing.
understanding of the board concerning their outcome. Moreover, these transactions were realised through a complicated network of subsidiaries employed in off-balance sheet partnership with Enron.  

The US Senate investigation on the role of the Enron board in the company’s collapse, sought to specifically address the issue of directors’ independence. The findings confirmed what was just mentioned, highlighting numerous financial ties between the company and certain directors, especially in the form of consulting fees paid in addition to board fees, and transactions with entities in which directors played a central role. It has been suggested that six out of twelve non-executive directors had potential conflicts of interest through financial ties, and most of these directors were members of the audit and finance committees, enhancing therefore the detrimental effects of their conflicts of interest.

Another aspect of the Enron governance system that can be pointed at as a reason for the board’s inefficiency is the compensation policy. The appointment of directors of public corporation, especially when sitting in high profile committees, often requires substantial remuneration, yet the high compensation can have the two-side effect of hindering directors’ critical approach and independence, since a sharp questioning of management’s decisions may play against re-appointment. Also, stock-based compensations can produce undesired effects since pursuing and protecting the share price can lead to short-term decisions conducive to conflicts. The importance and the advantage of stock option as a means to align managers’ and shareholders’ different goals can be compromised by the level of stock option granted to managers. An excess in the amount of option can in fact bring about two problems which arguably have been at work in the Enron case: the fraudster and the


33 Ibid.


35 A broader analysis of stock options is conducted in ch.3.
risk-preferring executive. It is observed that managers with a large load of options have incentives to get the share price high, by any possible means, fraud included; and that can be achieved often through risky practices that can diminish the value of the firm itself, but increase the value of managers’ firm-related investments. It is safe to say that stock option compensations played a central role at Enron and it has been suggested that the range and amount of stock options was far higher than the average of Enron’s peer group. This can be read as a reason behind some board’s behaviours, namely the attenuation of careful monitoring of management practices, especially concerning those designed to preserve the firm’s credit rating.

Generally speaking, the Enron board was repeatedly deficient in its controlling functions and this trend is particularly evident with regards to transactions involving the approval of SPVs and the subsequent monitoring of those partnerships. All in all it can be said that at several important junctures the board simply ignored red flags that could have restrained certain managerial actions that eventually led to the collapse.

5.3.3 – The gatekeepers’ failure

As part of the broad governance failure, the breakdown of general gatekeepers’ functions became evident during the years between Enron and Parmalat, with most of these scandals exposing malfunctions in the areas of accounting and audit most

36 Supra Gordon 2002, p.14. See also D. Skeel Jr. “Icarus and American Corporate Regulation”, in “After Enron: Improving Corporate Law and Modernizing Securities Regulations in Europe and the US”, by J. Armour and J.A. McCahery, 2007. It is observed that stock options reward risk, since options are all upside and no downside: there is no cost to the CEO if he gambles with the company’s business and the stock price plummets.

37 Supra Gordon 2002, p.15. Gordon observes that if options grants are large and exercisable in the short term, a positive swing in the market price can make executives very rich; but even if the stock price falls back, the well-timed option can be very advantageous.

38 Ibid.

39 As a matter of principle, if bonuses are based on performance thresholds, managers will be expected to manipulate earnings in order to reach those thresholds. See P. Healy “The effect of bonus schemes on accounting decisions”, Journal of Accounting and Economics, 7 85-107 1985.

40 Supra Gillian and Martin 2002, p.25; it is interesting to note that in October 2001 the Wall Street Journal suggested that Fastow had earned more than $7 million through compensations from one of the SPVs he had created; previously a report from the finance committee had requested further information about Fastow’s compensation, but eventually when the information was not provided by the senior compensation officer, the matter was just dropped.
prominently. This label, as said in the introduction, led to the prompt enactment in the US of the Sarbanes-Oxley Act in 2002.

Enron is regarded as a systematic failure of gatekeepers to detect and prevent the irregularities that led to the bankruptcy. This same approach is shared with regards to other financial scandals, from WorldCom in the US to Parmalat in Italy, in which the market realised that it could no longer rely on professional gatekeepers as a filter to verify and assess financial information. Enron has been prominently referred to as demonstration as well as the peak of gatekeepers’ failure, which in turn raises the question of how to rectify this particular governance breakdown.\(^\text{41}\)

The role of gatekeepers\(^\text{42}\) within corporate governance should be to assess a corporate client’s own statement or a specific transaction. In the United States the role of statutory auditors was defined with the Securities Act 1933 and with the Securities Exchange Act 1934, at a time when the markets had been hit by the Great Depression. These Acts required companies issuing securities in the stock markets to have their financial statement certified annually by professional and independent accountants, acting therefore within that function as watchdogs in the public interest.\(^\text{43}\) In theory this public interest function should be supported by the fact that gatekeepers have less incentive to lie than their clients, and their evaluation of relevant facts should be more trustworthy. Credibility stems in turn from what is defined the “reputational capital” that gatekeepers pledge and which is attained after many years of performing the same services for a number of clients. The assumption is that gatekeepers would not sacrifice their reputational capital for a single client and for a fee which is deemed to be modest when compared to the whole clients’ portfolio.\(^\text{44}\) However, evidence from the last decade shows a different picture and suggests that gatekeepers do acquiesce and sometimes even contribute to the

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\(^{41}\) Supra Coffee 2002, p.6.

\(^{42}\) Ibid p.7. Gatekeepers can be defined as intermediaries who provide verification and certification services to investors: auditing firms verify companies’ financial statements; debt rating agencies evaluate creditworthiness of a company; securities analysts assess companies’ business and financial prospects; investment bankers appraise the fairness and viability of specific transactions.

\(^{43}\) Supra Gillian and Martin 2002, p.27,28.

\(^{44}\) Supra Coffee 2002, p.6.
managerial fraud perpetrated by their clients, even though this behaviour may seem irrational and not in line with the above assumption.  

The question to address then, in the context of gatekeepers failure, is to understand the reason why they let their clients engage in frauds. Arthur Andersen was Enron’s auditor at the time of the collapse and the firm could count on a portfolio of around 2,300 audit clients; it seems therefore that they had little incentive to risk such a reputational capital for one client, as big as Enron could be. This reputation theory also represents a landmark within courts’ interpretation on these matters, as documented by Judge Easterbrook in *DiLeo v. Ernst & Young*. Arthur Andersen – a firm that could boost revenues for over $9 million in 2001 – became involved in a series of securities frauds in the 1990s that in the last few years of its life culminated with the association with the Enron scandal.

Generally speaking during the 1990s the standard of financial reporting went down, with an increasing average of earning restatements by public companies that indicated that previous earning management had completely gone out of hands. In other words the big accounting firms had earlier acquiesced in earning management – premature revenue recognition above all – that could no longer be sustained. This trend can be extended to other consulting functions beyond the audit. Securities analysts in fact were even more jeopardised after Enron since in 2001 sixteen out of seventeen analysts were still recommending a “buy” or a “strong buy” on Enron’s

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45 See R.A. Prentice “The Case of the Irrational Auditor: A Behavioural Insight into Securities Fraud Litigation”, *95 Nw. U L Rev.* 1333 (2000). The Enron case represents a typical situation where auditors had an interest in not investigating the company’s accounting arrangements too closely or disagreeing about transactions proposed by the management in order to preserve the increasingly more valuable non-audit services with the company. See also P. Davies “Enron and Corporate Governance Reform in the UK and the EC”, in “After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US” by J. Armour and J.A. McCahery, 2007.

46 Supra Coffee 2002, p.7. It is suggested however that a principal/agent problem may still arise since an individual partner within an audit firm could be dominated by a large client and might therefore defer to him to the detriment of the firm. This was precisely the case at Enron, which was by far the main client of Arthur Andersen’s Houston branch.

47 901 F.2d 624 (7th Cir. 1990). Judge Easterbrook confirmed that “... An accountant’s greatest asset is its reputation for honesty, closely followed by its reputation for careful work. Fees for two years’ audit could not approach the losses that the auditor would suffer from a perception that it would muffle a client’s fraud ….”.

stock.\textsuperscript{49} Once again, the desire to retain some sort of reputation and to be perceived as credible and objective was in that case superseded by the necessity to please investment banking clients.\textsuperscript{50}

It is easily assessable within the study of the Enron collapse that none of the watchdogs, who could have detected signs of the frauds, did so until the very last moment, when the downfall was inevitable. Two different explanations have been proposed for this collective gatekeepers’ malfunction that compromised the overall corporate governance system.\textsuperscript{51} The first theory focuses on the decline of the expected liability costs arising out of acquiescence by auditors. This explanation is grounded on the fact that the risk for auditors’ liability declined while at the same time the benefit of acquiescence increased. The reason for this can be traced in a decline in the threat of private enforcement as well as in a fall down in the prospect of the public one. On the other hand, the benefits of acquiescence rose as a result of the big audit firms’ strategic behaviour in the market, since they combined multiple consulting services, using the audit as a portal of entry to get big clients. From another perspective, this combination of consulting services with audit services enabled clients to exercise a form of pressure over the audit firm in a “low visibility” way. Without having to fire the audit firm and incur in public embarrassment and potential investigations, the client who was dissatisfied with the auditor’s intransigence, could still terminate the consulting relationship, depriving the audit firm of the largest source of revenue.\textsuperscript{52}

The second explanation relates to the so called market bubble or rather market euphoria of the 1990s, during which the role of gatekeepers became “irrelevant”. As stock prices kept soaring, gatekeepers were seen as troublesome from management’s perspective as their red flags would have dissuaded potential

\begin{footnotesize}
\textsuperscript{49} Ibid. According to a study conducted by Thompson Financial, the ratio of “buy” to “sell” recommendations increased from 6 to 1 to 100 to 1 in the period between 1991 to 2000.

\textsuperscript{50} Ibid.

\textsuperscript{51} Ibid p.11.

\textsuperscript{52} Ibid p.12-16. See also S. O’Conner “The Inevitability of Enron and the Impossibility of Auditor Independence under the Current Audit System”, available at ssrn.com/abstract=303181, 2002. The conflict of interest was evident at Arthur Andersen: It is documented that Andersen’s employees had concerns about Fastow’s involvement in the SPVs, but eventually they were not communicated to Enron’s audit committee.
\end{footnotesize}
investors. In that context auditors became as acquiescent and low-cost as possible. This same explanation can be applied to securities analysts who were overwhelmed by the boom of the IPO market and became the principal means by which investment banks could compete for IPO clients as underwriters.\textsuperscript{53}

Understanding Enron from the perspective of gatekeepers’ failure would also entail a minimum level of understanding of American accounting rules, which differ from those in place in most other jurisdictions. The next section will examine how the Enron management profited from a perverse use of these rules, combined with a bold exploitation of certain financial transactions. It can be stressed that Enron was the result of a “rule-based” system of accounting, whereby gatekeepers are only asked to certify the issuer’s compliance with a set of rules, without the auditor taking responsibility for the accuracy of the issuer’s statement. The widespread reaction to this was that the SEC called for a “principle-based” system, which would require the auditor to not simply certify compliance with the GAAP (Generally Accepted Accounting Principles), but rather to confirm that the issuer’s financial statement reflected its financial position.\textsuperscript{54}

\subsection*{5.3.4 – The financial engineering}

As already suggested, one of the features that explains Enron lies in certain managerial strategies and risky transactions employed. Structured finance\textsuperscript{55} is in itself a difficult area of law to fully understand and transactions therein are not always easy to assess as regards the risk they entail. Off-balance sheet financing, mainly in the shape of securitisation, represented a key tool for the Enron management to raise finance through capital markets, often coupled with high-risk derivatives transactions. The idea reflected by the Enron management in hindsight, is that it employed different means to disguise the rapid rise of debts: generally speaking Enron was consistently hedging\textsuperscript{56} part of its investments through the use of

\begin{footnotes}
\item[53] Supra Coffee 2002, p.17.
\item[54] Ibid p.24.
\item[55] A structured product is defined as a security derived or based on another security, for instance bond, baskets of securities, index, commodity, foreign currency. See SEC Rule 434; Securities Act Release No.42746 (May 2 2000).
\item[56] In finance hedge is an investment that is taken out specifically to reduce or cancel the risk in another investment. It is a strategy designed to minimise exposure to an unwanted business risk, while
\end{footnotes}
structured finance transactions, with the purpose of minimising financial statement losses and avoid to add debt to its balance sheet as this would have damaged the credit rating. It is correct to say that the primary motivation behind the employment of these strategies was to achieve accounting, rather than operative results.  

Before looking into details of the complex web of transactions that characterised Enron’ business, it is worth pointing out that an important factor in the achievement of the frauds consisted in the exploitation of the American accounting rules, whose legal use was stretched to the very limits. Under the GAAP it is common practice to record assets and liabilities arising from trading and other operations at market values, rather than at historical cost. This practice, known as mark-to-market accounting is also widespread for equity and bond trading among financial institutions, whereby assets are carried on the balance sheet at their market or fair value. Although market-to-market accounting can increase transparency concerning the real value of corporate assets, problems may arise when market values are not available; in that case the required market valuation involves subjective estimates that can affect the reliability of the company’s balance sheet. This was precisely the case at Enron, where the company recorded values of complex transactions which could not be confirmed by tangible and objective market values.

The accounting treatment was accompanied, as said with regards to the Enron governance structure, by a vast network of SPVs. It has been confirmed by the Powers Report that the use of non-consolidated vehicles was at the heart of Enron corporate structure and it also represented the means through which transactions were carried out. A typical transaction would see Enron transferring its own assets to an SPV in exchange for a note or cash; Enron would also provide a cross-guarantee still allowing the business to profit from an investment activity. See R.M. Stulz “Rethinking Risk Management”, Journal of Applied Corporate Finance, volume 9, number 3, 1996.


as a credit enhancement for the SPV’s value. The SPV would in turn hedge the value of a particular investment on Enron’s balance sheet, using Enron’s assets as source of payment.\textsuperscript{61} What the management at Enron did not predict was the fall of its stock value, which of course entailed the plunge of the SPVs’ value as well; this in turn triggered the payment of the guarantees provided by Enron since the SPVs would lack at that point sufficient assets to perform their hedge.\textsuperscript{62} Another consequence of the decline in share value was the breach of the three percent independent equity requirement for non-consolidation\textsuperscript{63}, which added the SPVs’ debts to the already alarming Enron’s balance sheet.\textsuperscript{64}

The problem therefore with the use of SPVs was not only a governance one, as analysed in the previous section, but it related to the huge level of contingent liabilities that were not consolidated with the company’s balance sheet. In other words, Enron was funding its growth through the syndication of capital investments in off-balance sheet SPVs.\textsuperscript{65}

An interesting example that illustrates this form of hedge transactions is given by the relationship between Enron and LJM Cayman L.P., an entity formed in 1999 directly by CFO Andrew Fastow who served as its general partner, in breach of the Enron’s code of conduct and more generally of the fiduciary duties that bound him to the company.\textsuperscript{66} LJM was created with the purpose to raise funds in order to hedge Enron’s merchant investments in other partnerships and to acquire other assets in Enron’s merchant portfolio. Among the transactions between Enron and LJM, one

\textsuperscript{61} Supra Schwarcz 2002, p.1311.

\textsuperscript{62} Ibid.

\textsuperscript{63} Under accounting rules, owning not more than 50% of a partnership (like JEDI or Chewco in Enron’s case) avoids consolidation with those entities. Another way to minimise the applicability of this 50% requirement for a company is to create a SPV with only a tiny slice of equity, to be easily assigned to an outside investor. In this case, the sufficient minimum capital from an independent source, that would avoid consolidation with the SPV, is considered to be 3%. See, F. Partnoy “Enron and Derivatives” EFMA 2003 Helsinki Meetings, available at SSRN: http://ssrn.com/abstract=302332.

\textsuperscript{64} Supra powers Report. The Powers Report observed that the financing structure Enron created for certain SPVs was at least 50% short of the required third party equity needed for non consolidation, because a portion of such equity was protected by reserve accounts funded by Enron.

\textsuperscript{65} Supra Gillian and Martin 2002, p.17.

\textsuperscript{66} Supra Schwarcz 2002, p.1312.
in particular raised concerns as it represented the first time that Enron transferred its own stock to an SPV and then used the SPV to hedge the value of a merchant investment.\textsuperscript{67} The background for this hedge was a $10 million investment in a partnership called Rhythm NetConnection in 1998 (chart 5.1); a year later Rhythms went public and the Enron management decided to hedge the unrealised gains (which had already been booked using mark-to-market accounting) of around $300 million. The solution therefore, to avoid any decline in Rhythm stock to be reflected on Enron’s income statement, was to hedge the Rhythm investment with LJM.\textsuperscript{68}

It is worth pointing out that LJM’s funds came in part from Fastow and from other investors, while the remainder came from the use of “trapped” value of forward contracts\textsuperscript{69} which the company had entered into with investment banks to purchase its own shares. When the company tried to release the value of the forward contracts in order to keep it as income, this implied another intricate procedure: firstly, settling the forward contracts in return for shares of Enron stock; secondly, selling these shares to LJM for a note receivable and then a put option\textsuperscript{70} on the Rhythm shares. The critical point of this transaction was that the LJM’s ability to honour the put option was contingent on the value of the Enron stock it owned; therefore it can be said that the value of Enron’s Rhythms put was relying on Enron’s share price itself. In other words, the put option was only utilised as a device to hedge earnings and resulted in no economic gain to Enron.\textsuperscript{71}

\textsuperscript{67} Ibid. This was done to hedge Enron’s investment in the stock of another partnership, Rhythms NetConnection.


\textsuperscript{69} A forward contract represents an agreement between two parties to buy or sell an asset at a pre-agreed future point in time. Therefore, the trade date and delivery date are separated. It is used to control and hedge risks related to other investments, for example currency exposure risk or commodity prices like in this case. See P.R. Wood “Title Finance, Derivatives, Securitisation, Set-off and Netting”, Sweet and Maxwell London 1995, ch.2.

\textsuperscript{70} Options are financial instruments that convey the right, but not the obligation, to engage in a future transaction on some underlying security, or in a futures contract. For example, buying a call option provides the right to buy a specified quantity of a security at a set strike price at some time on or before expiration, while buying a put option provides the right to sell. Upon the option holder’s choice to exercise the option, the party who sold, or wrote, the option must fulfil the terms of the contract. Supra Wood 1995, ch.2.

\textsuperscript{71} Supra Gillian and Martin 2002, p.16.
Other similar transactions were carried out between Enron and its SPVs, with similar objectives to the above ones. These transactions were referred to as “Raptors” and had usually great impact on Enron’s balance sheet, through the use of derivative transactions that followed the same structure just outlined. The slight difference is that some of these Raptors took the form of “total return swap”\textsuperscript{72} on Enron’s interests in merchant investments, with the consequence that the arrangement would only have worked if the SPVs had the capacity to meet their obligations. But again this capacity depended mostly on the value of the SPV’s principal asset, which was Enron stock.\textsuperscript{73} When the value of Enron investments started to fall, this caused the Raptors to suffer losses since the hedges were based on those underlying investments; similarly, as Enron’s share price declined, the Raptors’ ability to honour the hedge was compromised.\textsuperscript{74}

It can be concluded that the rapid decline that led to Enron’s bankruptcy was mainly linked to an aggressive and reckless use of derivatives and securitisation transactions, through a network of off-shore vehicles. It has been prominently observed before the United States Congress that by the time the bankruptcy became public, Enron had developed from an energy firm into a derivatives trading firm, and that could be recognised by the characteristic layout of the new building where the top floor was overlooking the derivatives trading pit below.\textsuperscript{75} Derivatives are extremely complex financial instruments that, unlike securitisation, belong to the finance world more than to the legal one and for this reason they appear too impenetrable to be understood by the average investor. The value of derivatives is based in fact on one or more underlying variables, like the price of stock or the cost of natural gas; moreover the market for derivatives where Enron engaged is mostly an unregulated one, since under US securities law, derivatives were not deemed

\textsuperscript{72} In finance, a swap is a derivative in which two counterparties agree to exchange one stream of cash flows against another stream. These streams are called the \textit{legs} of the swap. In our case the SPV agreed to receive future gains on Enron’s investments, but also agreed to pay Enron any losses incurred over the period of the swap. Supra Wood 1995, ch.2.

\textsuperscript{73} Supra Gillian and Martin 2002, p.17.

\textsuperscript{74} Ibid.

\textsuperscript{75} Supra Partnoy 2003.
securities and were not even audited.\textsuperscript{76} As suggested, Enron used derivative transactions to essentially manipulate its financial statements and this happened in three ways: firstly, by hiding huge losses suffered on technology stocks; secondly, by hiding debts incurred to finance unprofitable new ventures; and thirdly, by inflating the value of other already troubled businesses. All in all, it can easily been observed that most of these derivatives transactions did not involve energy at all.\textsuperscript{77}

The use of securitisation transactions represented another means for the Enron management to manipulate the balance sheet, transferring bad debts to off-shore partnerships that slowly became some sort of black holes. Securitisation is normally used by companies to obtain lower-cost finance, through disintermediation, since companies have a direct access to capital markets without incurring costs related to banks intermediation. The controversial point in Enron’s transactions was that the transfer of risks between the originator and the SPV was ambiguous. The transfer of risks, referred to as a “true sale” is normally a key element of the transaction since it avoids consolidation from accounting and bankruptcy perspective. Although Enron had the right to require the SPVs to buy assets at a predetermined price in case the value fell, that right was precarious because the SPVs were capitalised exclusively with Enron’s stock. Consequently, once again, when the value of Enron’s stock collapsed, the SPVs were unable to perform the hedge as expected.\textsuperscript{78}


\textsuperscript{77} Supra Partnoy 2003.

\textsuperscript{78} Supra Schwarcz 2002, p.1315.
5.4 – Parmalat: Enron made in Italy

After the Enron scandal unfolded in all its magnitude, European markets felt somewhat relieved and altogether vindicated by the fact that such a sequence of corporate failures had occurred on the other side of the Atlantic. There was a feeling that the American corporate governance system was immune from such malfunctions and the balance of powers in place would have prevented similar events. From a different perspective, Americans had always looked at European corporate governance as a system jeopardised by underdeveloped capital markets and by ownership structures that did not allow full growth of corporate power. The Enron bankruptcy however, proved the point of those who had always highlighted the greed of American executives and the overwhelming power that they enjoyed within corporations as a threat that could lead to frauds; the same scenario in continental

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Europe would have been hindered just by that same denigrated ownership structure.81

In any case, not long after the Texas corporation filed for bankruptcy, Parmalat was uncovered as one of the most astonishing financial frauds in history, involving what was considered a stronghold of Italian industry, affecting a group with more than 200 companies and some 36,000 employees, and above all opening up the floodgates to what appeared to be a fraud carried out for more than a decade.

What triggered the insolvency was a communication sent by Bank of America to Parmalat’s auditors Grant Thornton, stating that the document confirming a bank account for a Cayman Island company was a forgery. This company was supposed to hold almost €4 billion of Parmalat’s group, but the money had never existed in real.82 It is interesting to analyse the facts that led to Parmalat demise as they constitute an intriguing comparison with what happened in the USA at Enron, not only from a corporate perspective, but overall from a socio-legal point of view.

5.4.1 – The background

Parmalat was founded in 1961, in Parma, mainly as a family business operating within the food trade. Its founder, Calisto Tanzi, appeared immediately to be driven by a desire to expand the business and the first chances to do so were represented by the commercialisation of pasteurised UHT (Ultra-Heat Treatment) milk, which had a long shelf life and was therefore suitable to be exported to distant destinations.83 Tanzi was also a pioneer in taking full advantage of the “Tetra Pak” packaging process which, by the beginning of the seventies, allowed Parmalat to gain a strong position in the dairy industry.84 The big leap anyway took place in the eighties, when the group started pursuing a policy of expansion into foreign markets, mainly in

81 M. Landler “Scandal Outrages Europeans; Solutions May Be Patchwork”, N.Y. Times, Dec. 25 2003, at C1. In other words, two different and divergent ways to address the agency problem.

82 M. Gerevini “Parmalat, ecco il fax che segnò la fine di Tanzi”, Corriere della Sera, December 18 2004.


South America, and further consolidated a position of market leader in Italy. During this period, thanks to political connections, Tanzi tried to venture into new and different markets, from the TV one, to tourism and sport. These ventures proved to be critical for the group and probably marked the beginning of the group’s financial difficulties. The enterprises in the TV business\(^{85}\) and tourism in fact soon confirmed to be a complete fiasco and the relatively low margins of profit generated by the dairy production were not sufficient to match the high expenditures required for the new investments. The strategy to be pursued at that stage was therefore to resort to the public market and conduct what is referred to as a reverse merger\(^{86}\), which was then achieved by acquiring 51% of Finanziaria Centro Nord, a public company whose stock was already traded on the Milan Stock Exchange. This transaction gave Tanzi the opportunity to access the public market with the new corporate vehicle – Parmalat Finanziaria SpA – of which he still maintained control.\(^{87}\) Moreover, the merger served several purposes, namely obtaining funds without a substantial dilution of ownership and also incurring less costs and a lower degree of disclosure than a direct IPO would have entailed.\(^{88}\)

\(^{85}\) Odeon TV probably represented the first fraud carried out by Tanzi. When the TV channel went bankrupt, Tanzi had to pay huge amounts of money because he had personally guaranteed Odeon’s debts. However, it came later to light that the money came from Parmalat and not from Tanzi. This was probably the first case in which Parmalat’s money was used to cover Tanzi’s debts in other areas of the business. See G. Ferrarini and P. Giudici “Financial Scandals and the Role of Private Enforcement: The Parmalat Case”, ECGI Working Paper Series in Law, 40/2005, p.6.

