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BANK GOVERNANCE REFORMS AFTER THE FINANCIAL CRISIS: UNITED STATES AND EUROPE

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A chi mi è stato vicino

in questi cinque splendidi anni

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Introduction

The topic of my thesis is the analysis of the new bank governance reforms in the United States of America and in Europe after the recent financial crisis. The idea for this research first came to my mind than two years ago, when I realized how the world was changing after the crisis of 2008. Moreover, I was ever interested in the banking world.

The financial crisis shocked the entire financial market, the most important financial companies in the world suffered huge losses and several firms bankrupted. The U.S. government bailed out Bear Stearns, Goldman Sachs and Citigroup; meanwhile, investors lost all their savings. Furthermore, the financial institutions were accused to be one of the major causes of the markets' collapse.

The desire of change pushed the governments to reform the structure and the tools of the bank corporate governance.

Many authors focused their attention on the impact of the corporate governance in the financial crisis, but only few authors started to analyze the new reforms, so this thesis can be a good beginning for new studies on this topic.

This research intends to investigate the different reforms of bank governance in the U.S. and in Europe and the consequences that they imply for the firms.

In order to do so, the paper starts with a summary of the major events during the financial crisis and the possible impact of corporate governance. In fact, many studies analyzed how corporate governance could influence the financial markets.

The discussion proceeds, in the Chapter two, with the focus on the bank governance before the crisis, in order to understand the governance structure in the period 2002-2006. I will analyze bank governance and the reforms in the U.S. and in Europe before the crisis, so after I will be able to compare these old reforms to the new ones. Several academics, like the Professor of

Yale University, Roberta Romano argued that the Sarbanes-Oxley Act (SOX Act) was an inadequate reform. With this analysis, I intend to explain if the old reforms really played a role in the financial crisis.

The third chapter deals with the real focus of this analysis. In this chapter I will conduct an analysis on the new reforms: on the one hand, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in the United States of America in 2010; on the other hand, the Capital Requirements Directive IV (CRD IV) in Europe in 2013 and the Italian implementation of this European Directive in 2014. For now, just few authors wrote about these new reforms. Professor Bainbridge accused the Dodd-Frank Act to be new quack governance, like the SOX Act. In Europe, Professors Enriques and Zetzsche argued that also the CRD IV missed its goals, being quack governance too. I will focus my attention on the new regulations, basing my analysis on these previous studies.

Furthermore, I will try to find new possibilities to regulate bank governance, stressing the points in which the new reforms failed.

This first attempt to estimate the effects of these new reforms, far from being comprehensive, should be considered as a stimulus for further analyses in this direction.

Bank governance reforms after the financial crisis: United States and Europe.

Chapter 1: The financial crisis and the role of bank governance

1.1 The events

The Great Financial Crisis began in late summer 2007, precisely in mid-August, when the market cut off funding to some financial companies, and in particular with the failure of two Bear Stearns hedge funds.[1] This is now universally recognized as the worst economic crash since the Great Depression on 1929[2], on the basis of Boston Consulting Group studies[3], the global banking industry's market capitalization fell from 9,3 trillion in October 2007 to 3.1 trillion in the first quarter of 2009.

The emergence of sub-prime loan losses began in 2007 with the explosion of the global speculative bubble in real estate and equities, created by new assets called residential mortgage backed securities (RMBS) and Credit default swap (CDS), started this crisis in all world. With the explosion of the bubble, loan losses and the bankruptcy of the investment bank Lehman Brothers, the panic spread around global markets. As a consequence, many commercial and investment banks suffered huge losses and were close to collapse, shares and housing prices fell down, all the Stoke Exchanges around the world risked the default. Many States had to support companies with public capital in order to avoid the risk of bankruptcy, and governments tried to establish new forms of regulation for the financial markets.

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1 William Poole, "Causes and Consequences of the Financial Crisis of 2007-2009." *Harvard Journal of Law & Public Policy* 33, 421, 2010.

2 John Bellamy Foster and Fred Magdoff, "The Great Financial Crisis: Causes and Consequences" *Monthly Review Press*, 2009.

3 Boston Consulting Group Report, 2009.

Figure 1[4]

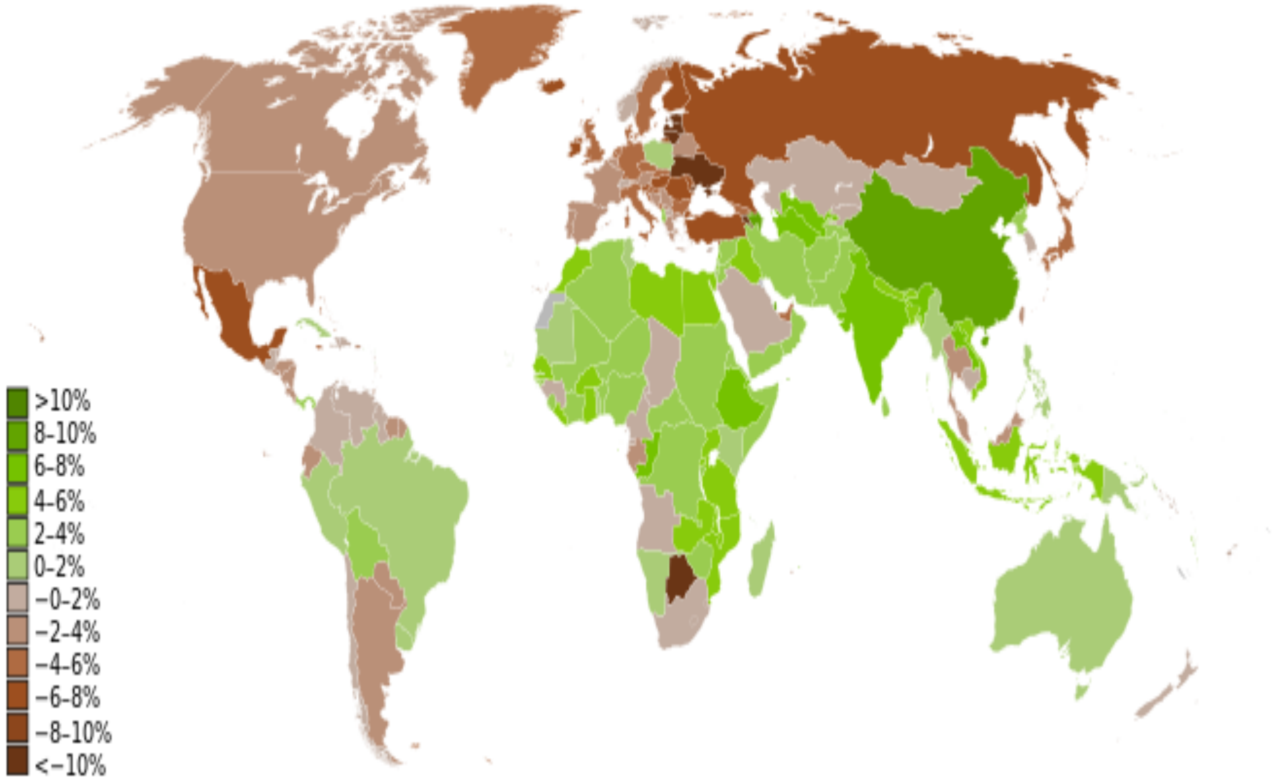


Figure 1 shows the real GDP (Gross Domestic Product) growth rate in the entire world for 2009. Real GDP is the first indicator used to value the health of a country's economy. It is an economic measure to value all goods and services that a country produces in a specific period, and it is usually expressed in year quarters. It is possible to see how the countries in brown were in recession, and they were the most important financial countries, like the United States, Germany and Japan.