\(^{86}\) A reverse merger or reverse takeover occurs when a larger privately held company acquires control of a smaller company which is publicly traded. Through this operation, the private company will become public without having to go through the normal route of an IPO and filing a prospectus with the disclosure of information that this entails. The shareholders of the private firm usually receive a majority of the shares of the new public entity and take control of its board. The private company’s shareholders will pay by contributing their shares into the new public entity they control. See W.K. Sjostrom “The Truth About Reverse Mergers”, Entrepreneurial Business Law Journal, Vol. 2, 2008.

\(^{87}\) Supra Storelli 2005, p.771.

\(^{88}\) It needs to be pointed out that with the enactment of the EU Transparency Directive 2004/109 the above scheme would have not sorted the same effects. The Directive introduced new transparency requirements with regards to information on issuers whose securities are admitted to trading on a regulated EU market. The Directive in particular regulated the publication of periodic financial reports (mandatory periodic disclosure obligation). More specifically, such disclosure consists in the publication of price-sensitive information on a continuous basis, and in this context of particular relevance are the changes to important shareholding, whereby the threshold was lowered to 5%. This means that in the context of acquisitions or disposals of shareholdings, where the proportion of voting right of the issuer held by the shareholder as a result of the acquisition or disposal, reaches or exceeds a certain threshold, disclosure is required (art.9 and 12). In the context of the Parmalat reverse
In the 1990s Parmalat launched a new more aggressive acquisition campaign, regardless of the financial difficulties experienced the 1980s. The group consolidated and then increased its presence abroad, with the ambitious goal in Tanzi’s mind to become the “Coca Cola of milk”\(^8\). In doing so, he tried to expand to different markets beyond the dairy one and mainly funded those risky operations by raising capital through the public market. During this period the interaction between the group and investment banks became intense since the group engaged in a number of bond issues\(^9\). This policy of unrestrained expansion was what ultimately led to irreversible financial troubles. The risks related to the new investments were in fact misjudged and as already mentioned mostly resulted in failures\(^9\) that cost the group a high price mainly because of increasing debt and lack of liquidity which was not supported by consistent profits. The new ventures in other words were sustained by debt incurred through continuous borrowing which Parmalat accumulated without reaping any profits in most cases; this trend further drained the company’s accounts and doubts started to creep among investors as to the real stability of the group\(^9\).

The South American financial crisis of 2001 and the Cirio scandal\(^9\) in 2002 somewhat endangered Parmalat’s situation since the cost of capital increased and this exposed the company to a higher cost of borrowing; moreover, in 2000 Standard & Poor had already rated Parmalat with a BBB- grade, which was the lowest possible investment grade. Tanzi’s policy anyway was to continue to borrow money from investors through bond issues, and to do so he needed to reassure the market takeover then, had the Transparency Directive been in place, it would have substituted the sort of disclosure that the group avoided by bypassing the obligations related to the IPO.


\(^{9}\) Supra Ferrarini and Giudici 2005, p.7.

\(^{9}\) Parmatour epitomised one of the failures of this period of Parmalat’s history. The company involved in the tourist business was run by Tanzi’s daughter and was not a Parmalat’s subsidiary. However, it later came to be known that huge sums of money had been siphoned from Parmalat for the benefit of Parmatour. See Repubblica, Mar. 8 2004, at www.repubblica.it/2004/b/sezioni/economia/parmalat11/scarcer/scarcer.html.

\(^{9}\) Supra Storelli 2005, p.772.

about Parmalat’s financial position. It was exactly at this point that Parmalat’s managers began “cooking the books”, making in other words major adjustments to the accounts in order to give a healthier image of the company. This practice was carried out by simply forging documents and through a variety of fictitious transactions whereby fabricated receivables recordable as assets were sold to SPVs. 94

Off-balance sheet financing, mainly in the form of securitisation, became in this phase a common tool for Parmalat’s CFO Fausto Tonna, to hide losses and create accounting dumps. 95 This mechanism however needed to be nourished because of the amount of interest rates to be paid on the various loans. Parmalat therefore went on pursuing its policy of issuing bonds, but when in 2002 they issued a €306 million convertible bond this caused their stock price to fall. Market observers 96 started to wonder why Parmalat was still borrowing, adding debt at a high rate, when its books showed profits and cash available for €1.4 million. 97 In 2003 then CONSOB 98 increased its controls on the group, following a negative stock market reaction to another attempt to issue bonds.

The fall in stock price was also related to a poor quality of disclosure (which was addressed as arrogant and opaque, just like in the case of Enron) that characterised Parmalat management and generally speaking the relationship with those gatekeepers who were trying to acquire information. 99 This attitude forced the group to attend a meeting with both CONSOB and Banca d’Italia in order to explain their policy and clarify the reasons behind the strategy of issuing bonds at very unfavourable conditions. At the same meeting they announced that the CFO had


95 Ibid.

96 It is interesting to read a recommendation written by one of UBM (Unicredit Banca Immobiliare, one of Parmalat’s underwriters) analysts who said: “As for the debt refinancing issue, we argue that post-Cirio and owing to the higher risk perception following the instability in South America, refinancing expiring debt at a reasonable cost has become harder. Moreover the group has shown no intention to use its Euro 3.3 billion cash pile. This point would need to be accurately assessed with the management, which however, continues to remain unapproachable”. Supra Ferrarini and Giudici 2005, p.9.

97 Supra Storelli 2005, p.776.

98 Commissione Nazionale per le Società e la Borsa, the equivalent of SEC in the USA.

resigned and a new one had just been appointed, Alberto Ferraris, a former Citi Group employee. This move was essential to the group’s strategy since the new CFO, thanks to his contacts in the banking industry, launched a wave of private placements, procuring the services of Bank of America and Deutsche Bank.\footnote{Supra Ferrarini and Giudici 2005, p.11.} However, the investment banks’ help did not solve Parmalat’s troubles; when Deutsche Bank announced a new private placement in September 2003 Standard & Poor further lowered the group’s credit rating to a level just above “junk” status.\footnote{Supra Storelli 2005, p.778.} When the company thereafter was requested by CONSOB to be more explicit about its accounts, more pressure mounted on the auditors, especially on the external ones Deloitte. They stated that they were not in a position to give a “fairness opinion” of Parmalat’s true value, since there was a grey area represented by a mutual fund in which the group had participation (the Epicurum fund, which will be analysed in more detail in the next section) and also by some complex “swap” transactions with the fund itself. At the same time another finding came to light as one of the group’s subsidiaries had entered into an obscure contract with a SPV created by Citi Group: Buconero (which in Italian means black hole).\footnote{Supra Storelli 2005, p.779.}

Parmalat’s agony came to an end when in December 2003 some of the bonds were due and the company publicly declared that they could not service them. At this point the credit rating was downgraded to “junk” status and Grant Thornton, acting as second auditor, was requested by CONSOB to investigate on a company in the Cayman Islands called Bonlat, which was supposed to hold €3.95 billion of the group’s cash. As said at the beginning of this account, the fraud ultimately unfolded at this stage.\footnote{Supra Capolino et Al. 2004, p.168.} Enrico Bondi was then appointed extraordinary commissioner; his attempt to try to establish the true status of the group’s consolidated balances, brought to a shocking result: there were debts for €14.3 billion and a complete lack of liquidity, which sharply contrasted with the group’s latest balance sheet. As the group’s insolvency procedure started, litigations commenced both on the criminal
side in 2004, and on the civil side in 2005, involving 27 defendants and some 7000 investors as plaintiffs.\textsuperscript{104}

\textbf{5.4.2 – The governance failure}

In simple words, the corporate governance structure of the Parmalat group was in plain contravention with the principles dictated by the Milan Stock Exchange. Unlike Enron, the Parmalat board exposed a deficient structure. Only four out of thirteen directors were independent and in the group’s history there was no hint of non-executive directors’ supervision over management. This happened for several reasons. First of all independent directors had no incentive whatsoever to perform their duties and provide an objective standpoint on the business, because they had been nominated thanks to personal ties with Mr Tanzi. Moreover, most of those directors had no expertise to cover that type of position and to dig into the group’s intricate business; this made them automatically acquiescent to Tanzi’s decisions.\textsuperscript{105}

The internal audit committee and the remuneration committee’s members were also linked to the group’s ownership and this hindered any effective mechanism of checks and balances.\textsuperscript{106} A further reason for the lack of non-executives supervision can be found in the absence of derivative litigation in Italy\textsuperscript{107}, since directors can only face lawsuits from bankruptcy receivers and that of course narrows the field of application for that remedy.\textsuperscript{108}

To draw a comparison with its American counterpart, Parmalat’s board was plainly unqualified, other than lacking independence. Tanzi in fact, who only had a high school diploma, covered the posts of both Chairman and CEO, and the CFO Fausto Tonna also had similar qualifications.\textsuperscript{109} This made the board largely

\textsuperscript{104} Supra Ferrarini and Giudici 2005, p.12.

\textsuperscript{105} Supra Dalcò and Galdabini 2004, ch.2; and Ferrarini and Giudici 2005, p.19. The same argument is valid to explain the inefficacy of the supervisory board to meet its duties.

\textsuperscript{106} F. Benedetto and S. Di Castri “There is Something About Parmalat (On Directors and Gatekeepers)”, \textit{Banca Impresa e Società}, 5/2005 p.211.

\textsuperscript{107} Italy has class action legislation now (D.Lg. 6/Sett./05 no.206, art.140bis). Consumer associations can file claims on behalf of groups of consumers to obtain judicial orders against corporations that cause injury or damage to consumers. See \url{http://www.classactionitalia.com/}.

\textsuperscript{108} Supra Ferrarini and Giudici 2005, p.20,21.

\textsuperscript{109} Supra Dalcò and Galdabini 2004, ch.2.
dependent on advice provided by external consultants, like lawyers, accountants and investment bankers, who all played an extremely important role in the frauds, since they often masterminded the strategies that led to the financial collapse.\footnote{The above is evidence of a different type of governance failure, compared to that of Enron.}

It is also worth reiterating that the second tier board, a typical feature of European corporate governance, was never effective at Parmalat in its duties of monitoring audit and accounts. It is argued however, that historically this body has never accomplished its tasks within the Italian governance system chiefly because its members are nominated by shareholders and tend therefore to be complacent with their willingness in a closely-held ownership scenario. For this reason, in 1975 a Company Law reform formally transferred the audit functions of listed companies to external auditors.\footnote{See art. 2409-bis Civil Code.} Then in 1998, another reform related to listed companies was enacted, limiting the statutory auditors’ (Collegio dei Sindaci under Italian Company Law) functions to two specific areas: firstly, the supervision of company’s compliance with relevant laws and statutes; secondly, the monitoring of company’s management, with particular regard to standards of good management and to organisational and management structures.\footnote{See art. 2403 (1) Civil Code.} In order to limit the board’s complacency towards controlling shareholders, the reform mandated that listed companies introduced clauses in the articles of association that enabled minority shareholders to appoint a statutory auditor if they represented a significant stake. At Parmalat anyway, this rule was somewhat circumvented because the required threshold set in the articles of association was 3\%, and it was not met.\footnote{Supra Ferrarini and Giudici 2005, p.35.}

However, it has been interestingly observed\footnote{Ibid.} that the Italian rules related to corporate governance are as strict as those provided under English and American Law, if not more stringent. The Milan Stock Exchange issued corporate governance recommendations to which listed companies have to either comply or explain. Substantive rules in other words should not be regarded as the main issue of this corporate failure, but what really marked a difference with the legal scenario of some
common law jurisdictions is the role of enforcement.\textsuperscript{115} It is fair to say that because of the absence of a real deterrent upon directors, both in terms of derivative litigation and class action, the governance issue falls back on gatekeepers, just like at Enron. The involvement of market players like Grant Thornton, Deloitte, Citi Group and Bank of America in the actions brought by the Commissioner is just a sign of the central role these professionals had, both for Parmalat and for investors.\textsuperscript{116}

**Gatekeepers and Parmalat**

The conceptual issues related to gatekeepers’ role and their presumed incentive to monitor their clients and thus perform a service in the public interest have already been examined in the previous section with regards to Enron.\textsuperscript{117} Yet empirical evidence from the Parmalat scandal showed that, just like at Enron, the incentives or disincentives, in the form of reputational disruption and legal liability, did not prevent gatekeepers from letting their clients engage in frauds and sometimes in planning them. The Parmalat case perfectly illustrated this trend, even to a greater extent than the Enron one.

Grant Thornton was Parmalat auditing firm since 1990 and under Italian law there is a mandating rotation of the audit firms after 9 years (the firm is appointed for three years and can be reappointed twice). In 1998 therefore the group faced the problem of having to choose new auditors, which at that time may have meant revealing to third parties the true picture of the company’s status and the purpose of some of the transactions in place.\textsuperscript{118} The solution then came from two Grant Thornton’s partners who suggested creating a new shield, the famous Bonlat, a subsidiary incorporated in the Cayman Islands, which could still be certified by Grant Thornton, acting as second auditor. Thus Bonlat started being used as a waste-

\textsuperscript{115} Ibid p.26-28. It is argued that the Civil Procedure framework is one of the main problems in Italy, and this can be confirmed by the pattern of litigation that followed the Parmalat scandal. In fact, whenever possible, both the Extraordinary Commissioner Bondi and other investors brought civil actions in the USA in an attempt to avoid Italian courts. Ferrarini and Giudici support the view that substantive rules need to be complemented by appropriate enforcement mechanisms, and especially in the area of financial scandals, this can be achieved by increasing the application of private enforcement in the form of class actions and discovery rules.

\textsuperscript{116} Ibid p.31,32.

\textsuperscript{117} Supra Coffee 2002.

\textsuperscript{118} Supra Ferrarini and Giudici 2005, p.27.
basket, thanks also to the cooperation of the primary audit firm, the newly appointed Deloitte.\(^{119}\) As it has been acknowledged by the CONSOB investigation\(^{120}\), Grant Thornton’s controls were totally lacking and the audit firm had a reputation – thanks also to its involvement in the Cirio scandal previously – for playing a central part in letting its clients pursue accounting irregularities. The primary Parmalat auditor since 1999, Deloitte, was also heavily engaged in non-audit services with the group. Although auditor’s independence and exclusivity of their service are considered central in the new approach towards auditing functions within most jurisdictions, this concept has consistently been thwarted by the peculiar way in which consulting firms organise their structure.\(^{121}\) Deloitte had also been investigated with regards to a transaction in which the Malta branch was involved in an inter-company loan between Bonlat and another subsidiary. Allegedly the investigation brought to light Deloitte’s lax attitude towards the transaction and overall towards several similar operations.\(^{122}\)

It appears that, just like Arthur Andersen at Enron, firms auditing Parmalat were ineffective and acquiescent in their roles of watchdogs, since their prime concern was to acquire more profitable consultancy services.\(^{123}\) Those among the auditors who raised red flags about information provided by Parmalat or because of transactions carried out, were systematically removed or simply disregarded.\(^{124}\)

\(^{119}\) Ibid, p.25.

\(^{120}\) CONSOB cancelled the company through which Grant Thornton was operating on the Italian market, since the Italian branch did not follow adequate procedures. The audit company was renamed Italaudit Spa after the Parmalat scandal. See CONSOB decision no. 14671 28 July 2004.

\(^{121}\) Supra Davies 2007.


\(^{123}\) Rules are very strict in Italy with regards to the exclusive activity of audit companies. In order to be certified by CONSOB, only accountancy services are allowed together with the audit. However doubts have been raised concerning the effective enforcement of these independence criteria, since auditors organise their business structures in a way that circumvent the rule; moreover the role of CONSOB, who has the power of supervision, has not been proactive in this area. Supra Ferrarini and Giudici 2005, p.29.

\(^{124}\) Ibid, p.26,27.
5.4.3 – The creative finance

A substantial part of Parmalat’s narrative is concerned with the analysis of certain practices and transactions conceived by management and external advisors to raise funds and ultimately to keep the group’s accounts look healthy from the market’s perspective. Whether the techniques adopted can be singled out as corporate finance is certainly doubtful, since forging documents and setting up fictitious transactions has little to do with finance. 125 However, the employment of certain legal tools, if nothing else as a façade to conceal the true scope and nature of the transactions, requires a brief analysis of how those transactions have been misused. The aim here is to understand how and to what extent legal devices have served fraudulent purposes, deceiving watchdogs and investors about the true status of the group.

Unlike Enron, Parmalat started having financial problems well before its final bankruptcy. It has been said that for more than a decade the group continued to operate despite a liquidity crisis due mainly to huge losses, overwhelming the profits generated by the core dairy business. Resorting to the capital markets was therefore the only way to keep the business running; this design, as will be shown, entailed the distortion of several financial tools and the adoption of aggressive and risky managerial practices. From a governance perspective, the group relied heavily on a vast network of off-shore vehicles (not as vast as the Enron one though) that allowed the management to take full advantage of accounting irregularities pursued by the group.

The analysis of the financial transactions that made the Parmalat fraud possible starts with the setting up of SPVs that were used as accounting dumps. In the 1980s the group had to start adjusting its balance sheet in order to obtain a better rating when issuing bonds on the stock market; this was done by establishing a number of wholly-owned off-shore vehicles that were conceived as a tool to absorb group’s losses through fictitious asset sales. 126 It later came to be known that through these strategies around €1.5 billion of non existing assets were absorbed by various

125 Supra Dalcò and Galdabini 2004, ch.1.

126 For a more comprehensive account of Parmalat’s financial activities, see: Storelli 2005, p.781; and Capolino et Al. 2004 p.289.
SPVs, up until 1998. Then, under the professional advice of Grant Thornton, Bonlat Financing was created as a further shell entity.\textsuperscript{127}

Transactions in other words were recorded on Parmalat’s accounts as liabilities for Bonlat and as assets for Parmalat. However, since Bonlat was part of the group and therefore its financial statement had to be included in the consolidated group account, Bonlat had to show some active entry in order to offset its debts to the parent company. This was achieved by the management in a very simple way: by forging documents confirming the execution of fictitious transactions involving other companies within the group.\textsuperscript{128} The over-evaluation of the group’s performances and the under-evaluation of its losses originated from these fake entries. Through the scientific approach to “cooking the books”, coupled with a fake bank account created at Bank of America, Bonlat’s non-existing, worthless assets were siphoned to $7 billion by 2002.\textsuperscript{129} When Bonlat’s accounts started to get out of hands, Parmalat management resorted to a new device, the Epicurum fund, set up under Grant Thornton’s and Mr Zini’s initiative.\textsuperscript{130} The core function of this fund based in the Cayman Islands was to create the appearance of financial activities and to conceal the misappropriation of funds carried out by the Tanzi family. Parmalat’s participation in the fund was itself fictitious since it resulted from the sale to Epicurum of €500 million of Bonlat’s credits from Parmatour.\textsuperscript{131} Eventually the obscurity of transactions related to this particular entity helped the authorities to discover the fraud, when in 2003 Deloitte announced that it had failed to certify Parmalat’s financial statement due to the lack of information concerning the relationship between Parmalat and the Epicurum fund.\textsuperscript{132}

\begin{itemize}
\item \textsuperscript{127} Supra Capolino et Al. 2004, 290.
\item \textsuperscript{128} Ibid p.292.
\item \textsuperscript{129} Ibid p.294.
\item \textsuperscript{130} Mr Zini was a former partner at the established Milan law firm Pavia Ansaldo. He then set up his own practice in Parma, supported by his main client Parmalat, for which he provided all legal services and advice. Together with investment banks and audit firms he was prosecuted, and sentenced to two years. Supra Storelli 2005 p.785.
\item \textsuperscript{131} Supra Capolino et Al. 2004, p.200.
\item \textsuperscript{132} Supra Storelli 2005, p.787.
\end{itemize}
Another subsidiary which raised concerns as to the genesis and scope of its operations was Buconero, an entity conceived directly by the Citigroup management who proposed to Parmalat a structured finance transaction centred around a subsidiary they incorporated in Delaware: Buconero LLC. This new company remained under direct control of Citigroup, despite being a financing vehicle for the Parmalat group. Buconero also entered into a joint venture with a Swiss subsidiary of the group, contributing €117 million to the partnership which the subsidiary intended to use to make inter-company loans to other entities within the group. Pursuant to the partnership, Buconero would then receive a share of the subsidiary’s profits. It later came to be known through Mr Bondi’s investigation that the whole operation involving Buconero was designed to characterise the loan as an equity investment on Parmalat’s balance sheet. Parmalat in fact recorded the amounts contributed by Buconero as equity, but Citibank had conceived the transaction as a way to give the bank a bond-like rate of return, while effectively shielding it from a loss on the investment.\textsuperscript{134} While those amounts should have been recorded as debt instead of equity, this would not have served the usual purpose of overstating Parmalat’s equity and understating its debt.\textsuperscript{135}

If structured finance had become an over-complicated business at Enron, where obscure derivatives transactions were being carried out, at Parmalat the same goals were mainly achieved through more simple and traditional means. Firstly, fictitious transactions were taking place. In particular Parmalat improperly reported that it had purchased and retired $3.39 billion of its outstanding debt; that was achieved by forging bank documents stating that Bonlat repurchased $3.39 billion of debt issued by another Parmalat’s subsidiary. Of course the debt remained outstanding but this was not mirrored in the financial statement that once again was giving a false image of the group’s financial status.\textsuperscript{136} Secondly, beyond the above transactions, Parmalat resorted to the use of “double billing” in order to inflate assets

\textsuperscript{133} Supra Capolino et Al. 2004, p.200.


\textsuperscript{135} Supra Storelli 2005, p.788.

and obtain liquidity. This scheme helped the group raising huge amounts of money since the fake invoices were being securitised and further liquidity obtained by banks. \textsuperscript{137} Thirdly, a further device employed to understate debt was to mischaracterise bank debts as inter-company debts, since the latter does not appear on consolidated financial statements, unlike debts owed to third parties. \textsuperscript{138}

All in all it can easily be recognised that a multitude of techniques were employed in order to alter the financial statement of the group. Some of them were plainly illegal but were somehow coupled or intertwined with valid financial schemes, like in the case for instance of the exploitation of stale or forged invoices in factoring schemes. Although the degree of opacity surrounding these operations is not comparable to what went on at Enron, there was certainly an element of intricacy in this web of transactions. This however does not justify the complete malfunction of gatekeepers who for almost a decade failed to detect a series of fraudulent acts.

From an accounting perspective this is even more evident since, unlike in the USA where Enron exploited the already flexible GAAP rules, the legal scenario in Italy is one characterised by stringent rules on paper, which have been plainly disregarded in the first instance and then not properly enforced. In other words, if in the USA gatekeepers were in a way deceived by a market bubble, by the sophisticated employment of structured finance and by the excessive flexibility of accounting rules, their counterparts in Italy played a more vital role in the scandal, since for a much longer time and to a higher degree they were contributing to hiding frauds and at the same time to their perpetration. This can also serve as explanation as to the rationale of recent reforms, which in Italy have been concentrated around the role and position of gatekeepers rather than on accounting rules. \textsuperscript{139}

\section*{5.5 – What to learn from the scandals}

Despite very different ownership structures and antipodeans corporate cultures, the accounts of Enron and Parmalat showed surprising convergence. Even more striking

\textsuperscript{137} Again Citigroup devised a securitisation program for phony receivables called Eureka Securitization Inc. through which Parmalat collected hundreds of millions of euro. Supra Storelli 2005, p.789,790.

\textsuperscript{138} Supra Reilly and Galloni, 2004.

\textsuperscript{139} Supra Storelli 2005, p.806.
is the extent to which both firms’ financial strategies revolved around the abuse of debt capital market finance, and more specifically around a very complex web of structured transactions involving remote offshore entities (SPVs) which all in all contributed to the initial apparent success of the two corporations and ultimately to their collapse. The persistence of similar corporate finance strategies, despite a rather divergent underlying financial environment in the US and Italy (the former a stock-market driven financial system, whereas the latter a bank-finance one), is definitely an element of concern and it justifies some of the criticisms towards the intrinsic dangers and instability of stock market finance analysed in the previous chapter.

The dependence of both firms on stock market finance underlines another aspect of the two accounts, namely the aggressive acquisitions made through the stock market, aimed primarily at inflating share value. Shareholder sovereignty was in fact pursued in both contexts and it inevitably led to the unrestrained application of takeovers as the ultimate means to achieve shareholder democracy and alleged control over management. As noted in chapter two, shareholder value and its practical applications enhanced managerial power rather than restraining it.

It is worth reiterating that beyond different managerial structures, the two corporations experienced a steep growth that remained almost unexplainable to analysts because the two core industries (energy and dairy products) were characterised by relatively small margins of profit. The nature of the expansions in other words were not to be found in operational profits, but in inflated accounts achieved through accounting manipulations, through the abuse of off-balance sheet and structured finance transactions.

More specifically, Parmalat’s rise as one of the largest Italian corporations was consequential to a wave of acquisitions that were backed by debt that the group was never able to recover because of the limited margin of profit of its core


business.\textsuperscript{142} Going public became for Parmalat a means to stay afloat by concealing a problematic financial status through accounting manipulations first and then by issuing bonds on the basis of inflated share value. The fraud, it could be argued, was conceived as a way to survive, as a temporary solution in order to “weather out” financial difficulties.\textsuperscript{143}

Enron’s rapid growth on the other hand was driven by an innovative approach towards the energy business, helped to a great extent by the industry deregulation in the USA. The corporate finance strategies came to have the same prominent role they had at Parmalat because through off-balance sheet financing the management dumped bad assets into the archipelago of off-shore entities; this again helped inflating the company’s stock price and creating a more successful image through the lens of capital markets. It needs however to be repeated that all this was exacerbated by perverse governance mechanisms where distorted incentives in the shape of stock options played a central part in pushing top executives to pursue aggressive (often illegal) strategies.\textsuperscript{144}

\textbf{What was missed by the regulatory reactions?}

While certain regulatory responses were readily enacted both in the US (chiefly the Sarbanes-Oxley Act) and in the EU (the Transparency Directive more prominently) as a reaction to the scandals, other areas of law escaped legislative correction. The reason for this may be found in the label that was given to the scandals (accounting frauds) and in the way legal concerns were channelled. In hindsight though, some of the legal issues characterising Enron and Parmalat remained unanswered as they found a clear echo in the events that underscored the more recent global crisis. The

\begin{footnotes}
\itemsuperscript{142} Supra Sapelli 2004, ch.3.
\itemsuperscript{143} Supra Storelli 2005, p.824. It is also observed that there was an element of personal attachment in Tanzi’s managerial approach as he regarded the company as “his own creature”, and was therefore very reluctant to see it going down, also because of the cultural and social consequences entailed. See also A. Galloni “Scope of Parmalat’s Problems Emerges”, \textit{Wall Street Journal}, January 27, 2004.
\itemsuperscript{144} The practice of awarding stock options in accordance with the firm’s stock market performance on one hand provided incentives to maximise the company’s value, but on the other hand unrealisable expectations in terms of earning targets forced executives to resorting to accounting manipulations and other deceptive strategies. See S. Bennett “The Real Reasons Enron Failed”, \textit{Journal of Applied Corporate Finance}, vol.18, issue 2, 2006.
\end{footnotes}
abuse of debt capital market finance, more clearly identified today with the securitisation process and with CRAs’ self-regulatory structure, has become post-2008 a more defined cause of modern financial scandals.

The undisputed reliance on market forces led regulators post-Enron to leave the process of financial innovation unrestrained and largely unregulated. As discussed in the previous chapter, this resulted in an increasing mass-employment of innovative securitised products until 2007, when the bubble burst. Equally, certain aspects of capital market finance were thought to be best left untouched by government regulation, because the market (CRA for instance) was better equipped to regulate. These axioms proved fundamentally flawed.

With regards to the specific role played by gatekeepers in the above scandals, legislations enacted after 2002 introduced more stringent rules for the regulation of the relationship between advisors and clients/issuers. What however remained deficient was the statutory legitimisation that auditors (and CRAs) still lack in performing their functions. While both auditors and rating agencies have come to perform an institutional and regulatory role, since they audit/rate their clients in the public interest, they still lack a legal and democratic legitimisation for this role. The framework designed in the US in the 1930s (certification of corporate accounts in the public interest) did not in other words consider specifically to whom this delicate function should have been entrusted. This institutional gap is perceived today as an urgent issue to address.

Finally, both scandals expose the limits and dangers of shareholder value. The spiral of acquisitions and the web of transactions had in both corporations the principal aim of maximising the value of stock and the short-term wealth of security-holders. Even though corporate governance became the main subject of research in response to these scandals, and despite a number of legislative interventions ever since, shareholder primacy has remained virtually unchallenged.

5.6 – Conclusion
The accounts of the Enron and Parmalat scandals served multiple purposes. Firstly they provided a more practical dimension to the corporate governance issues analysed earlier in the thesis and in doing so they provided a platform for a comparative examination of some of the main control issues. The two corporations epitomised different corporate cultures reflected in substantially divergent corporate
governance structures and arrangements. While Enron was a typical widely-held firm, relying on “external” control mechanisms mainly provided by deep and liquid capital markets, Parmalat was a closely-held, family-run corporation, reliant on more rudimental governance as well as financial mechanisms. Despite the underlying dichotomy, the story provides a rather similar and converging end, as both firms were found to be entrenched in risky, short-term strategies aimed at inflating share value, often through fictitious or illegal transactions that led to their long-term collapse. This leads to the second dimension of the analysis, namely the financial strategies in place and broadly speaking the corporate finance scenario characterising them. Surprisingly this account shows striking similarities as to the strategies in place, despite generating from very different financial markets. In spite of a more rudimental approach to certain transactions at Parmalat, their substance highlighted the same abuse of capital market finance, and in particular of debt capital market operations. Further similarity is represented by the cooperation the two corporations received from various consultancy firms and by gatekeepers’ failure to perform their monitoring roles. The audit function and that of credit rating agencies resulted particularly delicate in this context as they consistently failed to raise red flags and with their acquiescent behaviour allowed the frauds to be perpetrated. Finally, in the aftermath of the global financial crisis, it is worth acknowledging that many of its underlying legal themes had already been signalled as central concerns for the scandals erupting at the start of the decade. This corroborates the view taken in the thesis, leading to a common regulatory response, which is proposed under the ESC.
Chapter 6 – The global financial crisis, Northern Rock and Lehman Brothers: Déjà vu?

6.1 – Introduction

This chapter completes the case studies started previously, by presenting, together with more specific accounts of Northern Rock and Lehman Brothers, an overview of the 2007-08 global financial crisis. This will explore the background of the global meltdown, as well as the main underlying legal themes emerging from the analysis.

While some of the themes underpinning the global crisis have been discussed in chapter two of the thesis, in connection with general reflections on financial deregulation and abuses of capital market finance, this chapter provides a representation of the legal issues examined in part II of the thesis. In particular, from these early stages, it can be pointed out that the global financial crisis has exposed the urgency of very specific and long-standing problems. With regards to corporate law themes, the system of control over executives’ decision-making, and the overview of their policies, has proved completely flawed, both because of the inconsistency of market-based mechanisms (stock options, market for corporate control), and because of the optimism surrounding internal and statutory mechanisms, such as non-executive directors and directors duties. As regards corporate finance themes, the deregulation of the financial services industry, mainly in the UK and US, has propelled a process of unrestrained innovation of financial transactions, mainly of securitisation and credit derivatives. This has in turn allowed financial institutions to reach hazardous levels of leverage and risk-taking that regulators were not in a position to control.

An interesting element of the account emerges from the striking similarity of the circumstances that led to the two waves of crises, the 2001-03 first and then the 2007-08. Individual scandals highlighted in fact very similar breakdowns in corporate governance mechanisms as well as in the recurrence of the same transactions directed mostly at inflating share value, laying-off risks and concealing losses from balance sheets. The facts of Northern Rock and Lehman Brothers will no doubt be evocative of what has already been said for Enron and Parmalat. Moreover the unrestrained application of speculative derivatives transactions has further revealed its dark side in the context of sovereign defaults, where some European
government and regional agencies have been found to have incurred dangerous liabilities through interest rate swaps.¹

The chapter begins with a background to the 2007-08 crisis (section 6.2) which is complemented by an analytical chronology of the events examined. Section 6.3 presents the cases of Northern Rock and Lehman Brothers which epitomise the reliance of financial institutions on very similar strategic choices, especially as regards their over-dependence on securitised products. This discussion is coupled with the recognition of themes identified in connection with the global crisis. Critical considerations on the lessons to learn from the global crisis are provided in section 6.4, where some reflections on the regulatory reactions to the crisis are reiterated. Section 6.5 concludes the chapter.

6.2 – Background to the 2007-08 crisis

In the aftermath of the global financial crisis, there has been a certain degree of agreement in identifying its causes (or at least part of them) with the regulatory flaws in the architecture of the global financial system, and with the process of innovation of structured products that eventually led to abuses of capital market finance.²

The story of how the 2007-08 bubble developed needs to be traced back in time. Its roots lie in certain legislative changes that occurred in the 1980s, as a consequence of the neo-liberal cultural tide that from the previous decade started to exert significant influence on financial markets and financial regulation.³ The road to “financialisation”⁴, of which mention has been made in chapter two, is in fact strongly premised on the theoretical movement that was developed in the US in the 1970s, mostly within the Chicago School of Economics.

¹ V. Carlini “Ecco come la finanza creativa ha danneggiato gli enti pubblici”, Il Sole 24 Ore, 22 Marzo 2010.


⁴ “Financialism” or “financialisation” can be defined as the process through which finance has come to influence the whole economic system, thereby encouraging corporations to privilege financial functions ahead of their core ones. See R. Blackburn “The Subprime Crisis”, New Left Review, 50 March-April 2008, p.10.
Technological advancements in the 1970s, especially in the area of computing, provided the ideal platform for the application of new theoretical paradigms to be applied in the area of financial economics and financial engineering. These favourable conditions were also supported by a general ideology that had turned away from the post-war well-ordered world, centred on strong state intervention.\(^5\) The first milestone of this theoretical movement was represented by the options-pricing formula devised by Fisher Black and Myron Scholes who sought to contribute with their model to the management of risk in stock market operations.\(^6\) Their work, moreover, was the first to substantially apply natural sciences to economic theory, as they employed the mathematical model of the Brownian Motion to their financial model designed to foresee price fluctuations on stock markets.\(^7\) This gave way among other things, to the inexorable “mathematisation” of financial models that eventually went on to dictate trading activities and transactions flows.\(^8\)

At the same time, Black and Scholes’ formula was equally reliant on assumptions of strong economic forces and rational market actors that would bring about market equilibrium. They in fact respected the “Efficient Market Hypothesis”\(^9\) (according to which market prices reflect all available information at a given point in time) to a substantial degree as they accepted that almost all markets are efficient almost all of the time, this meaning at least ninety percent of times.\(^10\) If from a certain perspective this may sound as a loose concept of efficiency because of the approximate parameter, it should be pointed out that Black and Scholes’ model never aimed at a great degree of accuracy because they held that market price oscillated

\(^5\) Ibid, p.11.


\(^7\) L. Gallino “*Finanzcapitalismo – La Civiltà del Denaro in Crisi*”, Einaudi 2011, p.98. It is argued that in the 1970s economists started to increasingly interact with physicists, incorporating natural sciences in the study of social sciences, and concluding that the Brownian Motion model (concerned with an ambit of physical phenomena within which a certain amount of particles manifest consistently small and quick casual fluctuations) could be well adapted to foresee securities’ price fluctuations.

\(^8\) Supra Morris 2008, p.xiv.


\(^10\) Supra Blackburn 2008, p.11.
around the efficient price. Some proponents of the EMH went even further holding that only high levels of leverage would be conducive to a focus on performance that would in turn lead to the demanded market equilibrium.

These theories and models premised on financial markets’ self-equilibrium and on their capability to manage risks therein recorded initial successes, and soon expanded their application much beyond the pricing of options to encompass a wider array of financial products at global level. Overall, it is correct to say that these early successes marked the initial stage of a newly conceived market for derivatives and innovated financial products that deeply changed the architecture of the global financial system. This was more recently further advanced by the application of the “Gaussian copula function”, a mathematical formula that allowed complex risks to be modelled through a correlation number. The formula, among other things, allowed the uncontrolled growth of the CDO market as it facilitated the bundling of virtually any assets into securities that would receive AAA ratings.

The advent of structured finance in those years contributed among other things to create huge volumes of trades among institutions that were dealing with each other on a private basis, without disclosing details of their transactions through a clearing house. This practice, referred to as “over-the-counter”, has in the last decade exceeded stock exchange transactions and thus has come to defy the very presuppose of market efficiency, which is the correct flow of information that a well regulated stock exchange should provide.

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11 Ibid, p.12. It is argued that the underlying idea that price and value reflect socially necessary labour time, implies itself an approximation to efficiency.

12 Ibid.

13 It is argued that it was not actually the theory that correctly predicted price fluctuations, but rather traders who, believing in the theory made it real. According to this criticism, the model had not described market reality, it had actually created it. See D. MacKenzie and Y. Millo “Constructing a Market, Performing Theory: The Historical Sociology of a Financial Derivatives Exchange”, *American Journal of Sociology*, N.1, 2003.


15 Ibid.


In more recent times, the flag of neo-liberal policies has been held most prominently by Alan Greenspan, former chairman of the Federal Reserve between 1987 and 2006, who consistently remained supportive of the financial services industry. Despite his position and duty to monitor the industry’s excesses, he consistently opposed the idea of regulating derivatives products, holding that banks’ own risk-measurement schemes were always more accurate and simpler than those imposed by new regulation.\textsuperscript{18} His views eventually strengthened the deregulation process that culminated with the final repeal of the Glass-Steagall Act in 1999.

Before further analysing how structured finance and financial markets developed over the last two decades, it is necessary to briefly examine the deregulatory process that complemented the theoretical movement described above. The financial revolution that led to the 2008 collapse was in fact preceded by substantial changes in the regulatory framework as a number of legal restraints were dismantled during the 1980s and 1990s, both in the US and in the UK.

One of the consequences of the Great Crash of 1929 was the enactment of a tight wave of regulation, including most prominently the Glass-Steagall Act in 1933\textsuperscript{19}, that disciplined and constrained the activities of banks and financial firms. The Bretton Woods system established in the post-war years also relied on regulated markets with tight controls on the value of currencies (fixed exchange rates), and it was above all grounded on a general acceptance that government intervention in the economy was needed in order to guarantee economic stability and political peace.\textsuperscript{20}

The 1980s then registered the beginning of a deregulatory process, characterised chiefly by the liberalisation and integration of capital markets\textsuperscript{21}, by the collapse of Bretton Woods, after which exchange rate constraints were removed\textsuperscript{22}, and even more importantly by the progressive abolition of legal restraints in key


\textsuperscript{19} Banking Act 1933 Pub.L. 73-66 48 Stat 162, which was generally conceived to control speculative activities and introduced \textit{inter alia} the separation of banking activities (commercial and investment) as well as the prohibition for bank holding companies to own other financial companies.


\textsuperscript{21} This process initiated with the liberalisation of capital and the abolition of constraints to participate in other countries’ capital markets. See J.A. Frieden “\textit{Global Capitalism, its Fall and Rise in the Twentieth Century}”, New York Norton 2006, ch.16.

\textsuperscript{22} Ibid.
areas of financial markets. In particular, the Gramm-Leach-Bliley Act in 1999 finally repealed the last prohibitions left of the Glass-Steagall Act, by allowing financial institutions to operate beyond the separation created post-1929 between “casino” and “utility” banking. One year later the Commodities Futures Modernization Act was enacted and it suddenly removed centuries-old legal constraints on speculative derivatives trading.

In the UK on the other hand the demutualisation of building societies in the 1980s (such as Northern Rock and Bradford & Bingley) allowed financial institutions to engage in activities that were previously restricted by the very status and ownership of the entities. Moreover, the 1986 “big bang” revolutionised the structure of British banks by first of all obliterating differences between stockbrokers, stockjobbers, commercial banks, and merchant banks, and then by allowing membership to the Stock Exchange to corporate members (whereas previously this was reserved to partnerships of individuals).

The resulting dimension of the banking business prompted an increased competition between commercial and investment banks for the more profitable securities business that in turn pushed banks to over-reliance on trading speculations, with their own capital and mostly through leverage instead of more traditional deposit-based capital. Moreover, further to the abrogation of the Glass-Steagall Act,

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24 Financial Services Modernization Act, Pub L No 106-102, 113 Stat 1338.

25 Similarly in the European Union the European Second Banking Coordination Directive was implemented to allow deposit-taking European banks to also engage in market activities that were previously reserved to securities firms and investment banks. See Directive 89/616/EEC [1989] OJ L386/1, replaced by Directive 2006/18/EC OJL177.


27 Supra Stout 2011, p.3.

28 Typically building societies were restricted to retail deposits and mortgages. See S. Rex “The History of Building Societies”, BSA 2010.

29 C. Bamford “Principles of International Financial Law”, OUP 2011, p.176. It is observed that among other things, these changes blurred long-standing distinctions of banking business, especially with regards to the advisory functions and the trading ones.

new mega-banks started to emerge as a result of a wave of mergers between different financial firms, giving way effectively to huge conglomerates, both in the US and in Europe. The conjunction between the process of financial innovation, the move towards financial liberalisation (abolition of national controls over cross-border capital flows) and globalisation, and the afore-mentioned deregulation process, changed very dramatically the banking business, creating among other things what is referred to as “too-big-to-fail-institutions”. The globalisation of the banking business in particular allowed financial institutions to engage in activities with loosen requirements as regards borrowing and lending, while at the same time enjoying implicit government guarantee. This is arguably what gave pace to the “shadow banking system”, with financial institutions escaping capital requirement controls thanks to the myriad of off-shore special entities.

At the same time, the Commodities Futures Modernization Act had the effect of removing legal constraints on OTC derivatives speculations, thereby allowing their enforceability and their broad employment, especially, but not only, in the banking industry. The way in which speculative derivative contracts started to be combined with more traditional securitisation increased drastically the size of what became virtually a global, interconnected and unregulated market, whose systemic risk grew exponentially.


32 This is more closely analysed in chapter four.

33 Ibid p.12. In the US, beyond the separation of commercial and investment banking, other essential restrictions concerned the prohibition for banks to purchase securities for their own account, and the engagement of deposit-taking institutions in the business of issuing, underwriting, selling or distributing at wholesale or retail. These measures were aimed at preventing banks from endangering themselves, the whole banking system, and ultimately the public from unsound practices and conflicts of interests.

34 Ibid, p.10.

35 This will be discussed in the next section.

36 Supra Blackburn 2008, p.3.

37 Supra Stout 2011, p.5.
It is worth pointing out in this respect that English and American common law had historically distinguished among derivative contracts, between those accomplishing a hedging function and those only aimed at speculation.\(^{38}\) The common law doctrine in other words created a discrimination against speculators, mainly because speculation itself was seen as a form of gambling that reduced net social welfare. Moreover these speculative bets were also subject of manipulations as derivatives traders could be tempted to exert control over the fate of the assets they were betting on, in order to win their bets. The increased risk intrinsic with speculative derivative contracts was also a concern for judges who were keen to avoid trading losses resulting in bankruptcies and increased systemic risk.\(^{39}\) While at micro-level derivatives can reduce systemic risk, the macro picture is a different one because large amounts of credit risk have more recently been concentrated in the hands of few dealers trading mainly with one another.\(^{40}\)

Arguably, the enactment of the CFM Act gave legal certainty to speculative derivative contracts and also to its eligible participants (banks, corporations, mutual and pension funds etc.), by simply banning off-exchange trading and by excluding most derivative transactions from the ambit of the Commodities Exchange Act.\(^{41}\) As a consequence of this transactional development, banks opened up to a much more profitable business model where they could effectively externalise their losses through a multitude of off-balance sheet vehicles to which they were laying off risks related to structured finance products.\(^{42}\) The unrestrained employment of speculative innovative products made it possible for financial institution to utilise very high levels of leverage (hidden in the shadow banking system though) which guaranteed

\(^{38}\) Ibid. The main criteria to distinguish between the insurance function and the rent-seeking one was the recognition of whether or not the parties to the transaction owned or expected to own (by taking delivery) the actual physical asset or commodity underlying the derivative contract. When a party owned or was expected to take delivery of the assets, a derivative contract was deemed enforceable in public courts, whereas a contract between two speculating parties was considered void and not legally enforceable. See also *Irwin v. Williar*, 110 US 499 (1884).

\(^{39}\) Supra Stout 2011, p.11,12.


\(^{41}\) Supra Stout 2011, p.18. The Commodities Exchange Act 1936 had been enacted with a view to hardening the old common law rule, by prohibiting off-exchange futures, and at the same time by ensuring that speculative trading in commodities remained confined within regulated exchanges.

\(^{42}\) Supra Blackburn 2008, p.3.
much higher rates of return; this however despite the thin capitalisation and the risk-taking ensuing that very model.\textsuperscript{43}

Even though the Basel Accord cannot be dubbed as deregulatory, its enactment certainly created regulatory incentives towards the development of the originate-and-distribute model on a vast scale.\textsuperscript{44} The harmonised capital regulation in principle sought to reduce systemic risk by requiring banks to hold minimum amounts of capital against risk and also to limit regulatory competition and arbitrage by providing a level playing field for international banks.\textsuperscript{45} In this context however, securitisation and more generally structured finance became means to reduce transaction costs: the way in which loans and other risk assets weighted on balance sheets became critical in credit preferences and in the way banks started to manage risk accumulation by separating this process from that of credit origination, and by intensifying therefore balance sheet management.\textsuperscript{46} Once again, as seen above, the application of the Basel Accord combined with structured finance allowed banks to operate under a new model: they could loan to a wide pool of borrowers without necessarily having to hold loans to term on their balance sheet. Loans as said became subject of trade among banks and other financial institutions, all keen to participate to the prolific debt capital market where they could originate loans, sell the related risk to a wide range of investors and thus remain insulated from potential defaults.\textsuperscript{47}

The result of the above scenario was that at the end of 2007 the level of leverage and risk-taking that had been accumulated thanks to the deregulatory process and to financial innovation could not be recognised by the most sophisticated regulators. A wide range of originators had in fact sold their risky loans to investors via securitisation conduits with tranches lightly subordinated and

\begin{itemize}
\item \textsuperscript{43} Ibid.
\item \textsuperscript{44} D.W. Arner “The Global Credit Crisis of 2008: Causes and Consequences”, \textit{The International Lawyer}, Vol.43, No.1, 2009, p.108.
\item \textsuperscript{45} See Basel Committee on Banking Supervision “International Convergence of Capital Measurement and Capital Standards” (1988).
\item \textsuperscript{46} Supra Arner 2009, p.119.
\item \textsuperscript{47} Ibid p.121.
\end{itemize}
significantly overrated. The Basel Accord formulas aimed at measuring capital adequacy soon proved insufficient to supervise effectively the level of risk involved in transactions; even the revised version of the Accord issued in 2004 (Basel II), designed initially to address more specifically problems of risk classification, created significant incentives to the excesses witnessed before 2007: namely, greater recognition of quantitative risk-modelling, excessive reliance on credit rating, and regulatory recognition of credit risk-mitigation techniques, especially credit derivatives and credit default swaps.

6.2.1 – Chronology of the crisis

In order to represent chronologically the sequence of banking and financial collapses that contributed to create what is commonly referred to as 2008 crisis, a timeline is herewith provided, highlighting the most characterising events between mid-2007 and end-2008.


<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jul 2007</td>
<td>Federal Reserve announces losses in the US subprime mortgage market in the range of $100 billion.</td>
</tr>
<tr>
<td>Aug 2007</td>
<td>BNP Paribas suspends three of its investment funds exposed to the US subprime market: start of credit contraction.</td>
</tr>
<tr>
<td>Sep 2007</td>
<td>Northern Rock needs emergency support from the Bank of England: run on the bank and subsequent nationalisation in Feb 2008.</td>
</tr>
<tr>
<td>Mar 2008</td>
<td>Federal Reserve and JP Morgan arrange the takeover of Bear Sterns further to the investment bank's collapse in the subprime market.</td>
</tr>
<tr>
<td>Sep 2008</td>
<td>Lehman Brothers forced to file for Chapter 11 bankruptcy protection under debts of $613 billion.</td>
</tr>
<tr>
<td>Sep 2008</td>
<td>Merrill Lynch is sold to Bank of America for $50 billion for losses in its CDO portfolio.</td>
</tr>
<tr>
<td>Sep 2008</td>
<td>Insurance group AIG is given $85 billion support by the Federal Reserve in order to prevent the group's collapse.</td>
</tr>
<tr>
<td>Sep 2008</td>
<td>US Treasury announces the Troubled Asset Recovery Program (TARP).</td>
</tr>
<tr>
<td>Sep 2008</td>
<td>Bradford and Bingley, another UK mortgage provider, is nationalised.</td>
</tr>
<tr>
<td>Oct 2008</td>
<td>UK government announces a three-part refinancing package including £50 billion bank capital injection.</td>
</tr>
<tr>
<td>Oct 2008</td>
<td>G7 and EU leaders endorse rescue packages; in the UK, significant injections of capital in major banks.</td>
</tr>
<tr>
<td>Nov 2008</td>
<td>UK and Eurozone markets enter recession; G20 meeting in Washington confirms the outline of international financial response.</td>
</tr>
</tbody>
</table>
6.3 – The banks go bust

As the global financial crisis fully exploded at the end of 2008, a wide array of financial institutions was found dangerously close to collapse, facing either end of business or government bailout. In the context of this enquiry, two cases will be taken under brief review, namely Northern Rock and Lehman Brothers, because of the relevance that their accounts bear in the understanding of how the global crisis unfolded. Despite embodying two different types of financial institutions, they epitomised the effects of a reckless use of structured finance and derivatives finalised at maximising fees from the repackaging and selling of CDOs.

The former represented somewhat of an iconic event as millions of TV viewers witnessed the first bank run (depositors lining outside the branch to withdraw their money) since the scandal involving Overend Gurney & Co. in 1866. The failure of the Newcastle-based British mortgage lender also officially started what was then - in September 2007 - perceived as a “credit crunch” that would later turn into a much wider economic crisis. Lehman Brothers bankruptcy on the other hand is probably the event that, among the long sequence of bail outs and collapses, triggered the domino effect in global financial markets that marked the start of the economic crisis still affecting the world’s main business centres.