[4] *Source*: Alex Kowalski, "Recession Took Bigger Bite than Estimated." *Bloomberg*, 29 July 2011.

By mid 2008, the crisis in the subprime market in the U.S. and the consequential liquidity squeeze were having a strong impact on financial institutions and banks in many countries[5]. For instance, Bear Stearns had been taken over by JPMorgan with the support of the Federal Reserve Bank of New York in order to prevent this bank from failing, the same situation happened for AIG, an important American insurance company, helped by the Federal Reserve. Other investment banks in both the US (e.g. Citibank, Merrill Lynch) and in Europe (UBS, Credit Suisse, RBS, HBOS, Barclays, Fortis, Société Générale) significantly increased capital to cover massive losses, devaluing shareholders' stocks. The U.S. Administration decided to take into government conservatorship Freddie Mac and Fanny Mae, two important government sponsored enterprises that function as intermediaries in the US secondary mortgage market, when it was clear that their financial situation was weaker than expected. In the UK, Northern Rock was the first English bank to be nationalized in order to prevent future losses and in the US IndyMac Bancorp was taken over by the deposit insurance system. In Germany several years before two banks, Berlinerbank and WestLB, had absorbed two state banks, IKB and Sachsenbank. The crisis intensified in the third 2008 quarter with a number of bank collapses (for example Lehman Brothers on 15 September 2008) and a generalized loss of confidence that hit all financial institutions. As a result, banks that risked failing in Europe and in the US received government recapitalization towards the end of 2008.

However, Standard & Poor's and Moody's, some of the major credit rating agencies, announced important downgrades in the world's major financial markets already in June 2007.

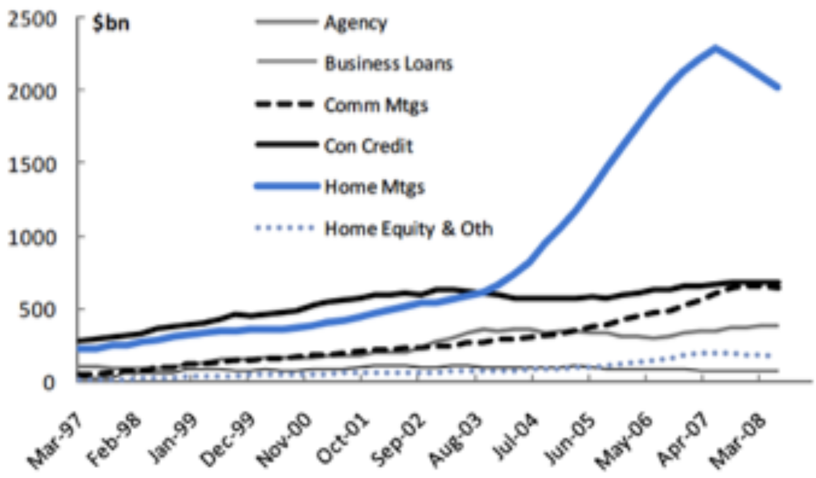
[5] Grant Kirkpatrick, "The Corporate Governance Lessons from the financial crisis." *OECD Journal: Market Trends* No.1, 61-87, 2009.

1.2 The causes

In the previous section we have seen that the main cause of the global financial crisis was the collapse of subprime market linked to a liquidity squeeze. Moreover the crisis grew out of the mistakes and incentives created by past policy makers.

For sure, the financial system incentivized the investments in new banking business models, like residential mortgage-backed securities (RMBS) with benefits. Indeed as we can see from figure 2, after 2004 RMBS had a quick acceleration with a climax in 2006-2007, exactly a few months before the collapse of the entire financial system.[6]

Figure 2[7]: ABS issuers, home mortgages and other loans



Source : OECD, Datastream.

There are several factors that supported the increase of the investments in RMBS in the U.S. In order to give zero equity mortgages to low-income

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[6] Adrian Blundell-Wignall, Paul Atkinson and Se Hoon Lee, "The Current Financial Crisis: Causes and Policy Issues." *OECD Journal: Financial Market Trends,* No.96, Vol. 2009/1.

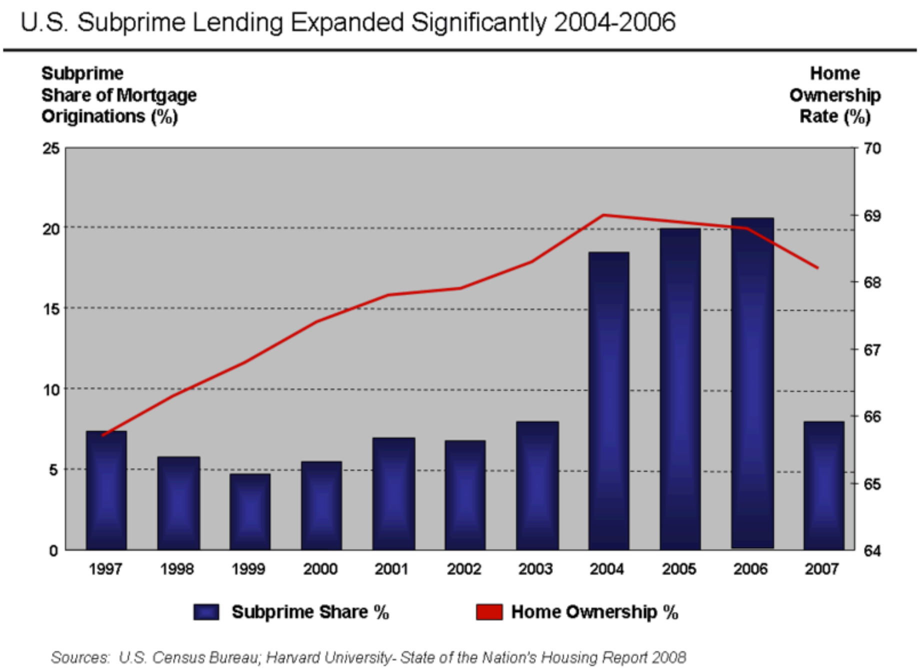
[7] Source: DataStream, OECD, 2008

families, in 2004 the Bush Administration's plan, called "American dream" became operative. In this way many families had the opportunity to buy a house, encouraged by zero equity mortgages.

Afterwards, the Office of Federal Housing Enterprise Oversight (OFHEO) decided to impose superior capital requirements and a strict balance sheet control on Fannie Mae and Freddie Mac, the two government-sponsored mortgage securitization companies. These two companies played an important role in the expansion of higher risk lending, because they accumulated an excessive number of subprime mortgages.

In that moment banks created their own Fannie and Freddie look-alikes in order to contrast OFHEO's new strict regulation in the form of structured investment vehicles (SIVs) and collateralized debt obligations (CDOs).

Figure 3[8]



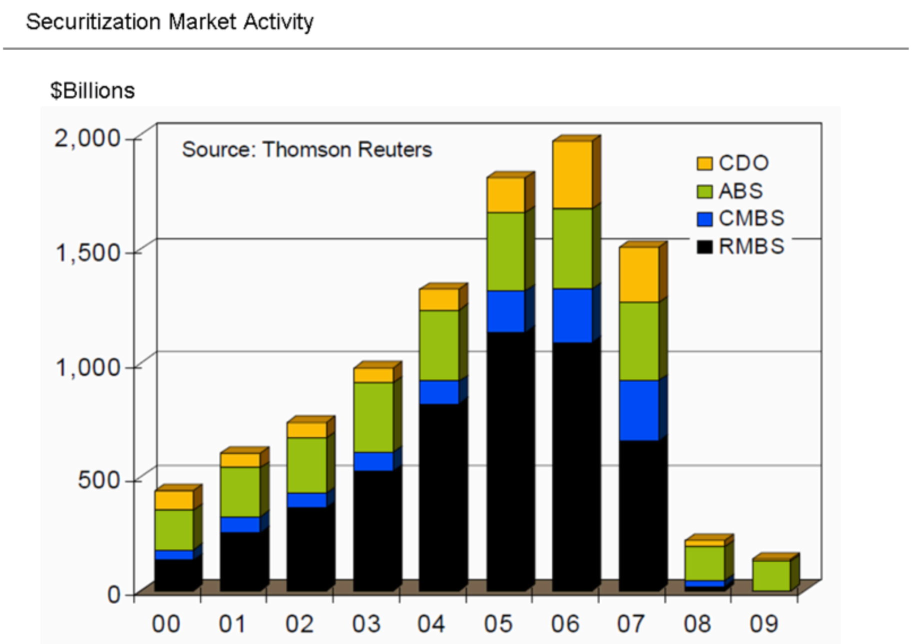
The financial engineers created CDOs, turning risky mortgages into apparently low-risk securities. CDOs were structured obligations with tranches

[8] *Source*: Us Census Bureau, 2008.

of various risk characteristics. Many banks distributed these offers to subprime borrowers, i.e. costumers who had a weak credit history and a serious risk of loan default.

Investors bought CDOs, with the belief that they were safe, trusting the AAA credit rating that the rating agencies, such as Standard & Poor's and Moody, assigned to them[9]. The fallacy was that investment banks CDOs paid these agencies for the rating of their CDOs, creating a dangerous conflict of interest. When U.S's housing market started to collapse, the financial system fragilities came out altogether. Those low-risk CDOs revealed themselves to be worthless, despite the good rating assigned to them, and it became impossible to sell these assets. After the Lehman bankruptcy, many other banks and insurance companies had financial problems and they risked failing. Overall, the system showed its thin basis: banks bloated their balance sheet, but actually they had not the capital to cover the losses.

Figure 4[10]



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[9] The Economist, "The origins of the financial crisis: Crash Course." School Brief, 7th September 2013.

[10] *Source*: Thomson Reuters, 2009.

Then, with the Basel II Accord banks had more freedom on off balance sheet activities, so the majority of them pushed mortgage securitization into off balance sheets, in order to avoid the monitoring and to boost the return on capital. This international accord did not impose a strict enough minimum capital requirements, and this left banks free to collect debt that they were not able to cover with equity. Moreover, the Basel Committee did not introduce any rules about the liquidity, and this caused many problems, as we'll see later.

In this entire situation even the SEC gave freedom to investment banks in order to manage their risk with less stringent rules. Especially in April 2004, the choice to reduce the rules about capital encouraged the most important investment banks to adopt an aggressive expansion of their mortgage-backed securities and to increase their financial leverage[11].

So, bankers are not the only one to blame for the great financial crisis. Also central bankers and the State's regulators had the responsibility of misunderstanding the signals of the imminent crisis and of not monitoring in the right way the global financial world. For many journalists, the Lehman Brothers' bankruptcy was a crucial point of the crisis. This event spread the panic across the markets. With the default of one of the most important banks in the world, which was seen as the fall of a giant, all investors became skeptic towards financial assets.

Central banks could have done something more and better. In the U.S. the Federal Bank did not stop the rapid acceleration of RMBS, in the E.U area the European Central Bank did not repress the credit surge, believing to be safe in a monetary union and in the U.K the Bank of England, being independent since 1997, lost the control over other banks.

European countries surely had several responsibilities. In fact, although European banks bought many American risky securities, a crucial impact was

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[11] Peter J. Wallison, "The True Origins of this Financial Crisis." *The American Spectator*, February 2009.

generated by the creation of the euro that created an extraordinary expansion of the financial sector within the Euro area. According to Hyun Song Shin[12], an economist at Princeton University, the euro encouraged the crisis, because European global banks influenced the American credit conditions and vice versa.

1.3 The role of bank governance

Many authors counted among the causes of the global crisis the innovation of financial products, we saw before, especially the CDOs, that played the main role within this economic tsunami, but also the wrong rate of the rating agencies, the lack of transparency in transaction with a strong news asymmetry and for sure the freedom of off-balance sheet given by the regulators were all causes of this catastrophe.

And in this set of causes what is the role of corporate governance?

1.3.1 Enron's Case

It is necessary to start this analysis back from several years ago in order to answer this question, with the Enron's case. Enron Corporation was an American energy and services company that during 2001 was involved in irregular accounting procedures followed by its bankruptcy. It was the biggest case of default in the United States up to that point, around 5,000 employees lost their jobs[13], and thousands of investors lost billions of dollars.[14]

Why did Enron fail?

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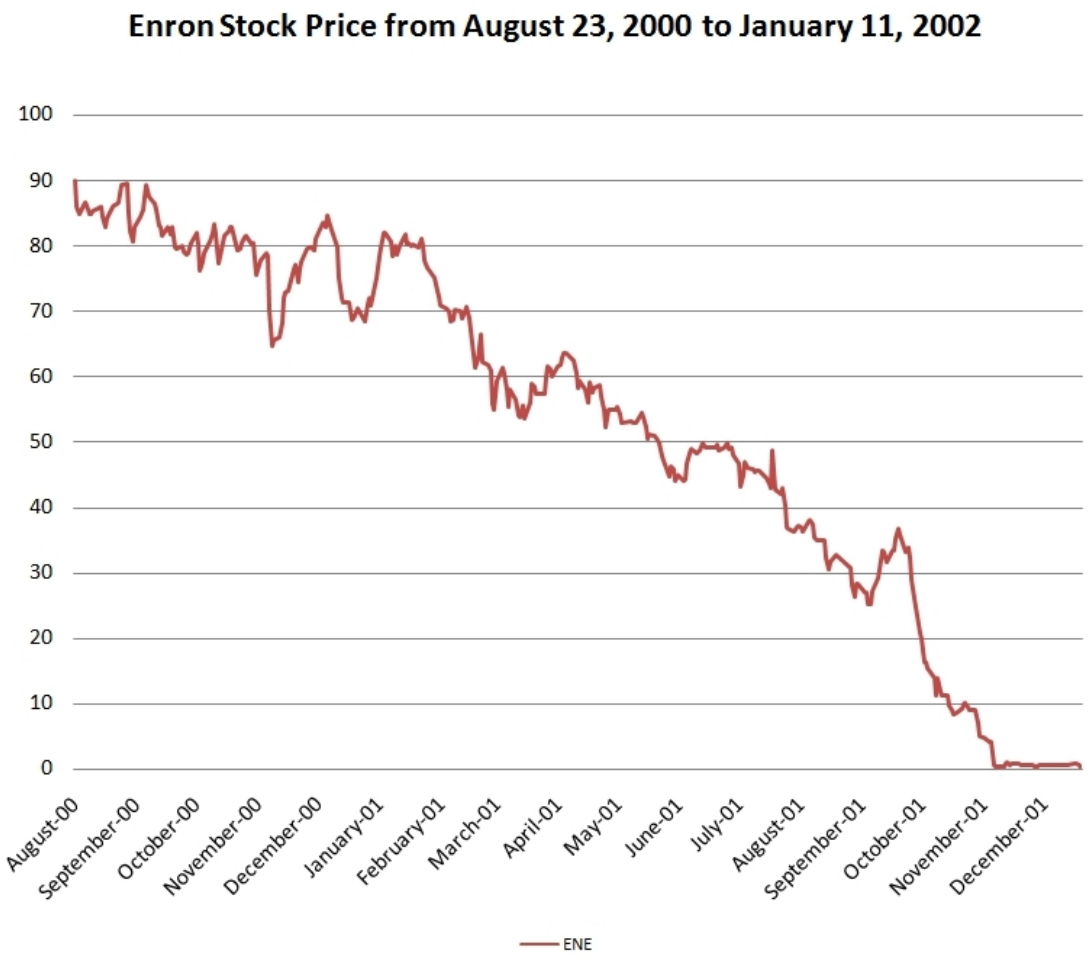
[12] Hyun Song Shin, "Global Banking Glut and Loan Risk Premium." *IMF Economic Review* 60, 155-192, 2012.