6.3.1 – Northern Rock

Northern Rock found its origins in 1965 through the merger of two building societies established in mid nineteenth century and was itself organised as a mutually owned savings and mortgage bank until the decision taken in 1997 to demutualise and float on the stock market. Although, like most other building societies, Northern Rock started operating as a regional institution based around the city of Newcastle, its ambition grew substantially over the last decade as well as its assets. The process of expansion can be said to have started after the demutualisation of the building society (which implied that activities were no longer restricted to retail deposits and mortgages as a matter of regulation), and that corresponded to a constant and very

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51 See previous section for a chronologic list of events.


rapid annual rate of growth that brought the bank to being, just before the crisis, the fifth largest UK bank by mortgage assets.54

A key aspect behind Northern Rock strategy of growth was represented by the sheer changes implemented on its funding base. It is observed that as the bank expanded its mortgage assets with a substantial and unprecedented factor of growth, retail deposits only grew very limitedly creating therefore a shift in the traditional prevailing pattern that had previously characterised the bank.55 Moreover, most of the retail deposits consisted of traditional branch-based deposits, the bulk of them being postal and telephone accounts that allowed the bank to expand its clientele beyond the North-East area. The gap in the funding base was then filled by resorting to securitised notes and other forms of non-retail funding, among which for instance covered bonds56 and inter-bank deposits. The extent to which Northern Rock relied on such instruments represents probably the main factor in the analysis of the bank’s collapse.57

Securitisation at Northern Rock however presented some very peculiar features if compared to the way in which it characterised the failure of other European and US banks during the subprime crisis (chart 6.1).58 The very heavy use of securitisation and the resulting substantial changes in balance sheet structure are not sufficient to explain the genesis of the bank’s crisis since structured finance was


55 Supra Shin 2009, p.7. Retail funding had amounted to 60% of total liabilities in 1998 but had then fallen to 23% before the crisis in 2007.

56 Covered bonds can be defined as debt instruments secured against a pool of mortgages against which investors have a preferential claim in the event of issuer’s default. Like securitisation, covered bonds have the benefit of priority achieved through the ring-fencing of the assets underlying the bonds, while unlike securitisation the issuer is liable to repay the full amount of the bonds which are issues on a recourse basis and remain on the originator’s balance sheet. See generally R.G. Avesani, A.G. Pascual and E. Ribakova “The Use of Mortgage Covered Bonds”, IMF Working Paper, January 2007.

57 House of Commons, Treasury Committee “The run on the Rock: Fifth Report of Session 2007-08”, Volume 1, London, The Stationary Office Limited, 2008, p.13. It is here outlined how securitisation accounted for roughly 50% of the bank’s funding. It was also observed by the Committee that these transactions raised ambiguity and confusion with regards to the ownership of risks associated to off-balance sheet vehicles.

employed under rather unusual modes. Northern Rock’s securitised notes were in fact of medium to long-term maturity, with average maturity of over one year, whereas most US and European banks caught in the crisis were holding mortgage assets funded with very short-term liabilities, such as asset-backed commercial paper. These liabilities needed to be rolled over several times each year and this made banks highly vulnerable when the market froze and became unwilling to fund new issues.59 Another difference in Northern Rock’s operations was the way in which securitisation was structured. Unlike most commonly, it did not employ off-balance sheet vehicles but instead it assigned portions of its mortgages to a trust which then entered into an agreement with another special purpose entity, which in turn would enter into a loan agreement with a separate note-issuing company.60 From an accounting perspective, the above structure meant that SPVs were consolidated under Northern Rock balance sheet, which therefore fully reflected the bank’s rapid growth and the amount of loans originated.61

It is also argued that the complexity of securitisation arrangements at Northern Rock played an important part in the Government’s decision to avoid administration procedures. The arrangements with the SPE Granite Fund were particularly problematic as this was holding around 40% of Northern Rock’s assets, with a continuing obligation on the part of the bank to supply securitised mortgages as the old ones were paid.62

Although securitisation played a rather central role at Northern Rock in the way it allowed the originate-and-distribute model to be implemented63, what ultimately led to the bank’s run from a broader perspective was the excessive level of


60 Supra Shin 2009, p.8.

61 Ibid p.9.

62 R. Tomasic “Corporate Rescue, Governance and Risk-Taking in Northern Rock: Part 1”, 29 Company Lawyer 2008, p.299. In case of administration, investors could also have been entitled to demand a return of value of assets hold by the SPE.

63 Supra, companyinfo.northernrock.co.uk. Securitisation played a particularly central role in 2007 when the crisis had started and securitisation notes already issued could not be placed with investors and were therefore taken back into Northern Rock’s balance sheet; at that stage then the bank was deprived of a valuable source of cash.
leverage that had been reached before the crisis. During its history as a public company Northern Rock’s leverage continued to climb, up to a level of 58.2:1 (asset:equity) in June 2007; a ratio that was very high even for the standards of American investment banks which at that time were at around 25 to 30:1. Under such conditions any institution would be vulnerable to a reduction in overall funding conditions for the market as a whole and an increase in measured risks would indeed normally lead to a pullback in leverage, which in turn would affect the entire system. It could be argued that some institutions could adjust their balance sheets in response to such scenario, by reducing their assets and paying back debts, but the system will anyway be weakened by the overall deleveraging and this is arguably what happened at Northern Rock. In particular, in the case of the English bank, the reduction in leverage permitted by the market became apparent when many outside creditors declined to roll over existing short-term loans.64

The run on Northern Rock in other words reflected the market reaction to the general shrinking funding conditions; as the market tide eventually turned, institutions with high level of leverage and balance sheet mismatches were found with lack of liquidity and without a sponsor - apart from government - willing to provide that.65 This situation also offers a reflection on what had become general paradigm of how the banking industry works, namely on the use of short-term debt to finance long-term assets. Despite the many arguments emphasising the importance of short-term debt as a means to discipline managerial actions66, it is also observed that in the case of Northern Rock creditors became subject to external constraints, beyond the bank/depositors relationship, and their actions did not respond to the above theory, but to the status of the financial system.67 Indeed, when the whole system follows certain patterns of funding long-term illiquid assets with short-term liabilities, chances are that not all firms will be in a position to hedge their maturity profile.68

64 Supra Avgouleas 2009 (Banking Act), p.206.
65 Supra Shin 2009, p.11,17
67 Ibid.
68 Supra Shin 2009, p.18.
This criticism is further stressed as a general problem that affected the banking industry beyond Northern Rock and that characterised other failures during the global crisis. It is observed that the English bank simply epitomised the extreme employment of a certain business model that was conceived to combine aggressive asset growth, minimisation of capital, and funding risk designed to maximise rates of return on equity. In particular, the role of capital as a cushion against unexpected losses and as a funding source was plainly overlooked at Northern Rock, becoming thinner and thinner to cover a growing range of activities and risks. All this was possible as it perfectly complied with – and in fact took full advantage of – the inadequate regulatory framework set by Basel I.\(^69\)

If securitisation played an important role as a tool that allowed certain strategies to be carried out, more importantly Northern Rock reflects the failure of a widespread business model and of flawed capital adequacy regulation that allowed increases in leverage beyond any reasonable capacity of banks to absorb increasing credit and liquidity risks.\(^70\)

This naturally leads to pointing at the role of the board in dealing with issues of risk-taking, and to reflections on the effective governance constraints on the board. In particular it has been observed by the Treasury Committee that the board failed to oversee the overall corporate strategy post-demutualisation and in particular to ensure the bank’s liquidity and solvency.\(^71\) This line of criticism again stressed the importance of corporate governance standards in the banking industry, where increasingly challenging scenarios need to be tackled by sound due diligence procedures, and by a clear differentiation between executive and non-executive directors. Weakness in these governance mechanisms has arguably been at the heart of Northern Rock failure.\(^72\)

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\(^70\) Ibid p.111. See also R. Tomasic “Corporate Rescue, Governance, and Risk-Taking in Northern Rock: Part 2”, 29 *Company Lawyer* 2008, p.330. It is observed that the bank had not been exposed in a substantial way to the subprime market, and the collapse depended heavily on its funding base (wholesale funds with weak deposit base) and on a model over-reliant on inter-bank loans.

\(^71\) Supra House of Commons, Treasury Committee 2008, p.19.

\(^72\) Supra Tomasic 2008 (part 2), p.333.
What Northern Rock also clearly manifested was a regulatory failure of the FSA in monitoring the industry as a whole and the bank’s management more specifically. The regulator proved to be overwhelmed by “laissez-faire”, light-touch rhetoric as a result of its affiliation to the banking industry and this hindered an effective day-to-day engagement with boards.\(^\text{73}\)

Unlike Lehman Brothers in the US, Northern Rock did benefit from government support. As the FSA and the Bank of England were informed in August 2007 about the irreversible liquidity problems faced by the bank (that eventually triggered the depositors’ run) government bailout seemed the only solution. Having failed to either facilitate a takeover by another bank or to find a suitable private buyer, the Bank of England was forced, as lender of last resort, to virtually nationalise Northern Rock in September 2007, and take on board losses amounting to around £565.5 million for the first six months after nationalisation only.\(^\text{74}\)

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\(\text{Chart 6.1: Securitisation at Northern Rock}\:^{75}\)

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\(^{73}\) Ibid, p.337.

\(^{74}\) Supra Singh 2008, p.35.

6.3.2 – Lehman Brothers
While the roots of Lehman Brothers lie in a dry goods business founded by two German-born brothers in Alabama in 1844 who later moved into the banking sector, the emergence of the present-day investment bank can be traced back to the early 1990s when Richard Fuld was appointed president and CEO. Under his leadership Lehman started to push its business beyond traditional investment banking schemes, moving aggressively into the new patterns of financial markets and in particular into the subprime securitisation market.  

Fuld’s managerial style came soon to prominence for his authoritarian manners as well as for the aggressive culture that was characterising at that time most rival investment banks and was in particular aiming at closing the gap with the two main rivals and market leaders, Goldman Sachs and Morgan Stanley. By mid 1990s then Lehman had established itself as a leader in the market for mortgage-backed securities and, riding the wave of the US housing boom, it also acquired five mortgage firms, among which BNC in California and Aurora Loan Services in Colorado (the latter specialising in loans for borrowers without full documentation), that contributed to generate record revenues in the capital markets amounting to a faster rate of growth than any other business in investment banking or assets management.

As said, this steep growth was propelled by the employment of new securitisation techniques, by CDO and CDS contracts in particular, whose relatively poor understanding on the part of Fuld as regards relating risks and long-term consequences, proved critical for the firm. His lack of sophistication on new financial instruments and his background as a bond trader all explained certain reactions to market trends and to the way Lehman approached the market in the years preceding the crisis. Between 2005 and 2006 Lehman became the largest producer of securities based on subprime mortgages; in 2007 then, although cracks in the US housing market had already become apparent, the firm’s philosophy

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78 Ibid.

79 Supra Swedberg 2009 p.15.
remained aggressive and based on “anything to make the deal” ethos that led Lehman to getting increasingly stuck in bonds and CDOs that could not pass on. Fuld however did not seem to perceive at that stage the perils behind that strategy and as the housing market kept going down, he decided to heavily invest in commercial real estate and in assets outside the US, without really realising the extremely strong links and overall level of interconnectedness of the financial system on one hand and of the housing market on the other. This of course was the natural effect of securitisation and of its developments which at Lehman as well as in other firms seemed to have been employed with little awareness of long-term implications. Indeed Lehman’s new investments turned out to be as toxic as the older ones, creating more bad debts on the already ailing company’s books.

Lehman’s position worsened substantially in 2008, as its shares fell sharply in response to the failure of two Bear Stearns hedge funds and to the near collapse of the bank itself (Bear Stearns was the second largest underwriter of mortgage-backed securities). It has been suggested that the high level of leverage and the huge portfolio of mortgage securities made the investment bank increasingly vulnerable to market fluctuations. Investment banks as a whole were looked at suspiciously by some investors as a number of features of their capital structure were pointed out. It was argued that they had been consistently using half of their revenue for compensations, which implied that employees maintained a very strong incentive to increase the level of leverage and overall to pursue short-term strategies. As regards Lehman, it was specifically observed that their leverage was 44:1, meaning that if the firm’s assets fell by 1% that would imply a loss of almost half of Lehman’s equity! Lehman’s assets were also a matter of concern, especially as investors were trying to assess the value of the firm’s exposures at the outset of the market collapse;

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80 Ibid. This also led to more than a dozen lawsuits initiated against Lehman by borrowers on the ground that the firm had improperly made them take on loans they could not afford.

81 Ibid.


83 Supra Swedberg 2009, p.17.
the picture that came out was not one characterised by transparency, probably because responses in such direction would not have inspired market confidence.\textsuperscript{84}

A lack of confidence was what Fuld pointed at as main reason behind Lehman’s deteriorating market status, rather than huge losses and an overall dwindling economy that was having its repercussion on several financial institutions. Fuld seemed to believe that Lehman could weather out any storms and while other firms were reporting heavy losses, Lehman was still declaring profits of several hundred million dollars for the first quarter of 2008, with the three main rating agencies maintaining their full support for the bank’s operations until its very end. However, as observed before, rumours of the firm artificially covering up its losses started to become stronger among investors and this proved to be determinant as the crisis grew deeper and fear mounted as to the real extent of the firm liabilities.\textsuperscript{85}

The way in which losses were concealed at Lehman deserves special annotation because of the transactions employed and the general support the bank received by various gatekeepers. It has been reported that $49bn had been shifted off-balance sheet through a process called “repo\textsuperscript{105}”\textsuperscript{86}, a transaction designed to hide the bank’s level of leverage and with little or no economic rationale.\textsuperscript{87} Lehman’s transaction was different from other more common repurchase agreements because instead of handing over securities, the bank was giving more than necessary, by over-collateralising deals that were accounted for as true sales instead of financing. Essentially Lehman was shrinking its balance sheet by reporting

\textsuperscript{84} Ibid.

\textsuperscript{85} Ibid p.18,19.

\textsuperscript{86} Repurchase agreements are exchanges in which a financial firm sells financial instruments to another financial firm at a discount to its market value, with a promise to buy it back at its full market value, a short time later. These deals have come to represent an important source of finance for short-term purposes, and are considered safe because the investor/lender can easily take possession of the underlying asset in case of seller/borrower’s default. The peculiarity of these transactions is that, even though legal title of the underlying assets passes to the purchaser, their accounting treatment is normally that of financing transactions. Supra Blair 2010, p.16.

obligations to repurchase securities at a fraction of their real value, using cash received from the transaction to pay off liabilities.\textsuperscript{88}

Interestingly, Lehman’s auditors Ernst & Young expressed confidence in the bank’s accounts after the audit they conducted in 2007. It can also be noted that their confidence was corroborated by a legal opinion provided by Linklaters, stating that “repo105” could be treated as sales under English law.\textsuperscript{89} By using a legal opinion that was valid only with regards to English law, Lehman managed to keep billion of dollars of debt off its US balance sheet.\textsuperscript{90}

As Secretary of the Treasury Henry Paulson emphasised Lehman’s difficult economic position and the urgency to find a buyer, initial attempts to reach deals with Goldman Sachs, Bank of America and Morgan Stanley, came to nothing, despite the Federal Reserve having helped with a huge loan.\textsuperscript{91} By the time Fannie Mae and Freddie Mac were nationalised with an infusion of around $200bn by the Treasury, Fuld was desperate to raise capital in order to appeal potential buyers, but at that stage he failed to meet requirements set respectively by Korea Development Bank, Citigroup (as regards accounts) and JP Morgan Chase (requiring $8bn collateral).\textsuperscript{92} A last throw of the dice was represented by Barclays’ interest in taking over the Wall Street bank, but at that stage the British counterpart was also conditioning the offer upon a heavy US guarantee against Lehman’s liabilities, and as it turned out, the US government made clear that it would not proceed to another bailout after Bear Stearns had previously benefited from such support.\textsuperscript{93}

\textsuperscript{88} Supra Hughes 2010.

\textsuperscript{89} Legal opinions are employed to corroborate the level of compliance within certain transactions, and have the purpose of satisfying gatekeepers. In structured finance they normally satisfy agencies’ requirements for the rating of securitised debts. See S.L. Schwarcz “The Limits of Lawyering: Legal Opinions in Structured Finance”, 84 Texas Law Review, 2005.

\textsuperscript{90} G. Wearden “Osborne blasts FSA over collapse of Lehman Brothers”, guardian.co.uk, Monday, 15 March 2010.


\textsuperscript{92} Supra Swedberg 2009, p.19.

\textsuperscript{93} A. Clark “How the collapse of Lehman Brothers pushed capitalism to the brink”, guardian.co.uk, Friday 4 September 2009; and L. Elliott and J. Treanor “Lehman downfall triggered by mix-up between London and Washington”, guardian.co.uk, Thursday 3 September 2009.
When Lehman Brothers filed for chapter 11 in September 2008 the event became somewhat of a public outcry of the “freefall collapse of the capitalist order”, as hundreds of employees were filmed outside the New York office, leaving the premises with boxes full of their belongings. What followed the public reaction however was even more of a tidal event as nobody had anticipated the size and the extent of what has become known as the “great panic of 2008”. Responses around the world’s main stock markets saw plunging indexes and the NYSE was again hit by news, this time of Merrill Lynch collapse only saved by a Bank of America buyout negotiated for $50bn.94

Paulson decision to ultimately let Lehman Brothers go down proved to be a crucial one, perhaps justified by the critics he had received for having previously used public money to bailout Bear Stearns, Freddie Mac and Fannie Mae, and for not having let the market deal with the crisis as it had been suggested among most professional and academic circles in the States.95 The idea that the market could police itself however resulted fallacious as it became clear that the laissez-faire attitude promoted by the Bush administration in allowing a major financial institution to collapse created a catastrophic environment: nobody in the financial world trusted anybody’s claims of solvency and the flow of money around the economy froze up.96

It has been observed before the Committee on Oversight and Government Reform97 that bad regulation, lack of transparency and market complacency were among the main causes that triggered the financial crisis and eventually led to Lehman collapse. The deterioration of lending standards, it was argued, was further

94 Ibid. The sequence of events following Lehman’s bankruptcy was quite impressive: again the level of interconnectedness of financial institutions around the world proved to be critical and banks in Japan, China and Russia had to take preventive measures to tackle the market slump, while in the UK government had to suspend competition rules in order to allow HBOS’ merger with Lloyds TSB.


96 Supra Clark 2009. The decision to let Lehman collapse was defined as a “colossal failure of common sense” by a former vice president, Larry McDonald, who also summed up the firm as a “scrappy overachieving investment bank … that had lived in tranquil seas for too long … lulled into the belief, from two decades of prosperity, that making money was easy”.

97 See L. Zingales “Causes and Effects of the Lehman Brothers Bankruptcy”, before the Committee on Oversight and Government Reform, United States House of Representatives, October 6 2008.
exacerbated by the employment of securitisation on lower quality mortgages. Checks that should have been performed by capital markets became problematic because of the nature of securities like CDOs; the picture then was made even muddier by the relationship between issuers and rating agencies mainly because of the increasing market power of the former and the consequential attitude endorsed by banks that started “shopping” for the best rating and for the riskiest way to get a triple-A. As regards Lehman, the high level of leverage and the strong reliance on short-term debt financing, coupled with the very low level of collateral posted for CDS contracts brought about the premises for a systemic failure and overall uncertainty about the true value of the bank’s equity.

As the ensuing bankruptcy inevitably forced the market to reassess the risks related to certain practices (mainly in relation to the impossibility to determine CDOs structures and which tranches and bonds had suffered losses), the event had an enormous impact on the global financial system and it is identified as what kick-started the economic crisis.

6.3.3 – Themes underlying the global crisis

The above cases highlighted a number of themes that can be recognised as common explanations to most of the banking failures during the 2007-08 global meltdown. Moreover, some of the legal issues emerging from the above accounts showed striking similarities with scandals like Enron, and Parmalat, especially with respect to abuses of debt capital market finance and oversight of managerial behaviours. The 2008 panic however reached historical levels of concerns – which led commentators to compare it with the 1929 Great Crash – mainly because of the systemic dimension it reached.

Bearing in mind that mention has been made to the way in which the banking business developed over the past two decades, certain stages leading up to the 2007 crisis need to be reminded before analysing in more details the themes underpinning the global crisis. The general economic environment that preceded the events just analysed was one characterised by the pervading euphoria within financial markets,

98 Ibid p.3-6.
99 Ibid p.11.
whereby persisting macroeconomic imbalances led to excessive liquidity, low interest rates, and a consequential willingness to follow the path of financial innovation in order to satisfy the increasing market demands for securitised products. As explained in chapter four, innovation took the shape of alternative investment schemes and new structured products, designed to move assets and liabilities off-balance sheet and to lay-off credit risk, giving way among other things to the shadow banking system. As financial institutions were reaching an unsustainable level of leverage, acquiring huge – and hardly quantifiable – exposures in the global credit market, the interdependence of market participants defied the very mechanism on which financial institutions were relying upon: investors at the end of the transaction chain (such as hedge funds, pension funds or banks) were in fact funding their speculations with money borrowed from the same banks that were originating innovative products to remain insulated from risks of counterparties’ solvency. What had not been predicted is that because of market interconnectedness (and also because the underlying loans were highly contagious), the risk of securitised loans returned to the originating institutions instead of moving away from them, increasing therefore the overall level of leverage. This is arguably what brought financial markets to a standstill as banks became averse towards lending to each other. Within this process the role of rating agencies became critical as guardians and gatekeepers of debt capital markets, despite their position having proven to be flawed, both because of their rating methodologies and because of the conflicts of interest affecting their operations. Beyond this, the general control over the activities of firms engaged in capital markets in the years prior to the crisis was deficient from a broad corporate governance perspective.

As said, some of the main themes emerging from the global financial crisis can be singled out from the previous section – namely, financial innovation, shadow banking, excessive leverage, failure of control system, complexity. A brief examination will outline how they respectively contributed to the crisis.

103 CRAs’ position in analysed in chapter four.
i) Financial innovation.
The way in which traditional securitisation schemes have progressively flowed into more innovative and obscure ones, such as CDO and CDS, has been subject of analysis in chapter four. It is worth reiterating in the present context that deregulatory legislations implemented over the last decade have spurred the innovation process that had slowly started with the disintermediation from banks in the 1970s. 105 From 2000 then financial institutions in particular exploited the advantage of repackaging their loans as soon as they originated them, capturing both transaction fees for originating individual loans, and servicing fees for acting as agent for those loans 106, and then repeating the process again, giving way effectively to an overabundance of credit. 107

It has also been said that the process of innovation brought about opaqueness as regards the risks attached to securities, because of the intrinsic difficulty to assess the value of underlying assets within the repackaging process. 108 The practice of collateralisation then, coupled with synthetic exposures, created synthetic CDOs, which were essentially securities backed by no assets, but by derivatives exposures, often in the shape of CDS contracts. The growth of this market in the last two decades was particularly steep for those financial institutions in the shadow banking system, which have now come to account for more in total assets than traditional depository institutions. 109

ii) Shadow banking.
One of the most important outcomes of the global crisis has been the definite recognition that much of what happened did not occur within the most scrutinised

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106 These fees countered for banks the stagnation and decline of traditional bank fees. See Blackburn 2008, p.8.

107 Ibid, p.11.

108 This is compared to more traditional securitisation schemes where the bundle of securitised mortgages would offer pro rata shares in the income stream, whereas more recent repackaging techniques entail the “tranching” of securities with different classes and priorities. See J. Coval, J. Jurek, E. Stafford “The Economics of Structured Finance”, 23 Journal of Economic Perspectives 3, 2009.

109 Supra Blair 2010, p.12.
financial institutions, but among a plethora of obscure entities and vehicles that had proliferated and played a determinant role in the global credit market.\textsuperscript{110} This “hidden” system had expanded very rapidly from the 1990s onward as a consequence of deregulation that firstly allowed financial institutions to engage in banking functions and secondly loosened rules concerning lending and borrowing.\textsuperscript{111} Even though the symptoms of this malaise had been already exposed by the Enron-type scandals at the start of the decade, where several layers of “invisible balance-sheets” were found to be at the heart of the problem, subsequent legislations did not introduce any effective ban on holding vehicles off-balance sheet. Regulatory measures directed at increasing capital and providing liquidity for the banking system were in fact missing the point as they did not target the shadow banking sector, which represented a major source of financial and economic instability.\textsuperscript{112}

The shadow banking system can be defined as a set of financial intermediaries – broker-dealers, hedge funds, private equity funds, structured investment vehicles, money market funds – involved in the creation of credit at a global level, but not subject to regulatory oversight, either because of the nature of the entities in question or because of the activities they carry out. This broad definition focuses in particular on the function of credit intermediation that takes place in an environment where prudential regulatory standards and supervisory oversight are not applied, or are applied to a substantially lesser degree.\textsuperscript{113}

A more narrow definition would focus more closely on specific risks that are likely to arise from non-bank credit intermediation activities. These risks can be identified with: systemic risk concerns, which arise in connection with activities that generate maturity and liquidity transformation, that in turn facilitate leverage; and with regulatory arbitrage concerns, which relate to activities directed at circumventing banking regulations.\textsuperscript{114} Maturity transformation is related to firms’


\textsuperscript{111} Supra Blackburn 2008, p.3.


\textsuperscript{113} Financial Stability Board “Shadow Banking: Scoping the Issues”, 12 April 2011, p.3.

\textsuperscript{114} Ibid.
short-term liabilities (like deposits) which are transformed into long-term ones (like loans), whereas liquidity transformation refers to the practice of issuing liquid liabilities to finance illiquid assets; as non-bank entities are more highly leveraged\textsuperscript{115} than banks (because they are not subject to the same regulatory requirements\textsuperscript{116}), their operations raise concerns because of the systemic risk they create.\textsuperscript{117}

A further problem is then represented by the level of interconnectedness of the shadow banking system with the regular banking one, as this interlink can exacerbate the accumulation of leverage and increase the risk of asset price bubbles.\textsuperscript{118} The interaction between banks and shadow banking entities is currently at the heart of regulatory concerns as a form of indirect intervention would look at hindering these relationships in order to reduce the spill-over of risk to the banking sector.\textsuperscript{119}

iii) Excessive leverage.
It has been observed that financial innovation over the last three decades has allowed corporations and financial institutions to almost bypass the traditional banking system through the process of disintermediation centred on securitisation.\textsuperscript{120} It has also been seen that through this process, coupled with deregulation measures, assets growth in the shadow banking sector has outpaced that in traditional depository institutions. These new sources of debt finance have had, \textit{inter alia}, the effect of

\textsuperscript{115} In the context of shadow banking the above activities are very conducive to high leverage, mainly because of the unregulated utilisation of non-deposit sources of collateralised funding (like repos) and also because of flawed credit risk transfer resulting from securitisation chains. Ibid, p.4.

\textsuperscript{116} In particular two types of regulation that apply to traditional banks are avoided in the shadow banking system: reserve requirements, which determine how much of the bank’s deposits may be loaned out or invested by the bank to earn a return; and capital requirements, which determine what share of total assets must be financed with equity rather than debt capital. See Blair 2010, p.17.


\textsuperscript{118} Supra FSB 2011, p.4. Banks often compose part of the shadow banking system, and sometimes provide support to it by enabling the maturity/liquidity transformation; moreover, banks invest in products issued by shadow banking entities and are often exposed to common risks through asset holdings and derivative positions.

\textsuperscript{119} Other forms of intervention would look at: directly regulate shadow banking entities in order to reduce the risk they pose to the system, or at the activities and risks implemented by these entities, or else at addressing more broadly the systemic risk in the shadow banking system. Ibid, p.8.

allowing banks and other financial institutions to create credit beyond the constraint of reserve ratios, with the only limit being the level of leverage to be reached by these institutions.\textsuperscript{121}

Leverage can be defined as the percentage of debt relative to equity that is employed by firms for financing, and is often represented by the ratio of total debts to assets (or assets to equity). In the financial sector, banks are constrained by reserve requirements and by capital requirements, with the latter determining in particular the financial cushion that a bank must have.\textsuperscript{122} Outside the banking sector however, capital requirements have historically not been regulated, mostly because it was largely believed that market mechanisms would impose informal constraints with lenders refusing to lend to highly leveraged institutions.\textsuperscript{123} This however proved to be rather delusional.

Beyond being relevant at micro-level, leverage also matters for systemic reasons because it increases the possibility that a firm will not be able to repay its creditors, giving way therefore to spill-over effects. Investments made by or to highly leveraged institutions are inherently more risky than they would be in case of higher percentage of equity, and this level of riskiness makes loans highly contagious and the whole system affected by problems of liquidity and solvency.\textsuperscript{124}

The Basel Accords then sought to coordinate capital requirements at international level, requiring banks to hold minimum amounts of capital against risk. The problems with the Accords however were twofold: firstly, they never had the binding force of law; secondly, the difficulty in determining the risk attached to assets and their classification allowed large banks to resort to their own models to determine risk classifications.\textsuperscript{125} This was again coupled with faith that the market would provide discipline by reining in the amount of leverage.\textsuperscript{126}

\textsuperscript{121} Supra Blair 2010, p.20.
\textsuperscript{122} Ibid, p.21. This relates to the amount by which a bank’s total assets must exceed its liabilities.
\textsuperscript{123} Ibid.
\textsuperscript{126} Ibid, third pillar.
The reality however was different as in the years before the global crisis financial institutions increased their level of borrowings in the credit market by issuing commercial papers, asset-backed securities, or through repo agreements, which all contributed to building up a very profitable (for the borrowing institutions) level of leverage. 127 This however was not the visible picture because banking institutions had actually been able from the 1980s onwards to reduce their level of leverage by developing transactions through which assets and liabilities could be moved off-balance sheet, to the panoply of SPVs/SIVs created for the purpose of holding assets and issuing securities. 128 Financial innovation in other words contributed to the creation of a “hidden leverage” 129 that allowed institutions to borrow at more attractive rates, hiding their debts and creating the appearance of creditworthiness. 130

By the time the global financial crisis unfolded the effective level of leverage of the global financial system (banking and shadow banking) had risen to an unsustainable level – this in spite of capital ratios recommended under Basel. 131

iv) Failure of control systems.

Corporate governance shortcomings have probably been relegated as lesser co-determinants of the global financial crisis vis-à-vis the more resounding financial themes, but a number of failures in the sphere of control mechanisms can still be recognised. Some of the corporate governance themes generally underpinning financial scandals have been discussed in chapter three, where a specific discussion

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127 Supra Blair 2010, p.22. The example provided to understand the profitability of high leverage is that of a buyer who acquires his $100,000 house through a 90% mortgage. If the property’s value increases, say by 5%, the homeowner will have realised a 50% return on his initial investment of $10,000. However, a similar fall in the value of the property will almost wipe out the homeowner’s equity in the property.


129 See M. Simkovic “Secret Liens and the Financial Crisis of 2008”, 3 American Bankruptcy Law Journal, 253, 2009. It is observed that securitisation at times reduced interest rates by 150 basis points, compared with a secured loan.

130 Despite apparent creditworthiness, leverage affected firms’ probability to repay creditors, adding therefore riskiness, magnifying spill-over effects and contagion because of the underlying interconnectedness.

131 Supra Blair 2010, p.25.
involved the control of managerial actions through fiduciary duties and compensation structures.

The last banking collapses have again highlighted problems of board practices, excessive remuneration, combined with a self-destructive bonus culture, which all contributed to encouraging short-term policies and risk-taking on the part of boards.\textsuperscript{132} As both Lord Turner\textsuperscript{133} and Sir David Walker\textsuperscript{134} indicated in their recommendations, key corporate governance areas that raised concerns during the crisis can be identified with the overall failure of board of directors at different levels, and with managerial remunerations. The first point in particular encompasses the independence and skills of non-executive directors and other executives involved in the risk-management process, and the overall functioning and supervision of boards’ activities. These issues have become even more central in the case of banks and financial institutions because of the externalities that have been borne by society after 2007. A tighter regulation of certain governance mechanisms has been therefore largely advocated, and this has become more urgent in the context of corporations or financial institutions that represent critical components of economies.

However, as the main regulatory tools in the area remain dominated by a comply-or-explain approach, a more prescriptive functioning of control mechanisms does not seem easy to achieve under the current framework. Similarly, as explored in chapter three, litigation against directors under the Companies Act 2006 provisions is rather scarce as courts remain reluctant to second-guess directors’ decisions.\textsuperscript{135}

v) Complexity.

One of the main problems underlying the difficulty in regulating the global financial system is the complexity that in different ways has made it obscure and inaccessible

\textsuperscript{132} Supra Arora 2011.

\textsuperscript{133} Lord A. Turner “A Regulatory Response to the Global Banking Crisis” FSA Discussion Paper 9/2 2009. Areas of corporate governance concern included professionalism and independence of risk management; the level, skill and time-commitment of non-executive directors; risk management considerations in connection with remuneration and risk-taking; ability of shareholders to constrain risk-taking.

\textsuperscript{134} Sir D. Walker “A review of corporate governance in UK banks and other financial industry entities”, 16 July 2009. Recommendations were made specifically in the areas of: board size, composition and qualification; functioning of the board and evaluation of performances; role of institutional shareholders; governance of risk; remuneration.

\textsuperscript{135} Supra Arora 2011, p.18.
to regulators and supervisors. This has happened along two different lines. Firstly, the innovation of securitised products has developed an increasingly obscure class of securities as already explored in chapter four. This affected the way in which products were structured in the first instance, as synthetic and collateralised exposures became common, giving way to multiple tranches bearing different risk and value. Complexity also concerned the underlying assets, mainly because of how they were pooled and sliced in different tranches of resulting securities. It has been suggested that the overall opacity of these products can create information failures and impair their disclosure, depriving investors of necessary transparency.\footnote{S.L. Schwarcz “Regulating Complexity in Financial Markets”, Washington University Law Review, Vol.87, No.2, 2009, p.221.}

Information failures then have arguably been exacerbated by rating agencies that assigned triple-A to dubious securities, with little due diligence backing the rating.

Secondly, the legal structure characterising the way in which corporate and financial firms organise their business has increasingly relied on archipelagos of corporate entities of different type and jurisdiction. Similar concerns had already arisen after the Enron and Parmalat scandals when off-balance sheet liabilities had been hidden in inaccessible off-shore entities, thanks to then obscure structured arrangements. During the last crisis this complexity has become more scientific because of the way financial institutions had designed their operations, which were often part of the shadow banking system, and could thus escape regulation.\footnote{Supra Gallino 2011, p.270.}

Prominent exemplification of this opacity is represented by Lehman Brothers, as one year after its bankruptcy charter accountants and lawyers were still busy trying to unravel the intricate web of transactions and exposures between different branches and funds of the investment bank. It was estimated that three years would be needed to identify all outstanding liabilities, while ten to settle them.\footnote{Ibid p.271.}

\section*{6.4 – Lessons to learn from the 2007-08 crisis}

When the bubble bursts, reactions are usually fairly imminent, and they commonly take the shape of legislations enacted to correct what are the perceived malfunctions.
That was the case with the Bubble Act 1720\textsuperscript{139} as a response to the South Sea Bubble, as well as a decade ago with the very prompt launch of the Sarbanes-Oxley Act in 2002.\textsuperscript{140} As described in chapters three and four, the global meltdown has been followed by similarly prompt reactions in the UK, in the US and at EU level most prominently. These interventions however did not necessarily reflect the full gravity of the crisis and most importantly the depth of regulatory flaws that became apparent in its aftermath. Despite the global crisis having been rightly compared to the 1929 Great Crash, the 2008 “panic” has not been followed by the same drastic regulatory corrections implemented eighty years earlier.\textsuperscript{141}

While a more radical revision of the financial system has been advocated within some circles\textsuperscript{142}, reforms so far have somewhat remained timid attempts to cure a chronic disease without eradicating its very source. There is in other words a clear willingness to cling to a business model (encompassing the financial and the corporate sector, and based on the undisputed reliance on the market) that the crisis unveiled as fundamentally flawed.\textsuperscript{143} Not only the recent global meltdown, but as evidenced in these case studies, a whole decade of corporate and financial failures, all pointed at very similar corporate governance malfunctions (failure of control systems) and at the dangers and abuses of overdeveloped capital markets.\textsuperscript{144}

It is worth stressing on this last point that while developed capital markets are instrumental to the life of industrial enterprises (which in turn boost labour markets

\textsuperscript{139} Royal Exchange and London Assurance Corporation Act 1719, which restricted the application of limited liability to all but few entities.


\textsuperscript{141} These flowed into the establishment of the SEC, probably the first financial regulator in history, and into the enactment of a number of legislative measures, among which the Glass Steagall Act.

\textsuperscript{142} Most prominently A. Turner “Reforming Finance: Are We Being Radical Enough?”, 2011 Clare Distinguished Lecture In Economics and Public Policy, FSA, 18 February 2011, p.25.

\textsuperscript{143} P. Jenkins “FSA’s head targets “shadow banking””, Financial Times, April 18, 2012. In response to Adair Turner’s proposals, one investment bank chief said “I believe in a market economy, Turner doesn’t I guess. This is all about a centrally planned economy, this is anti-competitive”.

\textsuperscript{144} These are epitomised by the label of “steroid banking” used in “Wall Street, Money Never Sleeps”, directed by O. Stone, 2010, “…they got all these fancy names for trillions of dollars of credit, CMO, CDO, SIV, ABS; you know I honestly think there’s maybe only seventy-five people around the world who know what they are…”; “…We take a buck, we shoot it full of steroids, we call it leverage. I call it steroid banking…”.
and serve social needs), the age of “financialisation” in Anglo-American economies has brought about a model that clearly departed from the social role of financial markets. This resulted in a huge apparatus that exists to serve its own purposes of extracting value from society, rather than creating value for it.\textsuperscript{145} The growth of the global financial system along these lines led to critical shifts in many countries that forsook traditional industrial economies to embrace financial ones based on inflated financial services sectors.\textsuperscript{146}

More importantly, as illustrated in the case studies, the legal mechanisms underpinning this new model are now scrutinised for their dubious rationale. Innovative products like CDOs and CDSs have finally come to light as being largely speculative tools that did not encompass any economic or social function, but rather contributed to the emergence of a hidden universe of risks, losses and liabilities (the shadow banking system indeed). It is worth recalling that in unsuspected times – when theories praising the efficiency of market mechanisms abounded – the dangers of overdeveloped financial systems were identified with their proneness to instability and crises. Countering the axioms of prevailing neoliberal ideologies it was then suggested that the end-stage of large financial markets was represented by a high level of leverage whereby the debt burden keeps increasing and firms continue borrowing to pay interests.\textsuperscript{147} This theorised scenario is actually close to representing what triggered the “credit crunch” in late 2007. On the other hand, the same neoliberal propositions that are still embraced as conventional wisdom in most financial circles, led in the years before the crisis to theorise through quantitative models that certain events could only happen once in a thousand years. In August 2007 those very events happened for three days in a raw.\textsuperscript{148}

\textsuperscript{145} See Gallino 2011, ch.1.

\textsuperscript{146} Ibid. These two types of capitalism differ for the way in which capital is created. Industrial capitalism applies the traditional paradigm whereby initial capital is invested into production and from the sale of produced goods a profit is made, which is the resulting capital. Financial capitalism skips the intermediate phase of investing in the production of goods, thus initial capital is invested in financial markets with the aim of producing immediate and maximised earnings.


\textsuperscript{148} K. Whitehouse “Quant expert sees a shakeout for the ages”, \textit{Wall Street Journal}, 14 August 2007.
The above considerations are a statement to the need to reconsider the role that financial systems play in society. This is the main lesson to draw from the global meltdown and it is worth reiterating the view that recent reforms have not fully reflected it as they are rather directed at trying to perpetuate a system by simply correcting some of its manifestations, whereas its foundations are still hampered by a flawed ideology.

The social dimension that financial markets should encompass leads to a last comment. The global financial system resulting from the age of financialisation is also characterised by a sheer lack of democratic process underpinning its governance. Problems of legitimacy and accountability (analysed in chapter seven) have progressively been exacerbated by an industry that was virtually internalising its gains while externalising its losses, thanks to connections (also referred to as “revolving doors”) that from the 1980s onwards have linked financial circles to political ones, resulting in the deregulation process first and ultimately in the undisputed application of neoliberal free-market principles.

The ensuing “free-market anarchy” that permeated large sections of the financial services industry could thus fit into an “Hobbesian” scenario, where the lack of legitimate governance – meant as strong central authority – may lead according to the English philosopher to a condition where individuals would have a right to do anything, that being well synthesised in the Latin maxims “homo homini lupus” and “bellum omnium contra omnes”.

These are arguably the stages that regulators should currently prevent from occurring.

What regulatory reactions should have been enacted?

It is becoming increasingly evident in the wake of the global crisis that the role of financial markets needs to be revisited. Beyond regulatory intervention in certain

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149 Supra Gallino 2011, ch.1. See also D. Muegge “Limits of Legitimacy and the Primacy of Politics in Financial Governance”, Review of International Political Economy, Vo.18, Issue 1, 2011, where it is argued that serious legitimacy deficits persist in the capital markets policy-making due to excessive influence of the financial industry, compared to other stakeholders.

150 Supra Gallino 2011, p.23,24. This refers to the simple exchange of high-rank personnel from financial institutions to political public ones, which has allegedly favoured the deregulation process.

151 T. Hobbes “Leviathan – Of the Natural Condition of Mankind as Concerning Their Felicity and Misery”, 1651, ch.13 (“every man is a wolf to another man”; “war of everyone against everyone”).
specific areas, what this really entails is a process of redistribution of regulatory
powers whereby states should re-establish some degree of national financial
sovereignty. Once the social function of financial markets is redefined, this would
allow reining in the innovative power of the market by taking over competences that
in the past twenty years have been subject of deregulation processes. More
specifically, it is suggested that empowering national authorities over capital markets
controls could, *inter alia*, limit the interconnectedness of global financial markets
and therefore protect society from market players’ externalities such as excessive
risk-taking and leverage.

While specific proposals will be presented in chapter seven, it is worth at this
stage reiterating some of the critique put forward in chapters three and four with
regards to the regulations enacted post-crisis. It is envisaged in this research that the
global meltdown should have prompted a drastic reflection on the role played by
private market players within financial markets and on their role in policy-setting
therein. The *quasi*-regulatory power of the financial services industry, together with
the deregulatory process that led, among other things, to firms becoming too-big-too-
fail, is identified as what regulators across the UK, US and EU should have sought to
redesign. It can be observed that while to some degree there have been attempts to
redress the latter issue (lastly with the Vickers Report), the former remains
somewhat of a *tabu*.

While the Dodd-Frank did tackle some pressing issues, namely the urgency
to regulate speculative derivatives, the public agency established in the Act is not
empowered to face the lobbying power of Wall Street investment banks. Some of the
propositions underlying recent EU initiatives present an even more negative
approach towards regulating the market. CRD IV\textsuperscript{152} for instance reflected a sense of
resignation that regulation cannot prevent disintermediation of capital flows, and that
the shadow banking system is still not well enough defined to apply onerous
regulation upon firms.\textsuperscript{153} If on paper ESMA represents a more fundamental change
(or an attempt in that direction) in the centralisation of cross-border financial markets’

\begin{footnotesize}
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\item[152] European Commission, Proposal for a Directive of the European Parliament and of the Council
\item[153] J. Berg “*CRD IV: The new EU framework for capital and liquidity requirements*”, EPFSF Lunch
Discussion, 4 may 2011.
\end{enumerate}
\end{footnotesize}
supervision, some of its powers are still constrained by formal triggers and its institutional status risks to diminish its activity to that of a collective actor.\textsuperscript{154}

Together with the exposition of the thesis’ substantive proposals, chapter seven will expand the above critique by charting the institutional foundations upon which the ESC paradigm is grounded. This will allow a deeper reflection on the issues above outlined and on the possible ways to counter the regulatory power of the market and of its players.

6.5 – Conclusion
The chapter completed the case studies started with Enron and Parmalat. The present account provided a brief overview of two banking failures that emerged from the period between 2007 and 2008, an historical stage that created reminiscence of the Great Crash of 1929 because of the severity of the credit crisis and because of the ensuing economic downturn. Exploring certain themes underpinning the global financial crisis required the broader examination of its background, both regulatory and politico-economic, beyond individual institutions’ case studies.

In this respect the chapter sought to delve into the theoretical and legal underpinnings that over the past three decades contributed to creating the legal and economic environment that proved to be so conducive to a financial collapse of historical magnitude. The enquiry was then complemented by the more specific identification of themes that emerged from the study of the crisis as a whole and from individual institutions’ collapses. Five themes have been highlighted: financial innovation, the shadow banking system, excessive leverage, failure of control systems, and complexity.

Interestingly, many of the legal problems underscoring the present analysis can be recognised as common denominators of the scandals occurred at the start of the decade, namely Enron, WorldCom, Parmalat among others. This leads to general reflections on the appropriateness of more drastic regulatory measures to curb once and for all the excesses herewith examined. Criticism towards the regulatory reactions to the last crisis is reiterated in the chapter, and it links to the more specific proposals discussed in chapter seven.

Chapter 7 – Defining the enlightened sovereign control paradigm

7.1 – Introduction
The purpose of this chapter is to define the enlightened sovereign control paradigm (ESC) which is proposed as a regulatory response to the legal issues identified in the thesis. While certain concepts of the proposals have already been introduced in chapters three and four, the paradigm is here more comprehensively developed. This is done by firstly defining its foundation, which draws from a number of selected theories in the field of corporate and financial law. These represent both the underpinning of the ESC paradigm, and a theoretical development of the themes analysed in chapter two. The aim of the paradigm is to put forward substantive proposals in response to the legal issues emerged throughout the thesis. In order to substantiate the proposals’ implementation, these are presented together with the regulatory body from which they should stem. The chapter therefore also discusses the institutional framework designed to link the theorised dimension of ESC with its practical substantive outcomes. It is worth stressing that while the advocated measures range across specific fields of corporate governance and structured finance, the paradigm results in a concept that provides a theoretical justification for both areas of law.

The chapter is organised as follows: Section 7.2 provides the ESC foundation by analysing underpinning theories in the areas of corporate and financial law. The institutional mechanism designed to implement the paradigm is illustrated in section 7.3, while the substantive proposals are offered in section 7.4. Section 7.5 concludes the chapter.

7.2 – Theoretical foundation of enlightened sovereign control
Following from the examination conducted in chapter two, this section expands that theoretical enquiry along similar lines. Drawing from different theories in the fields of corporate and financial law, the thesis proposes a common approach to the themes highlighted in chapter two, and to the legal issues explored in chapters three and four. The foundation herewith provided will flow in the substantive measures proposed under the ESC paradigm.
While general responses to the global financial crisis seem to have led towards more “populist” reactions involving either a high degree of state intervention in order to curb the excesses recently witnessed, or the enactment of bulky pieces of legislation, the proposals herewith outlined aim to provide solutions that first of all escape the sort of “reactive” regulation that normally follows events of such magnitude. At the same time however, this framework clearly departs from some of the neo-liberal regulatory models that have been in place over the last three decades, especially in the sphere of financial regulation and corporate governance. This section provides the foundation of the proposed paradigm by exploring a number of theories that underpin it.

7.2.1 – Corporate governance

This section develops the enquiry conducted in chapter two by presenting the theories that underscore the ESC paradigm. With regards to the corporate governance issues, the first problem to deal with is that of the corporate structure. Different scandals over the past decade have highlighted flaws in different ownership models (Parmalat was a closely-held firm, while Enron and WorldCom for instance widely-held) and have exposed malfunctions in different corporate governance systems. In particular, the explosion of corporate scandals in North America at the start of the decade contributed to shift the focus of corporate scholars from the ownership model to the quality of laws. Prominent scholarship has argued that either ownership model can work efficiently under an appropriate legal framework. In this respect, it has been observed that different ownership structures would result in a trade-off between different agency issues (managerial rent extractions as opposed to private benefits of control) and the

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1 “Reactive” regulation is meant as legislation enacted as a response to a particular event or to a bubble, as opposed to legislation that could be defined as “proactive”. The latter is to be preferred here because of its longer-term validity beyond the direct response to a crisis. This allows an approach to regulation that escapes the boom-and-bust cycles witnessed over the last two decades, aiming on the other hand at long-term stability.

way in which they are dealt with.\(^3\) In this context the control over corporate activities (decision-making processes) could be more effectively carried out by a controlling shareholder than the “panoply of market-oriented techniques” employed in widely-held corporations.\(^4\) Pushing this argument further, it has also been suggested that under certain circumstances close ownership – particularly in the case of family shareholding – can facilitate the development and the maintenance of firms’ reputation, which is essential for their overall success.\(^5\)

A more problematic corporate governance issue is that of identifying in the first instance in whose interest the company should be run, and then ensuring that directors and executives act in accordance with their duties. This very topical issue has become increasingly delicate in recent times, especially with the global financial crisis highlighting how society at large can suffer from the consequences of corporate and financial failures, and how social interests should be taken into account in the context of directors’ duties. The idea of encompassing social interest and the general social welfare among corporate goals is not new, and it partly revolves around the principles underlying stakeholder theory, which have already been discussed. However, it is fair to say that pressure to include social interests within corporate goals has increased in recent years, probably as a reaction to a soaring perception that public concerns have been regarded as lesser than the private corporate ones. Beyond perceptions, the concept of “corporatist state” developed mainly in the US and UK has become progressively more apparent over the last two decades, and the last political administrations have somewhat over-enhanced this trend as the interests of certain major corporations have come to determine general political designs.\(^6\) The outrage against the corporate world

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\(^5\) Supra Gilson 2007, p.4.

\(^6\) See N. Klein “*The Shock Doctrine. The Rise of Disaster Capitalism*”, Allen Lane London 2007, ch.15. After the war in Iraq several oil corporations benefited from deals agreed with the new Iraqi administration following the removal of Saddam Hussein. A similar argument can be made for the energy privatisation that allowed Enron to expand and develop its business.
flowing from recent events and scandals seems thus to justify some of the stances endorsed even at academic level.