[13] CBC News, 25 May 2006.

[14] Scott Horsley, "The Fall of Enron." *NPR,* 26 May 2006, www.npr.org/news/specials/enron/.

Several academics wrote that Enron's business plan collapsed because the company used its rising share price to finance off-balance sheet transactions, in order to increase the share price by inflating Enron's profits, so Enron did neither fall down because the managers' payments were too large, nor because its management were linked to universities and foundation that tried to cover the company's losses with great donations.

Figure 5[15]



15 *Source*: Enron Securities Litigation Website.

So, the Enron's scandal was read like an isolated case of bankruptcy but actually this failure anticipated the financial crisis. The most shocked of this scandal were the state pension funds and the Enron's employees. In fact state pension funds suffered important losses, expect who diversified its portfolio in order to limit exposure. Employees for sure had the greatest losses, without job and pensions.[16]

Media, public opinion and even many academics watched this case as an example of corporate fraud or a corporate governance failure, in which managers and board members pursued their interests rather than company's interests. For all these reasons the following Sarbanes-Oxley Act issued in 2002 is the expression of this school of thought. Unfortunately this Act was not able to make a big impact in the financial system, and we have seen the results after only few years.

1.3.2 Impact of the corporate governance in the financial crisis

Corporate governance is a structure that addresses agency problem and to controls the company's risk-taking. Many studies focused on the possible weight that corporate governance had on risk taking during last decade. It is clear that financial innovation created a new type of securitized credit tools, to satisfy investors' demand, but in this scenario, what was the role of corporate governance?

It is common to say that the breakdown of many companies feels like a breakdown of corporate governance too. Moreover, the failure itself was attributed to the weakness of corporate governance; clearly, it was not able to monitor in the right way the financial system.

[16] Simon Deakin, "Corporate Governance and Financial Crisis in the long run." *Centre for Business Research Working Paper Series* WP417, University of Cambridge, Cambridge, December 2010.

In practice, risk managers, appointed to control the risk level, were not able to anticipate the crisis and its devastating effects. Many scholars concluded their studies saying that the governance structures failed in the risk management area[17].

Lang and Jagtiani[18] instead blamed the complexity of these new types of financial tools (CDOs, RMBS) but also the inefficiency of senior managers and the board of directors to realize the true risk exposures. The authors argued that many companies did not understand clearly the quantity and the nature of their losses to the mortgage market. In fact the complexity of these obligations made it difficult and uncertain to estimate them, and this explains Standard & Poor’s high rate (AAA) to these products, especially to CDOs with large concentrations of subprime real estate.

Overall, the majority of studies focused on executives’ compensations. Moreover we should analyze also the relationship between risk taking and managers’ incentives. Excessive bonuses propelled managers in order to engage in extreme risk taking that then led to this crisis.

Furthermore CEOs had strong incentives to focus their investments on the short term instead of the long term, because all these bonuses were based on the short period. So, they tried to inflate the profits in the short term, in order to access to higher salaries.

It is clear that banks that pursued sound risk management procedures went better than those that hazarded dangerous investments[19].

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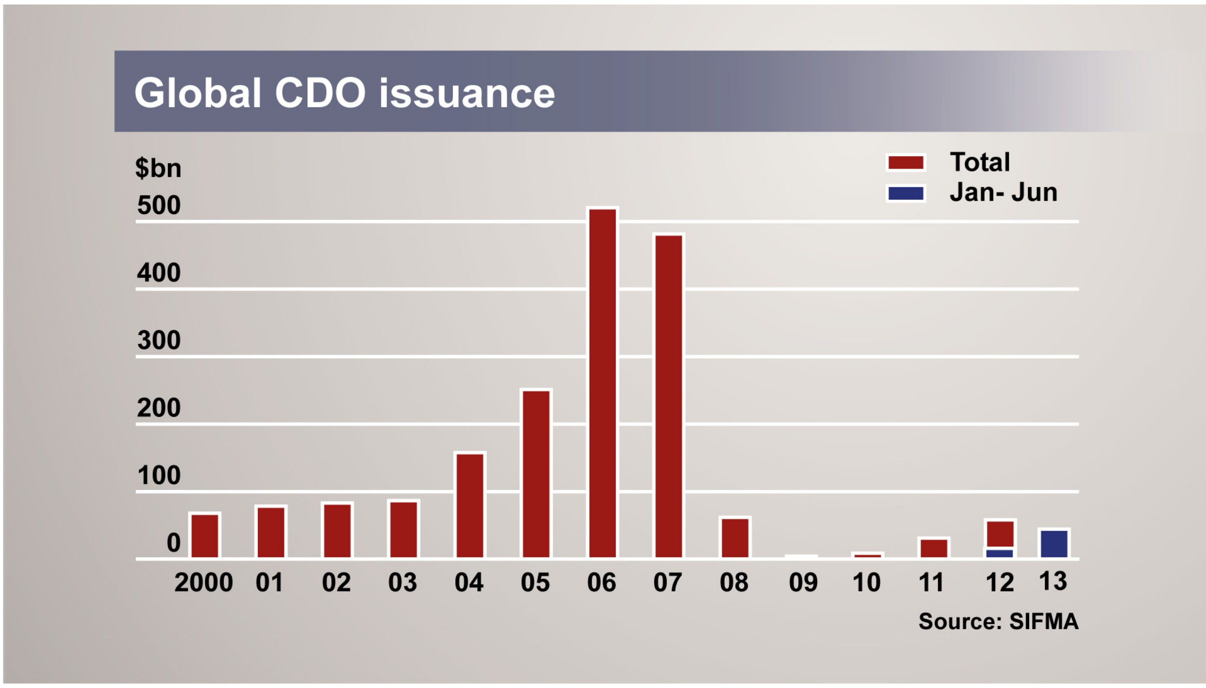
[17] For evidence, Ganesh Prasad, “Slicing the Gordian Knot of SOA Governance.” November 2012.

[18] William W. Lang and Julapa A. Jagtiani, “The Mortgage and Financial Crises: The Role of Credit Risk Management and Corporate Governance.” *Atlantic Economic Journal*, 123-144, 2010.

[19] Hussein Tarraf and Karl Majeske, “Impact of risk taking on bank financial performance during 2008 financial crisis.” *Journal of Finance & Accountancy* 13, 2013.

Figure 6[20]



Between 2008-2009, at the beginning of the financial crisis, many academics started to believe that the true cause of it was excessive executive pay that encouraged hard risk taking and so the best solution would to fix those compensations to prevent similar crisis in the future. In the U.S. the Congress, pushed by these pressures, voted in favor of a regulation, the Dodd-Frank Act, and the Federal Reserve Board emanated several guidelines about the compensation of managers. Also the G-20 expressed the orientation of implementing stricter international compensation standards.

It is possible to distinguish many hypotheses about the role of the corporate governance in the crisis. The first is that the activities of an investment bank are difficult to control from the boardroom. The second, as we have seen before, is that this new kind of business (CDOs) is harder to understand than a common obligation, so consequently it is much more difficult to estimate the risk.