A strong pluralist approach represents the foundation of this academic debate. This is grounded on an expanded concept of stakeholder value, whereby the company is regarded as an entity that should legitimise the privileges not only of its internal groups (shareholders, workers) but should rather embrace an external perspective of the firm’s management.\footnote{G. Teubner “Corporate Fiduciary Duties and their Beneficiaries: A Functional Approach to the Legal Institutionalization of Corporate Responsibility”, in Hopt and Teubner Corporate Governance and Directors’ Liabilities, De Greuter Berlin 1987, p.157.} The argument stems from the assumption that a corporation does not only exist as a self-serving and self-realising entity, but it also has to fulfil a broader social role. The interest of society at large should then legitimately contribute to shaping the organisational structure of the firm and also the way in which it is managed.\footnote{Ibid p.157,165. This entails a different determination of the corporate goal. To this extent different social groups would become relevant insofar as they represent social interests and are in a position to control fiduciary duties.}

A more radical approach has been envisaged by the “concession company law model”, which in simple terms views the limited company as a concession concurred by the state\footnote{The idea of limited liability as a right concurred by the state brings back to the restrictions of the Bubble Act 1720, which prohibited joint stock concerns for commercial purposes. See A.H. Miller “Subjeitivity Ltd: The Discourse of Liability in the Joint Stock Companies Act of 1856 and Gaskell’s Cranford”, ELH 61.1 (1994) 139-157.}, which in turn grants a right to incorporation.\footnote{J. Dine “Post-Concession Company Model in Potential European Company Law”, Conference Presentation for “Directors Duties and Shareholder Litigation in the Wake of the Financial Crisis”, University of Leeds, 20 September 2010, p.14.} This could be viewed, beyond stakeholder theory, as a possible ground to respond to the “contractarian” model that, as seen in chapter two, is the foundation of the shareholder primacy that has dominated Anglo-American corporations.\footnote{It is observed that this corporate model has emerged despite the fact that shareholders’ primacy is not actually a company law requirement, but it is rather an assumption of efficiency grounded on a “contractarian”, economic-based approach to corporate law. See M.T. Moore “Private Ordering and Public Policy: The Paradoxical Foundations of Corporate Contractarianism”, Working paper November 2010, available at ssrn.com/abstract=1706045, p.1-3; and C.M. Bruner “Power and Purpose in the Anglo-American Corporation”, Virginia Journal of International Law, vol.50 no.3, 2010, p.582,583.} If a pure stakeholder approach already looks at the firm
as a social and political entity encompassing the interests of employees, consumers, and local communities, it has also been proposed that the company is actually derived from society, and this would imply therefore a bottom-up, “dual concession” theory.\textsuperscript{12} Under this scheme, society should represent the foundation for corporations, and this would mean that communities should have the power to influence the organisational structure of firms.\textsuperscript{13} Companies in other words would be not only derived from society, but also responsible to a broad democratically represented community.\textsuperscript{14}

The main problem and criticism associated with the above theories is related to difficulties in their practical application. Pluralism in fact suffers from the intrinsic fallacy of not providing clear guidelines of how the board should measure different social groups’ interest \textit{vis-à-vis} other constituencies’. The possibility of including moral and ethical standards on the board also risks being an economically inefficient measure and also legally uncontrollable. A possible solution may consist in looking for state intervention for the fulfilment of the social interest on which the theory is premised, but this would prove to be a costly and bureaucratic solution. It has also been suggested that in order to coerce the board to adopt conducts that would cause restraints on economic actions, which have detrimental effects on the non-economic environment, a departure from voluntary rules would be necessary.\textsuperscript{15} This may entail a process of “proceduralisation” of fiduciary duties directed towards the creation of organisational structures that allow the optimal balancing of corporate performance and function, taking into account at the same time the interest of the non-economic environment.\textsuperscript{16}

\textsuperscript{12} Supra Dine 2010 p.16. The structure would be from the bottom because there would not be in this case a monarch or a sovereign giving the concession, but it would come from the bottom/society.

\textsuperscript{13} Ibid.

\textsuperscript{14} See P. Ireland “Property and Contract in Contemporary Corporate Theory”, 453 \textit{Legal Studies} 2004, p.506.

\textsuperscript{15} Supra Teubner 1987, p.165.

\textsuperscript{16} Ibid. p.167. “Proceduralisation” is defined as the process through which substantive standards of fiduciary duties are replaced by procedural standards and organisational devices which would guarantee the balancing of different interests at stake.
The application of a “concession company law model” would be even more problematic as it would strongly jeopardise the concept of limited liability as such. A move in such direction may have detrimental effects on the same social interests it aims to protect, simply because society at large has come to rely on the economic infrastructure grounded on limited liability companies.17

The proposed ESC approach embraces the motives of the above theories only to the extent that they offer greater recognition to social interests against the economic ones. The main purpose would be to find a sustainable alternative to the shareholder value model that has been dominant in Anglo-American economies and that was dangerously expanding (at least before the crisis) even beyond them. Drawing from the arguments laid down in the thesis, it appears that a more socially inclusive system governing major corporations in the world is urgently needed. The global financial crisis has proven it, with consumers and different social constituencies suffering from the failure of financial firms. More recently the BP case has shown the devastating effects of corporate affairs that did not take under due consideration the interests of local communities and the environment. The proposed model however, also recognises the economic importance of public firms for the creation of general social wealth and therefore looks at the same time at measures that would not curtail entrepreneurship. This ultimate need to combine the economic interest and the social one pushes towards a more balanced (indeed enlightened) intervention of the state as ultimate guardian of the social interest, at national level. If the regulating power of the market, together with economic literature influencing Anglo-American corporate theory18, has promoted the firm’s economic interests, a broader concept of corporate law encompassing wider socio-economic interests has been underestimated.19 This deficit has posed, inter alia, the problem of creating a public legitimisation of managerial power within a democratic

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18 Supra Moore 2010, p.20.

19 See J.E. Stiglitz “Globalisation and its Discontents”, London Penguin 2002. Stiglits points out that in the USA in particular financial institutions as well as the media have created the illusion of the “market” as a “dream factory second only to Hollywood”, able to determine the rules of public rhetoric.
society.\textsuperscript{20} Under this expanded idea of corporation, broad socio-economic interests would be more appropriately guarded by the state\textsuperscript{21}, because of its democratic underpinning and its suitability to represent different social groups.

These conflicting concerns pose a dilemma as to how a sustainable equilibrium could be found. This problem has historically been difficult to unravel. The way in which the proposed model addresses the issue of interests-weighing is by creating a two-tiered classification of corporations, each of them attracting a different degree of public intervention.\textsuperscript{22}

The first tier of public corporations would include entities whose activities can potentially have a negative impact on society at large. This classification categorises firms beyond their size, ownership structure, and industry sector, and therefore goes beyond the meaning of the “systemically important financial institutions” group.\textsuperscript{23} If financial firms are today perceived as intrinsically dangerous for many social groups, also because of the systemic risk they bear, other corporate entities can equally cause harm to society, and according to this paradigm need to be controlled and supervised adequately.\textsuperscript{24} The type of supervision and control required at this level would guarantee that the social role of corporations envisaged by the theories analysed above would be complied with. The pluralist approach then would be implemented by a system of public intervention in corporate affairs, through either a mandatory outsourcing or through certification of corporate activities by specifically established public bodies. The outsourcing and/or certification of certain activities and decision-making processes


\textsuperscript{21} Supra Teubner 1987, p.159.

\textsuperscript{22} Public authorities in this case are regarded – by virtue of their democratic underpinning – not only as legitimate guardians of different social groups, but also as super partes regulators and supervisors, which could escape the various conflicts of interest that undermined self-regulatory agencies and market players in performing these duties.

\textsuperscript{23} See P. Jenkins and P.J. Davies “Thirty financial groups on systemic risk list”, Financial Times, 29 November 2009.

\textsuperscript{24} A clear example would be BP, which recently affected the natural environment of the Gulf of Mexico and the life and activities of many communities inhabiting the coastal areas invested by the oil spill. See http://www.guardian.co.uk/environment/bp-oil-spill.
would ensure the consideration of non-economic social issues, and ease the board’s duties to balance various interests at stake, implementing *de facto* a pre-established corporate objective. While at this stage this remains a conceptual definition of ESC, specific illustration of how this mechanism works are provided later in the chapter.

The second tier of public corporations would include those firms that, regardless of their size, pose only limited risks to society, either because their eventual failure would not affect social wealth to a considerable extent, or because their activities do not naturally invest the interest of a broad range of social groups and local communities. While they would still be subject to a regulatory framework typical of public companies, they would not be interested by social concerns beyond a voluntary approach. This would in other words reflect an organisational framework permeated by shareholder value and by a number of self-regulatory, internal governance mechanisms, whereby private corporate interests prevail over social ones.

A key definition within this paradigm is the measure of whether and how corporate and financial firms have a negative impact on multiple social groups and are therefore deemed to attract a higher degree of “sovereign control”. In order to provide a categorisation of the two tiers, a number of sub-criteria are here identified; the degree to which firms trigger the emergence of these criteria cumulatively will raise concerns and thus call for public scrutiny. These sub-criteria can be synthesised in a number of factors:

1) **Size and number of employees (group level)**. This in itself is not a definite parameter, but it certainly contributes towards the definition of what should attract sovereign control. A high number of employees can play a part on certain strategic board policies, and combined with firm’s size this factor can lead to broad social considerations in case a city or regional community substantially relies on the firm for occupation and production purposes (which would be for instance the case of Parmalat). 2) **Group turnover**. This parameter should be looked at in connection with the previous one. In particular, a very high turnover should attract public scrutiny with regards to the audit first of all and more generally with a range of financial and accounting issues like off-balance sheet liabilities. 3) **Geographical spread**. It is envisaged that since multinational

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25 A more detailed proposal on the audit function is laid down later in the chapter.
entities benefit from economies of scale and are in a position to resort to “regulatory arbitrage” and “jurisdiction shopping”, this in itself deserves a higher degree of public concern over their activities which somewhat counterbalances the economic advantages deriving from their organisational pattern. 4) **Range of activities.** This factor has a twofold significance and should be examined in conjunction with the previous one. It relates firstly to the degree to which firms embrace multiple areas of business, becoming therefore conglomerates. This has increasingly been the case within the financial services industry, where deregulation has given way to “too-big-to-fail” institutions. It is suggested that this type of concentration should be highly scrutinised and it should attract sovereign control. This parameter refers secondly to the type of activity carried out by firms and by the level of risk it poses to society at large (typical example would be that of environmental risks connected to specific industries, like the oil or the mining one). 5) **Externalities on social groups.** More than a factor, this last criterion represents rather the synthesis of whether and to what degree firms’ activities can impact on a wider range of societal groups according to the four previous parameters.

### 7.2.2 – Corporate finance

This section advances the second enquiry conducted in chapter two and presents the theories that underlie the ESC paradigm in the sphere of corporate finance. An initial assessment in chapter two was the acknowledgment that a different type of financial development occurred around the world. This resulted in the dichotomy between two different systems: bank finance and capital market finance. If this distinction was progressively declining in the years before 2007, because of the converging forces of globalised capital markets and also because of the willingness at EU level to promote, through a common legislative framework, the opening up of member states’ markets\(^\text{26}\), there is evidence that European capital markets are still heterogeneous both in terms of

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number of listed firms and market capitalisation. An overview of the historical evolution of different stock markets showed how the state in one case as opposed to self-regulatory institutions in the other, played a prominent part in shaping the size and the socio-economic influence of respective exchanges. As highlighted in chapter two, causes for different development patterns can be found in a combination of legal, historical, political, and institutional preconditions.

If criticism towards one financial model rather than the other is beyond the purpose of this research, what is of interest is the identification of the financial scandals analysed in the thesis with abuses of stock market finance activities (more specifically debt capital market). This alone may be a reason for reflecting on the historical role of states in controlling and sometimes hindering the growth of securities markets, as it has been the case in Germany and France most prominently. Similarly, certain financial-economic theories have countered the mainstream hypothesis of market efficiency by stigmatising the dangers of economic systems dominated by financial markets, where, it is suggested, instability and crises become inherent features of such environments. The intrinsic volatility of economies over-reliant on stock markets may therefore have constituted a reasonable ground for state intervention in bridling financial activities therein in order to achieve more welfare-oriented policies. The main question today seems to concern the role of financial markets as a whole: should they serve the

27 See Commission of the European Communities “Report on the Implementation of the Directive on Takeover Bids”, 21/02/2007, p.12. The UK counts more than twice the number of listed firms than Germany and France together, while their aggregate capitalisation only matches the LSE.

28 A discussion on EMH is conducted in chapter six.

29 See H. Minsky and M.H. Wolfson “Minsky’s Theory of Financial Crisis in a Global Context”, Journal of Economic Issues, June 1, 2002. The theory configures a series of market stages, kicked off by positive structural developments, like the new credit technologies of the last decade or the takeover market of the ’80s fuelled by junk bonds; in the initial stages, firms do engage in leverage to the point where they must borrow money to meet some of their interest payments, all in order to meet short-term gains to finance higher-yielding long-term positions; at the end-stage however, there would be a proliferation of firms that must borrow in order to meet all of their interest payments, so the debt burden keeps increasing uncontrolled.

economic system and society, or should they rather (as it has been the case in the US and UK) become the driving force of economy?

It was also observed in chapter two that neoliberal corollaries have underscored to a high degree the architecture of the integrated and globalised financial markets, where the influence of sovereign states on stock markets has increasingly declined. This was chiefly due to the deregulation shift that propelled the industry in the early 1980s, and also to its global character that made fragmented legislative interventions difficult to implement. The fall of the Soviet Union at the end of that decade helped corroborating the idea that markets were better at allocating resources as opposed to bureaucratic processes, and this gave way to the undisputed application of a number of regulatory features that arguably exacerbated the occurrence of financial scandals.

If a traditional role of states has been to correct market failures\(^3\)\(^1\), a key question today is how far governments’ interference should go in the regulation of financial markets. A valuable distinction in this sense is provided by theorising two types of failures, the first one, whose consequences only harm the firm that carried out certain practices; the second one, related to consequences that extend their effects beyond market participants and therefore invest other market players by creating a systemic collapse.\(^3\)\(^2\) According to this framework, state regulation should only apply in the context of the second category of failures, where the related consequences amount to externalities, which governments traditionally try to regulate in order to be internalised.\(^3\)\(^3\) It is suggested that in the context of systemic failures, state intervention is essential, because individual market players are self-concerned as regards their strategic decisions, regardless of the resulting externalities.\(^3\)\(^4\) However, the market-discipline framework in place has arguably been grounded on firms’ presumed ability to limit their risk-taking in order to reduce risks of contagion for the whole system. As we all know

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\(^3\)\(^3\) Ibid, p.22.

\(^3\)\(^4\) Ibid, p.25. This is also referred to as “Tragedy of Commons”.

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this assumption has proven wrong, mainly because firms lacked the incentive to limit their own risk-taking and leverage.\textsuperscript{35}

The systemic risk\textsuperscript{36} triggered by the second type of failures involves to a very high degree issues that go well beyond the economic efficiency of financial markets as they can generate social costs in the shape of high unemployment rates and poverty, and can therefore affect lives and foster crime.\textsuperscript{37} Once again then, the rationale for regulating in order to prevent these forms of social distress should depart from the concept of economic efficiency. At the same time, as said previously in the chapter, for the balancing of social interests \textit{vis-à-vis} economic ones the state instead of the market seems to be better placed and more detached from conflicts of interest.

Among the regulatory techniques that have traditionally been employed to counter the failure of market-discipline mechanisms, many have been centred on the disclosure mechanism. It is observed that one of the major flaws affecting the disclosure paradigm has been represented by the high complexity of transactions, many of which resulting from continuous processes of innovation. With disclosure being insufficient in such circumstances, state regulation could require supplemental protection by proscribing transactions that defy the scope of disclosure.\textsuperscript{38} If this solution could entail the unfortunate consequence of curtailing useful contracts, additional cost-effective measures are envisaged in order to minimise the effect of information asymmetry intrinsic to some transactions. These could be in the shape of guarantees which in the

\begin{footnotesize}
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\item S.L. Schwarz “Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown”, \textit{Duke Law School Legal Studies Paper No. 175}, 2008, p.27. To put it simply, if a firm exercises market discipline by reducing its leverage, this will only marginally reduce the overall potential for systemic failure; on the other hand, if other firms do not take the same measures, the first firm exercising market discipline will lose value \textit{vis-à-vis} the other firms.
\item S.L. Schwarz “Systemic Risk”, \textit{The Georgetown Law Journal}, Vol.97,193, 2008, p.204. Systemic risk is defined as the risk that: an economic shock or a market failure triggers either the failure of a chain of markets and institutions or a chain of significant losses to financial institutions. All this would result in increases in the cost of capital or decreases in its availability, evidenced by price volatility in the financial market.
\item Ibid, p.207.
\end{enumerate}
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context of structured finance would imply investors’ recourse to the originator\textsuperscript{39}, or in
certifications of quality issued by the government, which would in a way represent the
public-sector version of CRAs, whose function has come under fire following the global
crisis.\textsuperscript{40}

Another line of proposals has looked at the establishment, at EU level, of an
independent commission for financial products. This would be aimed at scrutinising
investment products addressed to retail investors, and recommending default investment
options.\textsuperscript{41} The idea stems from the possibility of having a public watchdog to protect
against the most complex financial products, whereby its function could range, from
advising and recommending, to actually entering the market and regulating or
prohibiting certain products.\textsuperscript{42}

The framework proposed under the ESC is inspired to a substantial degree by the
above propositions. The main priority would be to safeguard social interests from the
effects of financial failures and systemic risk, and this should be achieved, as seen above,
through state intervention at national level. This however is difficult to attain because in
the context of financial regulation, the dichotomy between state and market regulation
has leaned towards the latter over the past three decades, for a number of reasons. Firstly,
because of financial-economic theories that created the belief that the unrestrained
development of financial markets could provide benefits for the economic system and
for society, and in order for this to happen, the market had to be left independent from
state interference/regulation.\textsuperscript{43} The role of the state resulted thus diminished, either
because of a delegation/devolution of regulatory and supervisory powers to private and
semi-private entities, or because of the sharing of such powers with market actors.\textsuperscript{44}

\begin{footnotesize}
\textsuperscript{39} Ibid p.11. It is pointed out however, that in cases of high complexity, the problem is not of information
asymmetry, but of information failure on both sides of the transaction.

\textsuperscript{40} Ibid, p.13.

\textsuperscript{41} E. Avgouleas “The Global Financial Crisis and the Disclosure Paradigm in European Financial

\textsuperscript{42}Ibid, p.40.

\textsuperscript{43} Supra Avgouleas 2009 (behavioural finance), p.45.

\textsuperscript{44} Supra Briner 2008, p.128.
\end{footnotesize}
Finally, the assumption that the “market-knows-best” led politicians to deregulate areas of financial regulation.\(^{45}\) The 2008 crisis strongly played against this conjecture showing how market failures and financial crises can impact on a broad spectrum of social groups, and justifying therefore state intervention to prevent similar scenarios to recur.\(^{46}\)

Unlike the proposals reviewed above, under the ESC a categorisation of “systemically important firms” is not advocated, simply because the definition of which firms are systemically important at national or international level is a complex one and might lead to controversy, as it happened in the case of Anglo-Irish Bank for instance.\(^{47}\) As already discussed, market integration and globalisation have become intrinsic features of financial markets and this, together with the nature of certain transactions, increased market interconnectedness as a whole.\(^{48}\) Therefore, isolating a class of firms by virtue of their status may prove in this context a non-comprehensive approach to the protection of the financial system and of different social groups. As a consequence, state regulation under ESC is configured as an *ex ante* measure aimed at regulating or preventing *tout court* certain specific activities originating from stock market finance, regardless of which firms they originate from. This approach encompasses what, in chapter four, was referred to as transaction-based regulation, which is concerned with the likely impact and rationale that transactions/products have.

\(^{45}\) In the US this was epitomised by the Commodities Futures Modernization Act, Pub.L.No. 106-554, 114 Stat. 2763 (2001) which left over-the-counter derivative unregulated as a result of the deregulation push initiated in the previous decade, and then culminated in 1999 with the Financial Services Modernization Act.

\(^{46}\) J.E. Stiglitz “Gambling with the planet”, Aljazeera, 6 April 2011, available at [http://english.aljazeera.net/indepth/opinion/2011/04/201146115727852843.html#](http://english.aljazeera.net/indepth/opinion/2011/04/201146115727852843.html#). It is observed here among other things, that society is at present regulated by a system that privatises gains and socialises losses, a system that has severely mismanaged risks.

\(^{47}\) The Irish bank was initially deemed not systemically important, but it was subsequently bailed out by its national government with disastrous implications for Irish taxpayers who had to pay for the bank’s losses instead of the bank’s shareholders. See [http://www.politics.ie/economy/140523-anglo-irish-bank-bondholders-revealed.html](http://www.politics.ie/economy/140523-anglo-irish-bank-bondholders-revealed.html).

At the same time however, this proposition does not purport to be a draconian measure against stock market finance as a whole, and consequently recognises the social benefits of many transactions, like securitisation for instance, which allowed a large share of society to access the housing market. The goal in other words would be to guarantee that transactions whose rationale lies in pure commercial and social interest would be facilitated through appropriate regulation. Once again, in order to achieve a sustainable balance between these diverging interests, the case of sovereign control over these activities is advocated.

To some extent, notwithstanding its democratic deficit, the EU framework represents in this context a valid example of regulation that relies on systems of accountability, defying self-regulatory mechanisms, because the power of the EU Parliament stems from each Member State’s sovereignty. This has been however only partially successful, firstly because of the regional character of the EU (opposed to the very global character of financial markets), and secondly because of the lax supervision and enforcement, which are powers that under the EU framework have so far remained of national competence.\(^49\) The establishment of a pan-European financial authority (European Securities and Markets Authority\(^50\)) with more extensive powers to directly supervise and regulate financial markets and its actors (among which also credit rating agencies) could be a positive step towards a more comprehensive solution, which would anyway still be subject to its regional efficacy and to the way in which this new model is going to work. What can be gathered from this reflection is that an ideal regulation of present-day financial markets should stem from a truly global treaty negotiated by states’ sovereign authorities. Such a solution is however unrealistic because of the political implications that would make international agreements on such a treaty impossible to reach.

The second-best option advocated under the ESC is the empowerment of national authorities in the regulation and supervision of financial activities carried out in


\(^50\) Regulation EU No. 1095/2010 Establishing a European Supervisory Authority (European Securities and Markets Authority).
their territory. It needs to be pointed out in this respect that the deregulatory process described in chapter six was grounded, among other things, on the abolition of national controls over cross-border capital flows as a result of the collapse of Bretton Woods. This was instrumental in creating integrated and liberalised financial markets, which eventually grew uncontrolled, giving way to problems of excessive risk-taking and leverage, and of interconnectedness. The renewed power of state authorities over financial systems is envisaged primarily as a means to limit market interconnectedness insofar as societal stakeholders should be insulated from market externalities and systemic risk. The lack of global governance of financial markets to exert this function leaves the state (through its democratic link with society) to act at national level. This could be achieved through controls over capital flows and transactions that would re-establish Bretton Woods-type system. A state regulator (which will be more closely described under the institutional framework) would exercise direct supervision over entities and activities based within national territorial competence (using in this sense stock markets as a territorial parameter), vetting therefore practices that are rooted in speculation and do not result in social or economic benefits, and protecting society from the externalities of globalised markets.

While more specific solutions underpinning from this paradigm will be given in subsequent sections, as a response to specific legal issues arisen in the thesis, what is important at this stage is to emphasise the urgency of bringing back under sovereign competence the powers that have in the past been “delegated” to private entities, such as rating agencies most prominently. Reassessing the social function of financial markets entails a different dimension of their regulation. This needs to stem from the authority and legitimacy to represent the interest of all social constituencies in order to protect them from the failures of regulated firms. This shift would have relevant implications especially in areas of supervision and control of financial activities and also in the measure in which they would be geared to general economic and social needs, rather than to the self-determining initiatives of market participants.

7.3 – The institutional framework
What was said in the previous section with regards to the envisaged social goals of regulation leads naturally to investigate the institutional nature of a regulatory framework designed to achieve the above objectives. In particular, the emphasis laid on the need for regulation to encompass a broad spectrum of social constituencies in the analysed areas of corporate and financial law brings about the necessity to define the nature of the regulatory body from which the desired regulation should underpin. Even though the research does not purport to delve into themes of constitutional law or institutional economy, a clarification of the institutional framework of the advocated body will pave the way for discussions on substantive measures proposed later in the chapter.

7.3.1 – The problem of democratic legitimacy and accountability
Most of the theoretical arguments proposed in the chapter are grounded on the establishment of a public body that would play a central role in ensuring that a social and pluralist approach is endorsed both within regulation and supervision of financial activities and within the decision-making process of tier-one corporations. This proposition however is in sharp contradiction with the trend that at international level characterised the last two decades. The perceived inefficiency of public/state regulation to face the challenges posed by an increasingly globalised business environment prompted during that period a shift to alternative regulatory patterns. These resulted chiefly in the delegation of certain regulatory powers to independent administrative authorities or agencies (both at national and international level) staffed with professionals deemed to possess both the independence from political circles and the necessary market expertise. Reassignment of political powers to non-elected bodies

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had however also the effect of depriving citizens of the accountability inherent with the chain of political delegation.\(^54\)

This shift originated, and found justification as already explained previously, in the economic downturn experienced by European social democracies in the 1980s, when state-centred policies and regulations exposed shortcomings because of lengthy and expensive bureaucratic processes.\(^55\) In particular, the rationale for delegating regulatory and supervisory functions to independent agencies rested on a number of policy justifications, among which the cost-effectiveness of delegation, the blame-avoidance, the expertise of its members, and above all the independence from government that also allows to bypass the problem of time limit which is inherent in democratically elected governments.\(^56\) The deficit of democratic legitimacy of these independent regulatory agencies was in other words considered to be validated by their presumed high credibility and by procedural accountability.\(^57\)

Within the above context, policies directed at delegating regulatory powers became extremely popular, especially in Anglo-American economies, where they were accompanied by deregulation and privatisations of several public services. What then really complemented the move towards a new regulatory model was the contribution of financial-economic theories (in particular the Efficient Market Hypothesis\(^58\) ) that postulated, \textit{inter alia}, that rational markets were better equipped than states at allocating resources and that legislative and supervisory intervention at state level was to be

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\(^{56}\) Supra Majone 1999, p.4.