[20] *Source*: Securities Industry and Financial Markets Association (SIFMA), 2013.

Another hypothesis obviously is that the incentives linked with the performance in short-term, inflated the company's profit in order to gain excessive bonuses. [21]

Is there a unique solution?

Table 1[22]

Company	%chg. in stock price since Jan 2007	Subprime related losses (USD bn)	(% of Tier 1)	(% of revenues)	(As of June 2007) Investment banking segment	Employee compensation. (% rev. > 20%)	Top 5/(salaries & benefits) > 0.78%	Risk committee chair not on board
PNC Financial Group	-24.1	n/a			..	x		..
BB&T	-30.5	n/a			..	..		..
Suntrust	-63.4	n/a			..	x	x	..
Regions Financial Corp	-72.5	n/a			..	x		..
Goldman Sachs Group	-60.4	4.9	11.5	5.6	x	x		x
U.S. Bancorp	-20.9	1.3	7.4	6.4	..	..	x	..
JP Morgan Chase & Co.	-34.3	18.8	21.2	16.2	x	..	x	..
Bank of America Corp.	-71.4	21.2	25.4	17.8	-	-	x	-
Morgan Stanley	-77.1	15.7	48.9	18.4	x	..	x	x
Wells Fargo & Co.	-18.6	10	27.2	18.4	-	x	x	-
Fifth third bancor	-76.4	1.9	21.3	22.4	..	..		..
Lehman Brothers	-99.9	13.8	59.7	23.4	x	-		x
Citigroup Inc.	-85.9	60.8	68.1	38.2	x	x	x	-
National City Corp.	-94.4	5.4	57.6	45.9	..	x		..
Merrill Lynch	-86.3	52.2	165.4	84.3	x	x	x	x
Wachovia Corp.	-89.5	52.7	121.1	94.9	..	x	x	..
Washington Mutual	-99.9	45.6	219.1	178.6	-	-		x

Source: Company reports, OECD.

[21] Adrian Blundell-Wignall, Paul Atkinson and Se Hoon Lee, *supra* note 6.

[22] *Source*: OECD, 2008.

The table 1 compares the most important financial companies in the U.S. in regard to the percentage of change in stock price after 2007, their losses in subprime and other indicators that I listed before. Analyzing the table it is difficult to find a single answer. Several banks, like Goldman Sachs and JP Morgan, seemed to handle well this complex business, while the indicator of medium salary for the top management is not a signal to identify a good firm.
Although many authors have identified different "good/bad governance indicators", in the operating reality facts have not always followed those indicators[23]. Therefore, I argue that there is not a common indicator for all but every strategy needs to be analyzed in relation to the single financial company.

1.3.3 The Bear Stearns and Lehman Brothers Cases

Nevertheless some authors have an opposing view of the problem[24]: they didn't think that the excessive incentives played a important role in the risk taking decisions that financial firms made in the first decade of 2000, rather they stressed on the important stock price's losses, the consequence was that executives took many risks, maybe for excessive optimism or maybe not perceived truly risks. An important journalist of the New York Times, Floyd Norris said about the Lehman's case that "*Wall Street pay didn't cause this crisis*" and Norris always from the column of the N.Y. Times wrote: " (Lehman's CEO) was later raked over the coals in Congressional hearings about his huge compensation. That most of it was in stock and options that he

[23] Adrian Blundell-Wignall, Paul Atkinson and Se Hoon Lee, *supra* note 6.
[24] Lucian A. Bebchuk, Alma Cohen and Holger Spamann, "Wages of failure: executive compensation at Bear Stearns and Lehman 2000-2008." *The. Yale J. on Reg*. 27:257, 2010.

never cashed in seemed to be something most legislator could not comprehend".[25]

Actually these words could seem true because it is clear from both balance sheets that the CEOs of Bear Stearns and Lehman held between $5 and $10 billions of shares in their banks respectively, and when in 2007 after the Lehman's default those shares became garbage, they had huge losses, especially Richard S. Fuld, the last Chairman and Chief Executive Officer of Lehman Brothers.

Professors Bebchuk, Cohen and Spamann, in their paper, analyzed the executive compensations of two important firms involved into financial tsunami, Bear Stearns and Lehman Brothers, the first sold itself to JP Morgan on a "sale" price, whereas Lehman declared bankruptcy in 2009. In contrast to standard narrative of this financial tsunami that found the wealth of the two firms' managers was lost with their companies, these authors noticed that the top executive of bear Stearns and Lehman were not economically devastated by their management during the period 2000- 2008. They in fact were able to assign high compensations, from bonuses and from share sale. As a result, the executive payoffs from their leadership of the firm were very positive.

They focused their analysis on the five executive officers, for both Bear Stearns[26] and Lehman[27], in 2007, for all compensations needed to be disclosure in the annual proxy statement under U.S. securities law: the CEO, the CFO and the three other most important and highly paid executive officers. Overall, these five figures held key managerial and board positions throughout

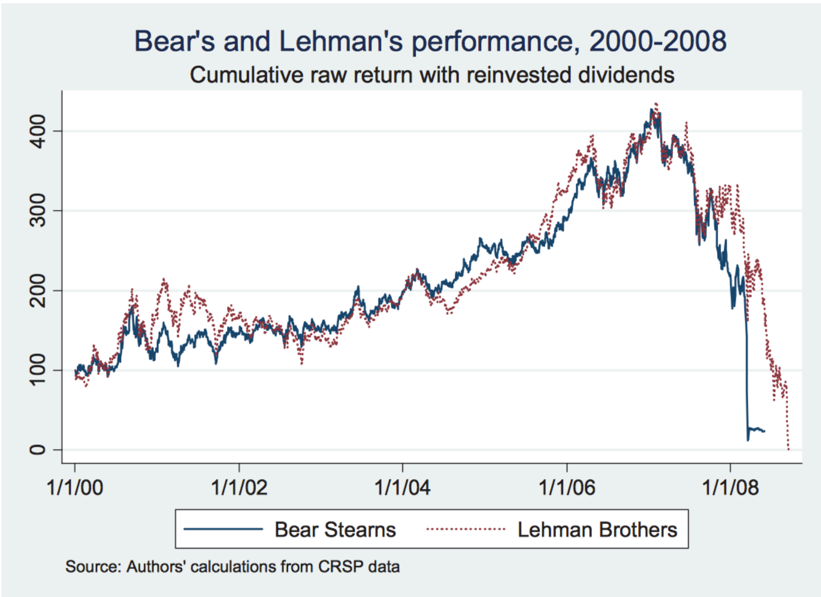
[25] Floyd Norris, "It May be Outrageous, but Wall Street Pay didn't Cause this Crisis." *N.Y. Times*, 31July 2009.

[26] At Bear Stearns the team includes: James Cayne, CEO from 1993 to 2008 and Chairman from 2001 through 2008; Alan Greenberg, Chairman of the executive committee from 2001 to 2008; Samuel Molinaro, CFO 1996-2008 and COO 2007-2008; Alan D. Schwartz, co-COO from 2001 until 2007, CEO from 2008 until the merger with Bank of America; and Warren Spector, co-COO from 2001 to 2007.

[27] At Lehman the team was: Richard Fuld, CEO from 1993 to 2008 and Chairman of the board from 1994 to 2008; David Goldfarb, CFO from 2000 through 2004 and CAO 2004-2006; Joseph Gregory, COO 2002-2008 and CAO 2000-2002; Christopher O'Meara, CFO from 2004 to 2007; Thomas Russo, CLO 1993-2008.

all of the 2000-2008 period. Certain compensations of several members of the companies could miss because, they were not technically "named executive officers" so they didn't have the duty of disclosure for the entire period.

Figure 7[28]



This chart explains that managers increased their companies' stock price until the first part of the 2007, then it is possible to see an incredible collapse both, Bear Stearns was constrain to sell itself stock for a ridiculous price to JP Morgan in March 2008, instead the fall of Lehman Brothers ending to the bankruptcy in September 2008.

The question of the authors is simple: how is it possible that the executive had an incentive to make decisions that created a dangerous risk of large losses?

[28] *Source*: CRSP data, Bears and Lehman performance, 2000-2008.

Furthermore this big incentive to take risk was based on the banks' short-term results.

It is not true that the executives were paid only in stocks and options; in fact they received large cash flows during the period 2000-2008.

From this table it is easy to understand how many cash flows the top managers of these two companies draw in the period.

Figure 8: Total cash flows from bonuses and equity sales 2000-2008.[29]

	Bear Stearns		Lehman	
	CEO	Executives 2-5*	CEO	Executives 2-5*
Bonus	$87,509,569	$239,337,718	$61,557,166	$102,407,231
Sales of stock	$289,088,081	$817,237,608	$461,173,614	$389,315,896
Stock remaining	$11,656,420	$17,494,360	$0	$0
TOTAL	**$388,254,069**	**$1,074,069,685**	**$522,730,780**	**$491,723,127**
Total Top-5	**$1,462,323,754**		**$1,014,453,907**	

Furthermore, it is important to stress that the CEO of Lehman alone gained from bonuses and equity about $522 million, leading his company to the bankruptcy.

The table of Top managers' compensation has to be compared with the table that shows the value of their stock and options. In spite of the great losses that the banks suffered, and the consequentially collapse of the stock price, the net payoffs for the management during this period is however positive. For sure each member of the teams had a positive payoff.

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[29] *Source*: Annual proxy statements of Bearns and Lehman,2008.

Figure 9: Estimated value of initial holdings. [30]

	Bear Stearns		Lehman	
	CEO	Executives 2-5*	CEO	Executives 2-5*
Initial stock	$360,277,489	$437,934,567	$194,570,847	$194,778,981
Initial options	-	-	$106,197,280	$105,654,222
TOTAL	**$360,277,489**	**$437,934,567**	**$300,768,127**	**$300,433,203**
Total Top-5	**$798,212,056**		**$601,201,330**	

In other words, the top management of Bear and Lehman collected from bonuses and other benefits, so they reduced the impact of the shares holding's decline, for sure they reacted much better than their shareholders.

This analysis is only an example, because the authors[31] studied only these two important banks, however it is a good beginning for a deeper examination of the problem. First of all, considering the structure of the bonuses compensation, the managers obtained large profits based on the high performance in the years before the crisis, but when the crisis started and the earnings revealed worst, they had to return nothing of those bonuses. Their short-term decisions had a good impact immediately, but they were blinded for the effects in the long period.

The real problem that this study reveals was that the interests of the executives (short term) were in conflict with the interest in long term of the shareholders, the structure of the performance based compensation was designed in such a way that managers obviously preferred managed investments in the short terms, going against the shareholders' interests.

[30] *Source*: Lucian A. Bebchuk, Alma Cohen and Holger Spamann, *supra* note 24.
[31] Lucian A. Bebchuk, Alma Cohen and Holger Spamann, *supra* note 24.

It is undeniable that top executives neither understood nor predicted the crisis, because they were able to sell more holding shares before the 2008, but they did not.

So, certainly the executive's compensation played a role in Bear Stearns and Lehman's losses, the management was encouraged to invest in risky assets in order to gain more, and moreover the bonuses were enough to made up to the losses on their holdings when the firms' collapse.

But this is only the beginning of our analysis, now we have to expand it.

1.3.4 The changed business model

Before 20th century, the business model for banks was said "3-6-3", borrowing at 3%, lending at 6% and play golf by 3 o'clock.[32] It was the era of "boring" banking system, in fact George Moore, Chairman of First National City Bank (later Citibank and now Citigroup) from 1967 to 1970, wrote in his autobiography that banking was the surest and easiest business that he had seen or known.[33] Furthermore investment banks were partnerships, in which the partners were personally liable for debts and exposure of their firms.[34] This structure limited the growth of investments banks that remain "medium size". The banks looked for investments in long term and the partners were careful in each transaction because they would cover each loss. In the 1990s the situation started to change, with the first deregulation reforms that helped to change this "boring" business model. The old "medium size" banks were pushed into a rush of consolidation and the number of banks was reduced to fewer than 8,000 in 2008.[35] So, the new system counted less number of banking

[32] Simon Johnson and James Kwak, "13 Bankers: The Wall Street Takeover and the Next Financial Meltdown." *Pantheon Books*, 2010.
[33] George Moore, "The Banker's Life." *Norton*, 1987.
[34] Brian Cheffins, "The Corporate Governance Movement, Banks and the Financial Crisis." *ECGi-Law*, *Working Paper* No.232/2014, December 2013.
[35] Lawrence G. Baxter, "Betting big: Value, Caution and Accountability in an Era of large Banks and Complex Finance." *Review of Banking & Financial Law* 31.1, 2011.

organizations, but larger. These new larger banks approach the market with new lines of business in order to create a financial "supermarkets" with a wide range of financial products to customers. Moreover the deregulation created a unique opportunity for risk taking in the banking sector. The era of the "3-6-3" model finished, the megabanks chose bold strategies, creating assets and giving risky loans. In the last decade the process of transformation continued, the investment banks engaged with the new kind of obligations (CDOs, RMBS) and made high-risk transactions.[36]

The U.S Government tried to legislate the corporate governance, especially in bank's area, for creating the figure of outside director, using the bonuses of compensation based on performance. In other words the government tried to apply the structure of corporate governance both to banks and non-financial firms, and exactly this fail contributed to the beginning of the financial crisis.[37]

In fact banks are different from non- financial companies; the megabanks became "too big to fail", so managers and the investors believing in a bailout or in state's support in difficult cases. Moreover the quality of banks' assets is commonly less observable than those of non-financial firms, and so makes it more difficult to control management decision-making.[38]

So, the new strategy of banks switched forward a faster growth based on trading assets via securitization, increasing risk taking and inflating revenues in order to boost the top managers' bonuses.

It is clear that this new model is riskier than the "3-6-3" model, and according to Professor David Skeel, it is undeniable to say that " *These are not your father's financial intermediaries"*.

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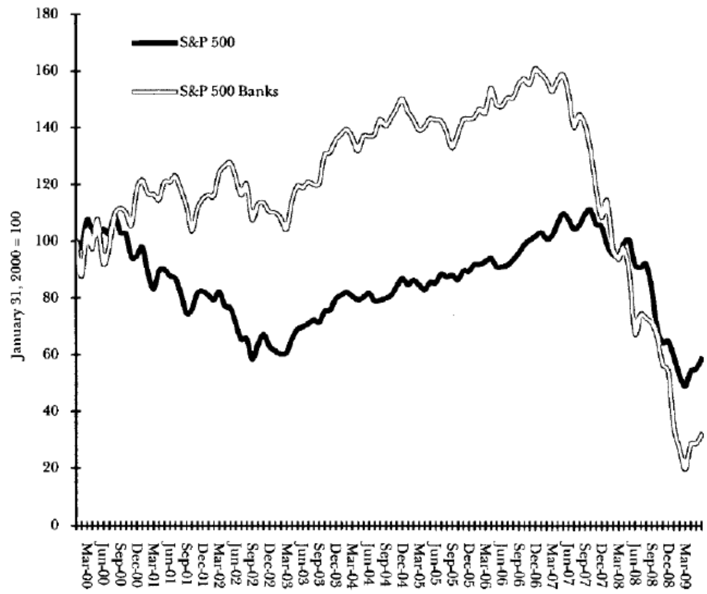
36 Allen N. Berger and Loretta J. Mester, "Explaining the Dramatic Changes in Performance of US Bank: Technological Change, Deregulation and Dynamic Changes in Competition." *Journal of Financial Intermediation* 12.1, 57-95, 2003.