\(^{57}\) Supra Maggetti 2010, p.3. Procedural accountability is based on the assumption of lawful, transparent and open procedure.

\(^{58}\) See R.J. Gilson and R.H. Kraakman “The Mechanisms of Market Efficiency”, \textit{70 Virginia Law Review} 549, 1984, p.550. The authors then argued that of all theories in financial economics, the EMH had achieved the widest acceptance by the legal culture.
avoided in order to allow the market to reach equilibrium. In the increasingly globalised world – especially in areas such as finance and corporate – state intervention became synonym of bureaucratic, costly and fragmented intrusion.

The tenets just illustrated have however somewhat lost their validity in the wake of the global financial crisis. If some theoretical debates on the merit of the above propositions are still ongoing, there is anyway widespread recognition that the global crisis is to a large extent the product of a regulatory framework that had from its implementation overestimated the self-equilibrating power of market forces. In the context of the present discussion concerning the institutional framework of regulating entities, the central question is whether and how they have a democratic legitimacy at all.

Regulation and supervision ultimately depend on human judgment, and mistakes and oversights are inevitable, all the more in contexts of fast, ever-developing business transactions. If a model for flawless regulation and supervision is probably unrealistic to attain, what should be envisaged is the setting up of a system of democratic representation and accountability of those who regulate.

Democratic underpinning is considered under the ESC paradigm an essential guarantee for a broad spectrum of social groups to be represented in this process. It has been observed that a number of objections could be raised with regards to regulatory agencies and/or commissions since they are non-majoritarian institutions, leading

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62 Accountability can be defined as the system whereby those who take decisions can be held accountable by being answerable in front of a predetermined forum. See M. Bovens “Analysing and Assessing Accountability: A Conceptual Framework”, 13 European Law Journal 447, 2007, p.450.
therefore to problems of democratic legitimacy and of public accountability. These concerns have not been adequately addressed by the traditional argument posing that the democratic deficit is compensated by the capacity of regulatory agencies to produce outputs that are evaluated as satisfactory by citizens (this is referred to as output-oriented legitimacy, grounded on the agencies expert-based knowledge). This, for two main reasons: firstly, because of a lack of clear evidence related to the results of regulatory reforms and agencies’ performances. This argument is further corroborated below by the account of the FSA. Secondly, it is also argued that the democratic deficit could not be superseded by a presumed better quality of regulatory outcomes, which is essentially an ex post legitimacy, which regulators should still substantiate with a prior democratic delegation. Beyond this, the assumption that citizens could evaluate regulatory outcomes remains very speculative in the context of complicated financial issues.

If delegation has become an axiom of modern regulatory processes - despite the consequential lack of democracy of the delegated entities - it is altogether evident that a degree of public accountability can still be achieved through an appropriate arm’s length relationship between state and agencies, reflected in an institutional design

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64. Ibid p.60; F.W. Scharpf “Economic Integration, Democracy and the Welfare State”, *Journal of European Public Policy*, 4:1 March 1997, p.19,20. While output legitimacy is concerned with justifications for organised political authority and with the formulation of actual policies, input legitimacy focuses on the definition of policy goals.

65. Supra Maggetti 2010 p.4.

66. Ibid.

67. R. Mayntz “Legitimacy and Compliance in Transnational Governance”, *Max-Planck-Institute for the Study of Societies*, Working Paper 10/5, 2010, p.9. It is observed that national political structures are not practicable at transnational level, and a direct democratic process and legitimacy can therefore be found in alternative forms.

68. Supra Majone 1999, p.7. It is observed that even though policy-making powers can be delegated by those who have been democratically elected, legitimacy cannot also be delegated. This principle is epitomised by John Locke in his “Second Treatise on Civil Government”, 1690, chapter 12, where it is stated that “the legislature cannot transfer the power of making laws to any other hands; for it being but a delegated power from the people, they who have it, cannot pass it over to others”.

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whereby agencies are independent from political control, but at the same time their actions are consistent with the interest of the democratically elected legislature.\textsuperscript{69} This type of indirect public accountability can in theory be achieved through procedural and substantive constraints imposed on the agencies that would be required to issue guidelines governing their discretion, to give reasons for their decisions, and more generally through a regime of legislative supervision and public participation.\textsuperscript{70} While such design could defy the problems inherent with procedural models such as top-down accountability (affected by the fiduciary delegation to the agencies that become virtually self-determinant)\textsuperscript{71}, and bottom-up accountability (weakened by the assumption that interest groups and stakeholders produce surveys on the agencies’ expected outcomes)\textsuperscript{72}, these theoretical models have not entirely corresponded to what happened in practice.

For the purpose of this discussion, two examples illustrate different ways in which this broad regulatory model has manifested.\textsuperscript{73} The most prominent case remains however that of credit rating agencies - analysed in chapter four - which embody the fallacy of regulatory powers entrusted to private entities without accountability procedures in place. Beyond this rather extreme example, the FSA in the UK and the recently established ESMA provide valid examples of how delegation of regulatory powers can occur under different institutional models.

\textsuperscript{69}Ibid, p.11.

\textsuperscript{70}Ibid, p.10. It has been observed that the intrinsic problem of accountability arising from delegation of regulatory powers rests on the dilemma of what degree of autonomy these actors should be given to perform their tasks, while ensuring an adequate level of control. See C. Scott “Accountability in the Regulatory State”, \textit{Journal of Law and Society}, 38:38-60, 2000.


\textsuperscript{73}Interesting examples worth analysing because of their institutional character would be also the SEC in the USA and the French AMF. For reason of space however the analysis is here limited to the two following cases.

\textsuperscript{74}CRAs are not typical Independent Regulatory Agencies, but they closely embody the problem of democratic legitimacy within private “semi-regulatory” bodies.
The FSA has been targeted as one of the chief culprits of the global crisis because of the light-touch principle-based supervision of UK financial institutions. The British Authority was found to be too close to market participants and its regulatory outcomes did not show the benefits of its market-based expertise.\(^{75}\) On the other hand, ESMA appears to be created under an optimal institutional framework, whereby an indirect legitimisation still exists through its accountability to the EU Parliament and its internal organisation.

**FSA**

The Financial Services Authority was established with the Financial Services and Markets Act 2000, as an independent non-governmental body, operating as a company limited by guarantee, and most importantly, funded through fees paid by regulated firms.\(^{76}\) Even though on paper regulating agencies in the UK are accountable to parliament (the FSA is accountable to Treasury Ministers, who also appoint the board, and via the Treasury to parliament\(^{77}\)), structural supervision is difficult because English administrative law does not traditionally encourage regulatory agencies to state clear criteria or reasons of their decisions, and this prevents courts from being able to reviewing their actions.\(^{78}\) Moreover, the FSA was conceived essentially as a market player, favouring flexibility and adaptability at the expense of a more intrusive approach towards regulated firms.\(^{79}\) This stance proved to offer a weak protection of all the interests that the FSA should have guarded - particularly those outside the financial industry, whereas consultation obligations made the regulator answerable to market


\(^{76}\) See http://www.fsa.gov.uk/Pages/About/Who/index.shtml.

\(^{77}\) Ibid.


actors - especially during the years before the global crisis when the Authority was unable to detect and correct certain behaviours.\textsuperscript{80}

The strong market-oriented position characterising the FSA was clearly the result of policies aimed at creating in the UK a favourable and attractive business environment for international firms, like financial ones.\textsuperscript{81} The role of market player that the FSA closely acquired was also a reflection of the very peculiar regulator’s funding base, which dangerously resembles rating agencies’ “issuer-pays” model.\textsuperscript{82} Under this structure, conflicts of interest and ties with regulated firms seemed very difficult to avoid and a certain reluctance to supervise tightly and impose penalties was probably consequence of the ensuing relationship.\textsuperscript{83}

Following the recommendations of the Turner Review\textsuperscript{84} and the general public outcry concerning the FSA’s failure, a drastic change in the regulator’s activity and style occurred, moving it away from light-touch axioms and paradigms of market disciplines. This entailed a more proactive and intrusive supervision, whereby FSA’s personnel are now prone to challenging decision-making and strategies of regulated firms. Overall the regulator’s post-crisis attitude has shifted towards a compliance-driven culture based on

\begin{itemize}
  \item \textsuperscript{80} Ibid, p.606. The FSA’s shortcomings in supervision were exposed in the context of Northern Rock, where the difficulty to take informed choices about firms’ activities was owed to the lack of capacity to assess data received. This was then aggravated by heavy workload, short staffing and poor standards of bureaucratic organisation, all tags that were thought to belong to public/state regulation!
  \item \textsuperscript{81} Ibid p.602. From a regulatory perspective, this resulted in principle-based rules, broadly stated standards instead of more detailed rules, enforcement conducted according to principle-based fashion whereby the FSA would grant waivers and modifications in order to promote the underlying regulatory requirements, leaving enforcement largely discretionary.
  \item \textsuperscript{82} It could be argued that fees could be configured as taxes because firms were actually obliged to pay. On the other hand though, the FSA’s funding base, unlike a normal tax, did not represent all societal stakeholders and exacerbated the Authority’s market-based position. Fees were only linked to the financial industry and reflected the FSA’s interest to have more firms on board and to keep them happy.
  \item \textsuperscript{83} This can be said to be a prerogative of delegated non-majoritarian regulators (the FSA does not qualify as such though), that rely heavily on relationship with their regulatees as a means to acquire information, expertise, and legitimacy. Supra Coen and Thatcher 2005, p.336.
  \item \textsuperscript{84} The Turner Review: A regulatory response to the global banking crisis, available at http://www.fsa.gov.uk/pubs/other/turner_review.pdf.
\end{itemize}
enforcement procedures and on credible deterrence represented by substantial sanctions.\textsuperscript{85}

The FSA is anyway due to be abolished as part of the financial reforms designed by the new government.\textsuperscript{86} A last reflection on its more recent operational changes should point at the fact that despite a clear shift in regulatory approach occurred in the last two years the regulator’s institutional framework remained the same, subject therefore to the same conflicts of interest and intrinsic fallacy. What was originally designed as a prototype of efficient market regulator fell short of its very aims, showing the same break-downs traditionally associated with public/state regulators, namely: lack of competence, poor staffing, low bureaucratic standards.

\textit{ESMA}

The European Securities and Markets Authority (ESMA)\textsuperscript{87} was established in January 2011, together with two other European Supervisory Agencies\textsuperscript{88}, in order to replace the CESR and the other network-based bodies, and as an institutional response to the global financial crisis. The apparent move towards a single EU regulator in the area of financial supervision was accompanied by obvious concerns with regards to some of ESMA’s powers in the sphere of decision-making and supervision. Tension in fact arose with regards to ESMA’s rule-making and intervention powers – in particular because of its more specific powers to inhibit products and services under specific circumstances, and its powers over cross-border actors with systemic concerns\textsuperscript{89} – because of the

\textsuperscript{85}Supra Georgosouli 2010, p.611.

\textsuperscript{86}Its powers are going to be transferred to the Bank of England that will be at the apex of the supervisory structure. See E. Ferran “The Break-up of the Financial Services Authority”, \textit{University of Cambridge, Legal Studies Research Paper Series}, No. 10/04 2010.

\textsuperscript{87}EU Regulation No. 1095/2010 OJ 2010 L331/84.

\textsuperscript{88}The Eropean Banking Authority and the European Insurance and Occupational Pensions Authority.

\textsuperscript{89}See ch.4 for a more specific outline of ESMA’s powers.
implications that this move would have within EU political dynamics.\textsuperscript{90} If on one hand rule-making has always been a central feature of EU financial regulation, supervision and enforcement have so far remained a matter of national competence. This asymmetric intervention was to a great extent due to institutional complexities arising in connection with direct EU supervision of market actors. The new supervisory powers vested in ESMA represent thus a shift in the centralisation\textsuperscript{91} of EU supervision\textsuperscript{92}, in spite of political, legal and operational challenges which are in a way countered by the Authority’s structure.\textsuperscript{93}

ESMA is in fact composed of a number of bodies, among which the Board of Supervisors is at the heart of decision-making policies and represents the heads of each Member States’ supervisors.\textsuperscript{94} The interesting feature of the Authority’s structure is first of all its independence from the market which is underscored both by its funding base (40\% EU funds, 60\% Member State funds) and by the terms of the Regulation stating that it has to act independently and objectively, in the interest of EU as a whole, without seeking or taking instructions from EU bodies, institutions, or Member States’ governments.\textsuperscript{95} Moreover, ESMA’s accountability to the European Parliament and Council is corroborated by a number of reporting requirements.\textsuperscript{96}

Finally, ESMA’s objective and institutional structure also differ substantially from the more market-oriented one envisaged by the FSA. The Regulation specifically


\textsuperscript{91} While there is centralisation of soft-law, rule-making and intervention powers (in defined circumstances), day-to-day supervisory powers remain exceptional. See ch.4.


\textsuperscript{93} Supra Moloney 2011(1), p.48.

\textsuperscript{94} Regulation 1095/2010, art.40(4).

\textsuperscript{95} Ibid, art.42,46,49,52,59.

\textsuperscript{96} Ibid, art.43(5).
states that protection of public interest for the Union economy, its citizens and businesses is the prime scope of the Authority\textsuperscript{97}, and this certainly encompasses a broader range of stakeholders than the previously analysed regulator. The institutional structure also suggests that great emphasis is laid on long-term goals (i.e. the establishment of a financial innovation committee) whereby the monitoring of new financial activities is pursued with a more proactive approach aimed at ensuring the safety and soundness of the market.\textsuperscript{98}

Even though the success of this newly created Authority will only be assessable in the future, its very existence is so far legitimised by a system of accountability emphasised by its institutional design and by the arm’s length relationship with EU Parliament and Member States. Even though this does not amount to a democratic process (because of the EU democratic deficit), it can be said to realise an indirect legitimisation, leading to a quasi-democratic structure whereby the EU Parliament is voted by member states’ citizens, and ESMA is directly accountable to the Parliament beyond being geared to pluralist goals. As outlined in chapter four, the drawback of ESMA’s institutional structure derives from its collective power (stemming from each member state’s authority), and from its effective exercise, which would be dependent on the coordination of different agendas pursued by member states.

7.3.2 – The proposed body

The themes analysed in the previous section and the ensuing issues of accountability and democratic legitimacy are dealt with by proposing a sovereign dimension of regulation in corporate and financial areas, through the intervention of an appropriate body. The sovereign link is considered an essential element of the proposed body, because this guarantees the more balanced (enlightened) intervention of the state in the regulation of corporate and financial activities. It has already been said that the interests of market players have been strongly represented in the regulation of corporate governance and financial markets, because of the broad consensus generated by financial-economic

\textsuperscript{97} Ibid, art.1(5).

\textsuperscript{98} Ibid, art.9(3,4).
theories in the past three decades that market mechanism alone could provide efficient regulatory outcomes. It has also been seen that these regulatory processes were devoid of democratic underpinning and left a broad spectrum of societal groups unrepresented. The state conversely, in its sovereign and democratic dimension, seems to be better positioned than the market to attain regulatory goals in the interest of a wider range of social constituencies.

The main issue then would concern the implementation of the politico/democratic legitimacy (opposed to reputational) that only stems from a democratic process. This could be achieved through an arm’s length relationship between state and regulatory body, whereby its institutional design would safeguard its independence from political power while at the same time guaranteeing that the regulator’s actions remain aligned with the interests of the broad electorate. Democratic legitimacy through institutional design is ultimately what would differentiate the proposed body from other regulatory agencies. As illustrated in the previous section however, a certain degree of democratic deficit is inevitable because the regulation of complex corporate and financial matters needs to be entrusted to non-elected professionals. This entails that the proposed body would be publicly accountable and aligned to the broad electorate (as outlined in the next section), but its democratic link would remain only indirect. The democratic deficit would be counterbalanced by close institutional oversight conducted by appropriate ministries, which would guarantee the sovereign essence of the mandate and coherence with the ESC proposition.

More specifically, in order to encompass a wide range of societal interests the proposed regulator is conceived as a permanent public organisation aimed at fulfilling the role of guardian of social goals within corporate and financial activities. The peculiarity of the institution would more prominently be reflected in its nature, because unlike most regulators, its chief character would stem from its personnel and from their recruitment process (outlined in the next section). Instead of drawing its members from other public bodies (like the French AMF), or from the market (like the FSA), the proposed body would set up a specific career path for most of its staff in order to

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achieve the required intellectual and independence standards. This knowledge-based preponderance, combined with the public mandate, would put the proposed regulator on the same footing as other institutions, such as for instance the “Avvocatura dello Stato”\textsuperscript{100} in Italy (State Law Council) and the Court of Cassation (“Cour de Cassation”) in France, where specifically qualified professionals hold consultative and judiciary functions in the public interest.\textsuperscript{101} The need for specific skills in the areas of corporate and financial law justifies thus the establishment of what could be a new profession embedded in a newly conceived regulator.

The overall regulatory failure registered during the last crisis is testament of the need to look for a new model. Equally, departing from assumptions that market mechanisms can actually regulate is a prerequisite and to this end a sovereign link should be established in order to equip the proposed body with necessary legitimacy. It is worth repeating that while the accountability of the proposed body would stem from its public character, its democratic legitimacy would only be indirect. This partial deficit would however be set-off by the nature of the institution and its mandate. The following subsection addresses some of the issues related to the proposed body’s structure.

**Funding, composition, independence, aims, expertise**

A central question and possible criticism against the creation of such institutional body would stem from the sources of its funding. It goes without saying that a public body would have to be funded with taxpayers’ money in order to fully operate in accordance with its pre-eminently social scope.\textsuperscript{102} Criticism against a further burden on taxpayers would easily be countered by pointing at the huge costs inflicted on the public by the various government bailouts during the last crisis. The cost of the “public takeovers” of major financial institutions was in fact much higher than the eventual employment of

\textsuperscript{100}www.avvocaturastato.it/node/595.

\textsuperscript{101}www.courdecassation.fr/institution_1/.

\textsuperscript{102}The “regulated-pays” model employed by the FSA embodies on the other hand the risks of conflicts of interest with regulated firms.
more supervisors would have been.\textsuperscript{103} Prevention in other words should be pursued in the shape of empowering a public institution with authority to regulate and supervise the industry, and break down the moral hazard that has resulted in a grossly unfair societal contract.

Another fundamental issue is that of the composition and governance of the proposed institution. Since the 2008 crisis exposed various failures of current regulatory bodies\textsuperscript{104}, the chief aim behind the establishment of the public institution would be to guarantee the competence of its officials, their independence and accountability, which would all be premised on the statutory definition of the institution’s regulatory scope, highlighted previously in the chapter.

A first problem in this respect would be that of achieving independence, to be intended here as necessary distance between supervisors and politicians.\textsuperscript{105} While the primary aim would be to detach regulatory outcomes from market logics and market-players’ interests, it is also paramount to insulate the proposed body from political pressures. Officials should escape risks of political capture which could influence their judgment because of ideological affiliations. At the same time however they should be subject to supervision, in order to create the accountability that would be the key feature of an institution rooted in democratic legitimacy. Sound supervision also serves the purpose of protecting the system from falling into the web of bureaucratic dynamics that too often hamper public institutions’ functionality.\textsuperscript{106} One way to create accountability would be through the establishment of appropriate interaction with representatives from market and consumers organisations as well as lobbies who could provide some form of

\textsuperscript{103} If the FSA for instance had employed ten times the number of supervisors, that would have represented only 0.7\% of the cost of total bailouts in the UK. D. Wright “European Supervisory and Regulatory Reforms in the Financial Markets”, University of Manchester, School of Law seminar, 9 March 2011.

\textsuperscript{104} Among them, regulatory and supervisory failures, intellectual failures and also a failure of competence.


\textsuperscript{106} Even though bureaucratic failures have also been found at the heart of FSA’s problems, despite its non-public nature. Supra Georgosouli 2010, p.606.
outside pressure and market responsiveness.¹⁰⁷ Without this implying the institution’s dependence on market’s assessments or the subjugation of regulatory activities to the interest of market lobbies (market capture, which characterised the FSA), these mechanisms could corroborate the institution’s transparency, which is essential for its balanced operations. Transparency should therefore result in a number of mechanisms (checks and balances) designed to prevent both political and market actors from exerting influence over officials.

Another mechanism which is conceived as a central tool to crystallise the institution’s aims and scope lies in its composition and in its staff qualification and background. The main assumption with regards to the intellectual skills required is that they should not duplicate what is already available to market players, but should rather complement them. This is particularly evident in connection with regulatory functions in the sphere of corporate law, where actions on board decision-making or supervision of corporate activities would need to complete the skills that firms already have on the board. One of the lessons from several corporate failures occurred over the past ten years is that non-executive directors were very often experienced professionals in their area of supervision, but were anyway not able to monitor or foresee risks undertaken by their firms and challenge the decision-making therein.¹⁰⁸ Instead of drawing its members from market players (which could also result in market capture), the institution should in other words look at different sets of skills and expertise, avoiding industrial ties or business-oriented bias. A similar case can be made with regards to the institution’s role in the area of financial supervision, where precedents in the US – the SEC and the Federal Reserve – offer a clear example of regulatory bodies that have been chaired by people who retained very strong ties with the market¹⁰⁹, or remained aligned to the interests of specific industrial lobbies and big market players.¹¹⁰

¹⁰⁷ Supra Enriques, Hertig 2010, p.5.


¹⁰⁹ In the US, Alan Greenspan, former chair of the Federal Reserve, served as economic advisor of several corporate and financial institutions, among which JP Morgan; similarly, the current chair of the SEC, Mary Shapiro, has served on the board of some multinational corporations, like Kraft Foods. Henry Paulson, who served as Goldman Sachs CEO, was nominated Treasury Secretary in 2006, a position that
One way of guaranteeing some degree of market expertise while avoiding at the same time the interference of market players’ lobbying power could result in the adoption of an operational structure including market expertise at the mid/lower-level of the institution’s pyramid. In other words, while big decisions and policy-making would still rest on people linked to the institution’s mandate, the day-to-day activity of the proposed body would benefit from the presence of staff with industry background.

Another way of pursuing this type of expertise would be through a specifically tailored selection process. In order to instil in the institution’s officials the right set of skills, knowledge and priorities in the conduct of their roles, they should be ideally drawn from a predetermined educational path and should be selected further to a qualification process. A valid example in this respect is provided by the French financial regulator (AMF) which draws its members from public bodies, such as the Court of Cassation. The proposed body however would establish a more direct link with its officials who would be specifically educated for that role, just like members of the Court de Cassation in France. The selection process could also be complemented by the creation of a specifically established academy for the training of a broader range of professional who, beyond the necessary skills, would be intellectually educated to balance the more traditional economic rationale of regulation with the long-term interests of different social groups affected by corporate and financial firms’ externalities. It is also envisaged that a clear career path should be designed for such profession in order to avoid losing the best talents to the private sector. This could be achieved through longer terms of office, and adequate career advancement that would keep staff motivated and avoid slack.

raised concerns over resulting conflicts of interest, mainly because of the rescue plan he devised, which proved to be highly beneficial for his former firm (especially with regards to the AIG bailout).

110 In the UK, the FSA represents such example, firstly because of its status of independent non-governmental body, and then because of its regulatory style, driven, at least in the pre-crisis era, by a laissez faire, hands-off approach.

111 This could either result in a state exam, which is typical of many civil law jurisdictions, where civil servants and other high-rank state employees (judges, notaries, state lawyers, regulators) are selected as a result of written and oral examinations which in turn follow a period of specific academic preparation.

A final component to align officials to the institution’s social scope would be the setting of adequate compensation schemes. If compensations should be high enough for star personnel to remain motivated and not to be lured by the private sector, it is also clear that a public institution would most likely depart from short-term pay arrangements such as ill-designed year-end bonuses.

Last but of equal importance is the statutory definition of the regulatory style to be employed by the institution. It is correct to say that the dichotomy in recent years between attachment to market discipline (which was for instance advocated by Basel II) and complete isolation from the market has mostly leaned towards the former. While a certain connection with the market through constant communication with industry associations is to be considered necessary, the axioms of market discipline have finally exposed a number of flaws that make reliance on market mechanisms a very volatile regulatory strategy. The institution herewith proposed would therefore rely primarily on a regulatory architecture based on hard rules underpinning from sovereign authority (thus from a legislative process) and sovereign control (as opposed to market control) over regulated entities.

The purpose of regulating *ex ante*, in order to anticipate and eventually frustrate market trends that are at danger of increasing systemic risk, would be the main priority of the institution. This would be achieved through a strategic approach towards intervention in the affairs of corporate and financial entities, based, as outlined before, on a preliminary classification of tier-one corporations and in the identification and regulation of financial activities that raise concerns for the broad social welfare. The scrutiny over these entities and activities would be carried out by way of continuous supervision performed directly by the institution, defying therefore the paradigms of market discipline that have prevailed over the past decades, as well as the *laissez faire* approach that has characterised certain financial regulators in the years before the crisis.