37 David A. Skeel, "The Market Revolution in Bank and Insurance Firm Governance: Its Logic and Limits." *The Wash. ULQ* 77, 433, 1999.

38 Mark J. Roe, "Structural Corporate Degradation Due to Too Big To Fail Finance*." ECGI-Law, Working Paper* No. 253/2014, 9 April 2014.

But it was impossible to prevent the facts happened after the 2007, and the graph below can help us understand why.

Figure 10[39]



The S&P 500 is a stock market index based on the market capitalizations of 500 large companies and it is one of the most commonly used benchmarks for the entire U.S. stock market.

The figure shows that the index went down during the bubble of “dot.com” until 2002, but the shares of banks continued to go up for the following 5 years, then in 2007 it possible to observe the start of the collapse. (In 2008 S&P500 dropped down about 60%)

The value of banks’ shares increased during the period from 2002 to 2007 because the growth of their loans was strong, the economy was stable and the hypotheses of default were uncommon. However, the financial market

[39] *Source*: William W. Bratton and Michael L. Wachter, “The Case Against Shareholder Empowerment.” *University of Pennsylvania Law Review*, 653-728, 2010.

increased not simultaneously with the real market, so leaving banks vulnerable, and in fact as soon as the market crashed, all banks were in a seriously weakened state.[40]

Many banks were on the hedge of the collapse caused by this change of strategy model. For evidence, the Northern Rock, an English bank, grew assets at a rate of 25% per annum, based on risky loans, a classic example of equity culture mixed with credit culture.[41] The Northern Rock's growth was encouraged by Basel II minimum capital requirements. The 75% of its assets were mortgage products, so by 2007 when the crisis started and the liquidity decreased, the Northern Rock had insufficient reserve to cover its exposures. The U.K. Government had to intervene to safeguard shareholders' interests and bank's depositors and finally the bank was nationalized in 2008.[42]

Other evidence was the UBS case. The Swiss bank was seeing others banks' growth, understood that itself get left behind to its competitors. The UBS's strategy was based especially on the fixed income business and by the creation of alternative investment businesses. In 2006 the board decided to focus its business to increase the exposure in the subprime markets, i.e. transactions off-balance sheet. The bank bought many U.S. mortgages in order to "re-pack" them

and consequentially re-trade them. Sales managers were appointed to the board, they did not have risk management background.[43]

The 60% of UBS's assets was made of CDOs, and when the financial bubble exploded in 2007/2008, the financial firm suffered huge losses and the Swiss Confederation had to make a bailout. Nobody of the executives in the risk committee understood the serious danger that the bank was following.

[40] Brian Cheffins, *supra* note 34.
[41] Adrian Blundell-Wignall, Paul Atkinson and Se Hoon Lee, *supra* note 6.
[42] Simon Deakin, *supra* note 16.
[43] Grant Kirkpatrick, *supra* note 5.

The UBS example described how corporate governance was influent in the crisis, the banks that chose a diversified portfolio, not specialized in mortgage, operated quite better, for sure with less financial problems.[44]

UBS appointed a risk committee, like usually in Europe, whereas in the U.S. is more common an audit committee e not a separate risk one. KPMG report of 2008 described how an audit committee felt obstructed in its work by the board's influence.

Moreover it is important to highlight the quality of board members, from outside is very difficult appreciate it. Often they undoubtedly do not have any financial and banking skill, and more often they are appointed in the risk or audit committees. However, the situation is not clear and univocal: in the U.K. experience, Northern Rock had two managers in the board with banking background, at Bear Stearns the majority of the directors had banking experience, but nevertheless we know what happened to these two banks.[45]

1.3.5 The importance of the CEO

Jack Welch, General Electric CEO from 1981 to 2001, is recognized as the first Imperial CEO. With the Enron's scandal the figure of the "Imperial CEO" was dismissed, nevertheless it persists in the financial firms, in which the figure of the magnetic CEO remained essential throughout all these years. Richard Fuld, chief executive and chairman of Lehman Brothers from 1994 to 2008, was called "King Richard" and he was described like the only person that took decisions in the Lehman's board. Fuld is only an example, but it is quite easy to list many of this type of CEO: Chuck Prince, CEO and Chairman of Citigroup, was defined by American Banker magazine "a king within the walls of Citigroup"[46]; Stan O'Neal, chief executive of Merrill Lynch, that

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[44] Adrian Blundell-Wignall, Paul Atkinson and Se Hoon Lee, *supra* note 6.
[45] Grant Kirkpratrick, *supra* note 5 .
[46] *American Bankers*, March 2005.

managed the firms in very autocratic behavior; James E. Cayne, CEO of Bearn Stearns until the collapse of the firm's stock, named by the CNBC as one of worst American CEOs of all time[47].

The presence of this influent figure in the banking branch had significant implications during this period. On the one hand the excessive power and the fame of the CEO and on the other hand the tolerance of the other managers and shareholder to CEO's behavior encouraged also the aggressive risk taking without any constrain.

Starting from 2007 many companies removed their CEO's, someone resigned, like Chuck Prince that under shareholders' pressure decide to step aside.[48] The most important decision was to split the seats of CEO and Chairman; in this way the Chairman should monitor the CEO's activities.

John Gapper, Financial Times' journalist, in his editorial on 17 May 2012 called Jamie Dimon, Chief executive officer and Chairman of JP Morgan Chase, the "last star CEO", and in fact it is true, because Dimon is the unique survivor, among the CEOs in important financial companies, after the financial crisis. His power is still strong, but after a robust criticism, the board of JP Morgan was forced to design the figure of a "lead independent director", in order to monitor Dimon's job and to drive CEO's succession.[49]

The major critic that media and shareholders move against the chief executive and top managers is that their remuneration have not closely followed company performance, so also when the things go wrong, the company has many losses, these managers continue to gain highly salaries.

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[47] Portfolio's Worst American CEOs of All Time, *CNBC* 2009.

[48] Kevin Dobbs, "Crisis Casts Bank Boards As Activists." *American Banker Magazine*, 14 July 2008.

[49] Tom Braithwaite, "JP Morgan Acts to Curb Dimon's Board Power." *Financial Times*, 10 Sept. 2013.

Figure 11[50]

Name and company	Estimated payment	Losses from options, shares etc
Mudd, Fannie Mae	USD 9.3 million (withdrawn)	n.a.
Syron, Freddie Mac	USD 14.1 million (withdrawn)	n.a.
Prince, Citibank	USD 100 million	50 % drop on share holdings of 31 million shares
O'Neal, Merrill Lynch	USD 161 million	Loss on shares
Cayne, Bear Stearns		USD 425 million (sales in March 2008 at USD 10 per share)

Source: OECD.

1.3.6 The relationship between corporate governance, risk taking and financial performance

Studying the role that corporate governance may have played in the financial crisis of 2007 many authors used empirical evidence. For these kinds of evaluations is frequently to make use of common indicator: the z- score.
The z-score measures the distance from the insolvency based on the probability distribution of the revenue earned by the financial companies. It equals the return on assets (ROA) plus the capital asset ratio (CAR), divided by the stand deviation of return on assets (s).

$$\text{z-score} = \frac{ROA+CAR}{s}$$

50 *Source*: OECD,2009.