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113 Instead of bonuses, motivation could be achieved through a flat hierarchy structure, where members of staff would receive recognition for their initiatives.
7.4 – The substantive framework

The brief description of the authority’s institutional framework provides the necessary background for discussing more specific measures of sovereign intervention and control proposed in the thesis. The substantive framework of the ESC is strictly related to the specific legal issues emerged in connection with the analysis conducted in chapters three and four, and with the critical considerations provided in the case studies. The solutions proposed within the paradigm stem from a converging theoretical background and from analogous rationale, despite embracing two broad spheres of law: corporate law and financial law.

7.4.1 – Corporate law

Drawing from what has been said earlier in this chapter, the ESC paradigm results in substantive measures aimed at ensuring the consideration of a broader range of social interests within the operative framework of corporate organisations. This priority is mitigated by the two-tier classification of corporations which has been illustrated earlier in this chapter. The first tier would attract regulatory concerns intended to implement a prioritisation of social interests, and as said, this would generally happen through public intervention in corporate affairs. More specifically, public intervention has been identified in this context either as mandatory outsourcing of corporate activities, or as certification of corporate activities, and in both cases the public body described in the previous section would play a central role in ensuring a pluralist approach in the decision-making process. This is illustrated in connection with the two control strategies analysed in chapter three (directors’ duties and compensation arrangements), and bearing in mind the role of the public body above analysed.

Directors’ duties

With regards to directors’ duties, the primary objective of the ESC paradigm is to ensure that tier-one corporate boards are bound to develop strategic policies in light of the repercussions they have on a broader social context, beyond their pure economic or business rationale. The measure is therefore aimed at creating ex-ante mechanisms to pursue a predetermined corporate goal. In order to achieve this, two possible ways are
The first one would consist in outsourcing major policy-making resolutions to the body, whose cooperation and direction would guarantee that the social interest is duly considered and would therefore serve as a guardian of that interest. This solution however, presents a number of practical concerns, mainly because it would entail a cumbersome and bureaucratic procedure involving the exchange of information between two different and estranged bodies (the board and the public body). Such procedure would be likely to create operational breakdowns because of the lengthy and eventually costly process of communication, which is generally associated with two-tier board systems in continental Europe, where the role of supervisory boards is often impeded by the lack of participation to day-to-day business operations.¹¹⁴

If the outsourcing solution seems problematic, the second solution may present a more attractive operational framework. Certification would in this context result in a process carried out within the board, without delegating the decision-making outside it. The public body would in this case serve a rather different function. Corporations classified within tier-one would be required to include in their board of directors a number of professionals pooled from the body, with the authority and the expertise to shape board policy in order to guarantee consideration of social interests. For corporate policies to be implemented, resolutions at board meetings would then need to pass the scrutiny of the majority of these professionals. This certification function would in other words result in a sort of gate-keeping role, performed in this case by the board, whose finalised policies and decisions would be certified as regards the due respect of the interest of society at large. Unlike other existing gatekeepers (primarily accountants, auditors, credit rating agencies and securities analysts) these boards would have the advantage of relying on the influence of a public component, which, because of its nomination, compensation and mandate, would be able to escape the conflicts of interest that have impinged the efficiency of other gatekeepers, and therefore provide legitimate and accountable decision-making.

Stock options
With regards to compensations and stock options, the main purpose within the ESC paradigm would be to dislodge the compensation theorem from the strict assumption that remuneration has to be anchored to share value and shareholder supremacy. In order to embrace a pluralist approach, a preliminary assessment of the need to compensate through stock options and bonuses at firm level is envisaged.\(^{115}\) Compensations generally speaking should be geared to the long-term value of the firm, and this is necessarily a value comprehensive of a broad category of stakeholders. In this respect it can be stressed that managerial interests could be rather aligned with those of bondholders, because they are certainly keen to ensure the continuing existence of the business, unlike shareholders who can be more easily concerned with short-term gains.\(^{116}\) High-end employees should therefore be remunerated with company’s debt, because in this way the risk of insolvency would weigh on their decision-making, which is exactly the opposite scenario occurred before the crisis, when equity-based bonuses and the implicit state guarantee of bailout increased short-termism and moral hazard in corporate management.

Remuneration remains anyway a delicate area of legislative reform, mainly because it is still regarded as a field that pertains to private contracting between private parties (again heritage of a dominant “contractarian” view of the firm\(^ {117}\)). While this regulatory stance might be legitimate with regards to tier-two corporations, according to the paradigm, tier-one corporations would necessarily fall outside the private contracting boundary and would need to receive public scrutiny for a correct alignment of their policies with related (and eventually conflicting) social interests. This could happen

\(^{115}\) It has to be reminded that in some jurisdictions whose corporate law is characterised by stakeholder value, there is hostility towards stock options, which create the undesired effect of binding managers to shareholders; in jurisdictions like Sweden or Germany, they are hardly considered ethical as senior managers are supposed to represent the interest of all corporate constituencies. See M.J. Roe “Political Preconditions to Separating Ownership from Corporate Control” 53 Stanford Law Review 539 (2000), p.570.

\(^{116}\) D. Benson “The EU’s proposed rules on pay are misguided”, Financial Times, 10 October 2010.

primarily through the influence within the board of professionals drawn from the body described earlier in the chapter, who could perform the function traditionally associated with remuneration committees. It has been observed in chapter three that the role of independent committees in board dynamics is generally hindered by agency problems generated by persisting CEOs’ influence over, among other things, pay arrangements.

This problem could be overcome through the powers exerted by the public body over certain corporate practices. Firstly, it would lead to optimal pay arrangements and to bonuses and stock options being awarded to executives only if needed, and in accordance to conditions that would align their interests with those of a broad stakeholder base. Secondly, professionals from the public body would be positioned to counterbalance short-term behaviours and policies in pursuance of which executives have so far remained unchallenged. Thirdly, while shareholders’ vote on pay arrangements is still advisory and corporate governance arrangements on this matter result in voluntary recommendations, the public body would provide legal certainty to this key control strategy through binding mechanisms.

While specific legislation aimed at limiting the legality of excessive pay remains an urgency, the proposed paradigm can contribute to rein in board breakdowns by channelling sovereign intervention towards tier-one firms, and then by representing broad societal interests therein.

**Audit**

The proposed sovereign body would play a fundamental role in integrating market actors’ functions in areas of auditing and accounting. The examined case studies evidenced a general gatekeepers’ failure which reflected the inability of consulting firms to perform their certification role. Auditors in particular were not only inefficient in raising red flags with regards to their clients’ business, but were also found to mastermind strategies that they should have censored.

The paradigm advocates entrusting to the sovereign body the controlling functions that have so far been performed by accounting and consulting firms. In this guise the proposed body could be inspired by the existing tasks carried out by the HM Revenue & Customs in the UK with regards to the VAT control. In this particular area,
the state exerts through this agency a very stringent and effective form of control over public and private firms with regards to the imposition of value added tax. Similarly, the certification of companies’ financial status should fall more directly into the public sphere, simply because its outcome concerns a broad spectrum of social constituencies whose interests are to different degrees affected by the activity of large corporations and financial institutions. Such public audit would then serve as a statutory guarantee that a certain firm’s financial position does not pose significant threats to the general economic and social environment in which it operates.

From a practical perspective, instead of seeking the services of accounting firms for audit and general certification purposes, tier-one companies would be mandated to obtain a public audit. Consequently, instead of paying consulting fees to private firms, the same amount of money would be paid as “audit tax”, which would then contribute to funding the staffing and operation of the sovereign body.

It is also suggested that, following the identification of tier-one and tier-two corporations illustrated earlier, a private audit function could still be preserved for firms whose turnover does not exceed a certain predetermined threshold (tier-two firms). The rationale again lies in the recognition that many firms do not actually pose systemic concerns because of their activities and size, which do not affect to a substantial degree the interest of a broad range of social groups. This would in a way allow the private audit market to continue to exist, while on the other hand it would limit the relational flaw represented by the intrinsic conflict of interest within it.

7.4.2 – Financial law

With respect to the financial law sphere, proposals under the ESC paradigm are premised on the recognition that beyond the enactment of new reactive legislation, a more drastic rethinking of the theorems underpinning financial markets is needed. Against the prevailing axioms of market efficiency, leading to unrestrained growth of financial markets, the proposed approach advocates reconfiguring the social dimension that financial markets need to encompass in the wake of the global crisis. In redesigning

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118 A brief analysis of regulatory responses to the crisis has been conducted in chapters three and four.
a regulatory framework capable of achieving economic and societal goals, the paradigm is centred on the identification of the rationale behind financial activities (including both transactions and products), which would then be regulated *ex ante* by being approved or banned. The purpose for identifying viable activities *ex ante* is indeed twofold: firstly, it screens them against the risks deriving from transactions whose rationale is rooted in speculation and arbitrage. Secondly, it insulates them, through regulation, against the innovation process which tends to reflect market practices and interests instead of social and economic ones. In essence, this preliminary identification should be conducted through the examination of the underlying rationale of specific transactions and contractual schemes, before they are endorsed by market players. If such *ex ante* assessment may result in obstructions to capital market activities, it would also constitute a means to bridle the creativity of market trends and thus mitigate the intrinsic volatility that so far characterised financial markets.

The paradigm needs naturally to be complemented by a regulatory process entrusted to an authority founded on political legitimacy (as opposed to reputational119), reflecting therefore in its mandate the social priorities of its tasks. The institution designed in the chapter is envisaged as the “proper actor” in this regulatory construction, because sovereign regulation in the area of financial markets is thought to be better positioned to represent the interests of all social constituencies at stake.120 It follows that regulatory powers in the past delegated (formally or informally) to private or semi-private agencies should be brought back under the umbrella of sovereign regulation and supervision, in order to break down the self-regulatory structure that permeated certain aspects of financial activities.

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119 Supra Bruner 2008, p.126.

120 While this position is advocated earlier in the thesis as the best to pursue social and economic interests, it is also acknowledged that there has been support, even after the crisis, for preserving substantial regulatory powers within the market. See H.L. Scott “A General Evaluation of the Dodd-Frank US Financial Reform Legislation”, 25 Journal of International Banking Law and Regulation, 477, 2010.
Securitisation

With regards to securitisation, it needs to be pointed out that a great level of innovation and sophistication has traditionally characterised this area of finance, and the law has struggled to balance the need to let innovation thrive while at the same time limiting its excesses.\textsuperscript{121} The difficulty in establishing a convincing equilibrium in the regulation of securitisation stems primarily from the problematic definition of the transaction: while the term refers to a broad spectrum of contractual schemes, commercial practice has clearly developed a variety of transactions whose rationale should probably require independent legal definition and specific rules. Topical examples in this sense are synthetic securitisations – whether they should be treated like cash-flow ones – and the more complex role that SPVs assume in the former transaction. In other words, the regulatory framework of securitisation results from the practice developed mainly in the US and UK, where the main concern was to avoid regulatory costs that could hinder market practice.\textsuperscript{122}

Mention has been made in section 7.2.2 of the sovereign dimension of regulation and supervision of financial markets under the ESC. Under this architecture, the proposed body would play a key role in defining and scrutinising structured finance schemes at national level. While this could give rise to problems of regulatory competition, it would also insulate individual states (and its societal stakeholders most importantly) from risks connected to other jurisdictions’ lax legislations, and thus from the spill-over effects of globalised activities. It needs to be stressed that in order to implement transaction-based regulation, the proposed body needs to be entrusted with the ability to control capital flows, and therefore to limit the effects of interconnectedness derived from certain transactions, and the risk-taking and leverage that may ensue from their application. Also, under the assumption that an \textit{ex ante} approach to product innovation would limit complexity and interconnectedness, there are reasons to believe that rules of private international law could appropriately regulate

\textsuperscript{121} A great level of instability and uncertainty has arguably been exposed during the 2008 crisis, partly as a consequence of the creativity that characterises these products. See G-20 Declaration of the Summit on Financial Markets and the World Economy, 15 November 2008.

\textsuperscript{122} Supra Munoz 2010, ch.1.
matters arising out of transnational schemes. These should allow securitisation to keep operating at a cross-border level, while at the same time limiting the level of uncertainty and risk-taking experienced before the crisis.

As a consequence, among the tasks the proposed institution should be entrusted with, of paramount importance would be the standardisation of contractual models of securitisation schemes. This would result in the substantial control of financial innovation through the pre-emptive activity of the sovereign body over products and transactions.\footnote{This would be somewhat similar to what is done by ISDA, which gathers private market players in the derivatives market, but in the above scenario it would be done in the public interest.} The preliminary assessment of the commercial aim of different schemes and the ban of products rooted in speculation and arbitrage\footnote{Developments such as synthetic CDO have been recognised as devoid of social or economic value.} would facilitate the social function of securitisation, which has traditionally been the creation of liquidity and an easier access to finance.

Structured transactions addressing these social functions would be facilitated through regulation, which would then protect against risks and uncertainty associated with product innovation. Under this framework, market players resorting to securitisation would by default employ clauses predetermined by the public body. In this respect, a key proposition under the paradigm would be to mandate the inclusion of recourse clauses to firstly, bind originators to bear most of the risk of originated assets, and secondly, mitigate moral hazard. It is contended that the function traditionally performed by capital adequacy rules, to limit risk-taking by requiring financial institutions to set aside a certain amount of capital against risk, could be better and more simply achieved in the context of structured finance through a tight inclusion of recourse clauses. Unlike what has been proposed at US and EU level with regards to risk-retention provisions, the level of recourse would need to encompass an economic interest in the originated assets significantly higher than the contemplated five percent. Arguably, notwithstanding the risk of making securitisation financially inconvenient, the level of risk-retention should not fall below fifty percent.

Another central proposal concerns the structure of SPVs, especially in the context of more dynamic transactions where the asset pool keeps changing as assets...
reach maturity. The paradigm advocates bringing the legal structure of SPVs under statutory footing as this would address a number of legal issues highlighted in chapter four. Firstly, a statutory definition of SPVs’ governance would clearly delineate the relationship between the vehicle, its directors, the originator and more importantly the sponsor entity. Despite sponsors being investment banks who often play a central part in the selection of the asset pool to securitise, their legal position has remained unclear especially insofar as conflicts of interests can arise. This instance was epitomised in the SEC v. Goldman Sachs case\(^\text{125}\) where the defendant was found to have manipulated the structuring of a synthetic CDO. Secondly, defining through statute the asset pool composition would answer problems faced within collateralised securities and particularly with their heterogeneity and with the dubious mathematical models underlying them.

**CRAs**

With regards to credit rating agencies, the several flaws in their operations and the way in which they have contributed to the development of the crisis can be said to stem primarily from their self-regulatory character, exacerbated by the regulatory power they have been granted, especially in the US. From a certain perspective the new European Authority (ESMA) should exert a more substantial control over the activities of CRAs registered in member states and its powers seem to be *prima facie* more intrusive than it has been in the past. CRAs however are likely to maintain their character of market-based regulators with all the implications in terms of conflicts of interests which will be difficult to eradicate.

These concerns are corroborated by a number of proposals both in the US and EU, seeking the establishment of a public rating agency. Beyond ESMA in fact, there have also been suggestions concerning the setting up of a pan-European public rating agency with a view to first of all addressing lack of competition in the market, and then the distortion of ratings caused by persisting conflicts of interests and flawed methodologies. A rating from the public rating agency would become mandatory, in

\(^{125}\) 10-cv-3229, 2010 United States District Court, Southern District of New York.
conjunction with a second private one, for each debt finance product issued.\textsuperscript{126} In the US too there have been proposals to set up a federal government agency with a view to replacing CRAs at least as regards the rating of residential mortgage-backed securities and related CDOs. This would in principle allow the securitisation market to perform its most important functions avoiding conflicts of interests that have resulted in unreliable ratings.\textsuperscript{127}

The institutional body herewith proposed, because of its public character and its composition, could well perform the gate-keeping function that has been misguided entrusted to private actors such as CRAs. The institution would be equipped to correctly assess risks and liabilities attached to securities because of the type of officials employed and their underlying selection process; at the same time, a different compensation structure would make the institution well positioned to avoid conflicting activities with issuing firms. If, because of their nature of gatekeepers, CRAs should certify the reliability of securities for investment purposes, it is essential that this function is performed in the public interest, that is to say, for the benefit of all social constituencies at stake within this process. It can be argued that this role is naturally to be conceived as an intrinsically public one and an institution with sovereign link and authority could better perform the relating functions.

\textit{Shadow banking}

Finally, the proposed sovereign regulator could perform a vital function in addressing many of the problems associated with the shadow banking system. It has been observed that the interplay between regulated financial entities and unregulated ones (those operating in the shadow system) resulted in systemic risks impossible to quantify, because of hidden balance-sheets, invisible levels of leverage and liabilities that affected the financial system globally. What would effectively be a national gatekeeper under the


proposals would enjoy the power and the tools to break down the relationship between regulated and unregulated firms. This could be achieved through the institutional body’s scrutiny over certain activities and transactions, which would result either in their certification or in the segregation of entities such as hedge funds and private equity funds. It is accepted here that while a strong audit on financial activities would help limiting interconnectedness by screening and eventually banning products (beyond enhanced transparency), as suggested under the paradigm, this would also entail in the short-term an increase in the cost of finance and a relative overall inaccessibility to the financial system. It is however envisaged that this tight state-level supervision could lead in the medium/long-term to a more balanced and democratic regulation of international finance, based on bilateral/multilateral sovereign treaties.

7.5 – Conclusion
The chapter defines the proposed ESC paradigm. This is illustrated firstly through its theoretical underpinning, which points at theories of corporate and financial law that underscore the rationale of the hypotheses. These converge in a set of conclusions that broadly speaking emphasise a social (opposed to economic) approach to the regulation of corporate and financial activities.

The ESC paradigm is further illustrated by outlining the essential features of the institutional authority ideally in charge of the regulation and supervision of corporate and financial matters under scrutiny. The authority is chiefly characterised by its sovereign link and social legitimisation; these features are epitomised by its structure and by the powers entrusted to it.

A substantive framework of the paradigm is also explored in the chapter, mainly as a response to the legal issues analysed in chapters three and four and to the criticism raised in the context of the case studies. The underlying theme of the proposals expose the need for a renewed but enlightened participation of the state in the regulation and supervision of certain corporate and financial activities deemed to encompass social interests beyond the private sphere. In spite of what has been conventional wisdom for the past three decades, it is contended that in order to represent and protect the interest of a broad range of social groups, a departure from market discipline is needed. The
specific proposals in the areas of corporate governance and structured finance aim at establishing a different regulatory culture grounded on hard law mechanisms and on the recognition – and subsequent supervision – of activities whose externalities impact on societal groups.
"Unhappy events abroad have retaught us two simple truths about the liberty of a democratic people. The first truth is that the liberty of a democracy is not safe if the people tolerate the growth of private power to a point where it becomes stronger than their democratic state itself. That, in its essence, is Fascism – ownership of Government by an individual, by a group, or by any other controlling private power. ... Among us today a concentration of private power without equal in history is growing”.

F.D. Roosevelt, 1938

8.1 – Summing up the main themes of the research

Despite coming from a rather remote past, the above quote, and the overall speech given by the American president before Congress, reflects certain issues that, eighty years down the line, have remained extremely pressing and perhaps unresolved. The concentration of economic power among an increasingly smaller number of people and, even more importantly in the context of the research, the control exerted by finance over industry, are in the wake of the global financial crisis issues that still need to be addressed.²

The thesis has attempted to analyse the broad and far-reaching implications of the above questions by looking at financial scandals that have occurred over the last decade and by providing an examination of specific legal issues in corporate and financial law. Beyond the more traditional legal enquiry, research in this field has also allowed an assessment of more theoretical aspects of the problems, which inevitably entailed reflections on their politico-economic underpinnings and on the rationale behind the regulatory architecture of corporate and financial law. Ultimately the thesis purported to contribute to current policy debates by proposing the ESC paradigm. This encompasses both a theoretical definition and more substantive proposals in the areas of corporate governance and structured finance.

Chapter two of the thesis provides the theoretical platform of the study and explores historical as well as politico-economic arguments underlying the discussion.


² Ibid.
of the identified corporate and financial law themes. These represent essentially the background of the research and are linked to the subsequent legal analysis and case studies.

Chapters three and four form the legal backbone of the thesis as they analyse legal issues related to corporate and financial law. In particular, the former highlights the emergence of a control problem over managerial actions, reflected in the functioning of statute-based directorial duties and in market-based mechanisms such as compensation structures. The predominance of shareholder value ethos in Anglo-American corporate law poses further problems of accountability, because wider spectrums of corporate and societal constituencies are found to remain isolated from corporate decision-making. In this respect the ESC proposes a two-tier classification of firms that concentrate state control over tier-one corporations which, by virtue of their status, are deemed to impact on a broader range of social interests.

Financial law issues are centred on the analysis of the legal risks related to capital market finance transactions, particularly with regards to the innovation of more traditional securitisation schemes into CDO and CDS contracts. Complementary examination of credit rating agencies within structured finance provides a comprehensive perspective of the problem and leads to advocating a stronger, more prescriptive role of states in the regulation of these transactions. Since states are deemed under the paradigm to better represent the interest of all social groups, regulation and supervision stemming from a national public authority are advocated as measures to rein in the excesses of the market and above all to redefine the role of financial markets vis-a-vis society, industry and the economy.

The case studies in chapters five and six provide the springboard for theoretical themes and legal issues analysed in the thesis. Moreover they expose the re-emergence of certain legal concerns at different historical times and the common denominators of two apparently different sets of financial scandals. This reflection corroborates the proposed hypothesis that modern financial scandals are the offspring of two main problems: a failure to govern big public corporations that probably finds its roots in the definition provided by Berle and Means in the 1930s;

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and an abuse of capital market finance as a consequence of the “financialisation”\textsuperscript{4} that over the past two decades has characterised, \textit{inter alia}, the way in which public firms are run.

Chapter seven draws from the critical considerations previously laid down and introduces the ESC paradigm whose foundation draws from a selection of theories. The paradigm then focuses on institutional mechanisms and on the ideal regulatory body that should support it. The concept advocates a redefined role of states in the regulation of certain activities in the sphere of corporate and financial law. In particular, substantive proposals in the chapter address the aforementioned legal issues. The proposals converge towards the proposition of a more democratic and inclusive approach to regulation of key spheres of corporate and financial law. This stance counters the ideological underpinning of the scandals under examination namely the undisputed reliance on neoliberal tenets, financial-economic theories (both unchallenged since the 1970s) and on the unconditional trust on the market for regulatory and supervisory purposes.

\textbf{8.2 – Proposals under the enlightened sovereign control}

The thesis assessed a number of theories in the field of corporate and financial law upon which the proposed paradigm is grounded. In the context of this concluding chapter, proposals will not be detailed again, but will be analytically summarised in the following charts.

Chapter 8 – Conclusion and proposals

ESC Paradigm

Theoretical Foundation

**Corporate Law**
- Gilson: Quality of corporate laws rather than ownership structure; trade-off between agency issues: direct monitoring of blockholders vs panoply of market-oriented techniques.
- Teubner: Broader social role to be fulfilled by large public firms; proceduralisation of fiduciary duties in order to encompass pluralist goals.
- Diane: Post-concession model proposed as revisited concession model; companies derive from society and should be responsible to a democratically representative community.

**Financial law**
- Schwarcz: Different types of financial failures; those whose consequences extend beyond market participants call for state intervention.
- Schwarcz: Criticism of disclosure as market mechanism to regulate financial transactions; complexity of structured finance defies the purpose of disclosure.
- Avgoulea: Fallacy of disclosure as a regulatory technique; proposal to establish an independent commission for financial products in order to scrutinise transactions for retail investors.

Definition

**Corporate Law**
Two-tier classification of firms based on five factors; a different degree of state intervention is attached to each tier; tier-one firms are subject to a system of public intervention in corporate affairs in order to ensure the implementation of a corporate objective encompassing the interests of societal constituencies.

**Financial law**
State intervention revolving around ex ante regulation of transactions regardless of the institution they originate from; the aim is to limit the effect of interconnectedness and risk-taking by pre-empting the market of the innovation process.

Institutional Framework

Establishment of an institutional body in charge of regulatory and supervisory functions at state level. Its main scope is to address issues of democratic legitimacy through accountability procedures and through its structure and composition. The proposed body has authority and knowledge to counter the regulatory power of the market and because of its institutional legitimacy it represents all societal groups affected by the activities of tier-one firms and financial institutions.
### ESC Paradigm substantive framework

#### Control of managerial actions
- **Directors' duties**: implementation of ex ante mechanisms to ensure that the decision-making process in tier-one firms is aligned to a broad spectrum of constituencies' interests. This is achieved through the inclusion in their boards of professionals pooled from the proposed body.

#### Financial innovation and credit rating agencies
- **Securitisation**: preliminary classification of transactions according to their rationale (social and economic vs arbitrage and speculation) conducted by the proposed body. This is aimed at curbing the innovation process and limiting the level of complexity and interconnectedness of transactions.

- **Credit rating agencies**: stripped of regulatory power as their gate-keeping role is taken over by the proposed body. This solves problems of accountability, conflict of interests and also fixes the issue of rating methodologies' arbitrary obscurity.

#### The new role of the state through the proposed body
- **Audit**: revised role of state through the proposed institutional body in the certification of gate-keeping functions for tier-one firms. These would be mandated to obtain a sovereign certification of their financial status.

- **Shadow banking**: state control through the proposed body over cross-border capital flows, together with supervisory powers over firms and transactions. This is aimed at limiting market interconnectedness and the interplay between regulated and unregulated entities.
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