Kenneth Spong and Richard J. Sullivan[51] in their study said that the z-score represents the standard deviations under the mean that return on assets would have to fall to eliminate capital and force the bank to collapse. So, the higher is the z-score, the lesser are the chances of risk for the bank. In fact, a higher z-score means that the bank is stable and that has less problems of insolvency. It is possible calculated the z-score of a bank only if there are accounting information for at least four years.[52]

Tarraf and Majeske compared 74 Bank holding companies (BHC) in order to understand if the BHCs' corporate governance could have played a role during the financial crisis. They collected the Gov-score (measure the strength of a bank), the ROA, the ROE and the z-score for each BHC and then they analyzed every hypothesis.

The final results explain that in part the corporate governance did not affect banks' risk taking, which it means that many studies, that said that entire corporate governance played a crucial role in the current crisis, failed their conclusion. Whereas the results showed that risk taking is an indicator of ROA and ROE, so the risk taking affected the profits of the BHCs. The results stressed that the current system of banking governance does not limit risk taking, so indirectly it played a role in the crisis. The authors' study concludes that banks that pursued sound risk management procedures performed surely better than those that did not. The board needs to be educated on risk issues and the managers have to give sufficient information to the board's directors in order to enable them to understand really company's risks. Then, shareholders cannot control the firm but the management has to inform shareholder on the risk assumed by management.

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[51] Kenneth Spong and Richard J. Sullivan, "Corporate Governance and Bank Performance. Corporate Governance in Banking: A Global Perspective." *Edward Elgar Publishing*, 40-61, Northampton 2007.

[52] Hussein Tarraf and Karl Majeske, *supra* note 19.

This study shows that there was a relationship between banks' risk taking and their financial performances; whereas it is not statistically proved that there was a relationship between banks' governance and their risk taking.

Also Berger, Imbierowicz and Rauch[53] tried to examine the role of corporate governance in bank default during the "Great depression", comparing the different ownership and management structures of default and no default banks in the U.S, precisely they took 249 US commercial banks defaults and 4,021 no default US banks. They used different indicators than Tarraf and Majeske; in fact they focused their analysis on a combination of accounting variables, different governance structure, subprime risks, house price evolution, competition market and regulatory features. The results show that a bank's ownership structure played an important role in order to explain default's reasons. They saw that banks have more possibilities to collapse if they have fewer outside directors, chief officer shareholdings. Inside managers with many shares may take much risk because of the moral hazard problem, whereas outside directors are professionals and so they are discredit by default, so they have less problem of moral hazard. Second their analysis the bonus payment programs had a role in the financial crisis; in fact managers should raise their level of stock or stock options to increase their presence in the bank, whereas the lower level management should reduce their level of share, in order to increase bank's stability.

The work of Andrea Beltratti and René M. Stulz[54] is very ambitious. Their study in fact wondered why banks performance managed so wrongly during the financial crisis. The results showed that banks with more capital, less exposure in the U.S real estate performed better. Banks from countries "close" to the U.S. generally performed worst than those from countries economically

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[53] Allen N. Berger, Bjorn Imbierowicz and Christian Rauch, "The Roles of Corporate Governance in Bank Failures during the Recent Financial Crisis." *Unpublished Working Paper*, University of South Carolina and Goethe University, Columbia, SC, and Frankfurt am Main, Germany, 2012.

[54] Andrea Beltratti and René M. Stulz, "The credit crisis around the globe: Why did some banks perform better?" *Journal of Financial Economics* 105.1, 1-17, 2012.

distant to the United States. They argued that there is no support for studies that attribute an important role to governance: in fact those banks, which are usually considered better because they have a board "shareholder friendly, are those that have reacted worse in the crisis. The analysis prove that there is a negatively relationship between banks and their performance in 2006, so the banks that performed better in 2006, are those that suffered many losses after. Another finding is that banks from countries with more constrains in 2006, are those that passed better the impact of the crisis.

In 2008 Luc Laeven and Ross Levine[55] were the first authors that conducted an empirical study about the relationship between banks' risk taking, their ownership structures and bank regulation. They analyzed the structure of almost 300 banks in 48 countries with different bank's regulation. The findings stressed that the same regulation could have different impacts on bank risk taking, because each bank have a different ownership structure. Moreover they asserted that banks with more powerful owners take higher risk but there are greater fragilities in the economies with stronger shareholder protections.

So, for the Leaven' and Levine's analysis the effects of the same regulation on a bank can be positive or negative, overall depending on the bank's ownership structure.

Overall, almost all the empirical works argue that corporate governance has played a role in this financial crisis, however it is not clear if this role influenced directly or indirectly the economic collapse. Only few authors did not find the evidence of this influence.

As we have seen, whether failures in the governance of banks were a major cause of the financial crisis is highly controversial. There are authors that argued that the corporate governance had an important role in the crisis and authors that asserted the contrary. As most often the truth is in the middle.

[55] Luc Laeven and Ross Levine, "Bank Governance, Regulation and Risk Taking." *Journal of Financial Economics* 93.2, 259-275, 2009.

Surely, there were false incentives, deficiencies in board practices and internal control failures. All these factors contributed to make complex and opaque banks' structure. However there were many others and more important elements that led to the financial crisis.

Chapter 2: Corporate governance scenario before the financial crisis

2.1 Overview

Before analyzing the new reforms, it is useful to observe and comment bank governance scenario before the financial crisis.

At the beginning of the new century many financial scandals shocked the world.

All began with the Enron's bankruptcy in winter 2001, after that Wall Street had gradually collapsed scandal by scandal. These scandals shocked people's trust in the economy and fed a popular cynicism toward business that permeates many aspects of politics and culture.

In a short time this crisis of faith in the financial market spread over also in Europe, helped by several scandals, such as Parmalat in Italy in 2004.

In the entire world, people were worried about the suspicions of possible accounting frauds.

In the wake of widespread abuses and corporate scandals, corporate governance issues emerged as the focal point to reform, so the government around the world had to give a positive signal starting to enact new rules for stopping other possible accounting fraud.

The United States were the first country to begin this new course with the Sarbanes-Oxley Act in 2002. In response to the belief that innovative financial governance laws are needed, other regulations were enacted in Germany, Italy, and France and in other many states. [56]

All regulations tried to restore confidence in the securities market. These new laws undertook to improve the accuracy of corporate disclosure by modifying governance, reporting and disclosure rules for companies.

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[56] *Financial Times,* May 2004.

2.2 United States: Sarbanes-Oxley Act

The Sarbanes-Oxley Act (SOX) was enacted in 2002 as a reaction to several corporate and accounting scandals including those affecting Enron, WorldCom, Tyco International and Waste Management. These failures, the unreliability of managers, monitors and market raised the debate in favor of a need to change the current corporate law in order to restore faith in financial companies. [57]

In fact, what these scandals had in common was the skewing of reports of financial transactions; companies, like Enron and WorldCom, misrepresented many transactions, resulting in huge losses towards shareholders and in a crisis of investors' faith.

The bill was enacted in a rough moment of congressional activity in the run up to the midterm 2002 congressional elections, so the Congress had to demonstrate its idea of innovation in order to obtain votes.[58]

This new law was the biggest federal law's improvement relating to corporate governance since the adoption of the starting federal corporate laws (New Deal) in 1933-1934, and it promised enhancements in the transparency and efficiency of corporate disclosure by changing governance, reporting and disclosure requirements for public companies.

It is arranged into eleven titles containing additional corporate board responsibilities, an increase of responsibility for auditors and a redefinition of SEC's tasks.

In response to this sentiment of renovation of corporate governance laws, SOX-similar regulations were consequentially enacted in Europe and in the entire world.

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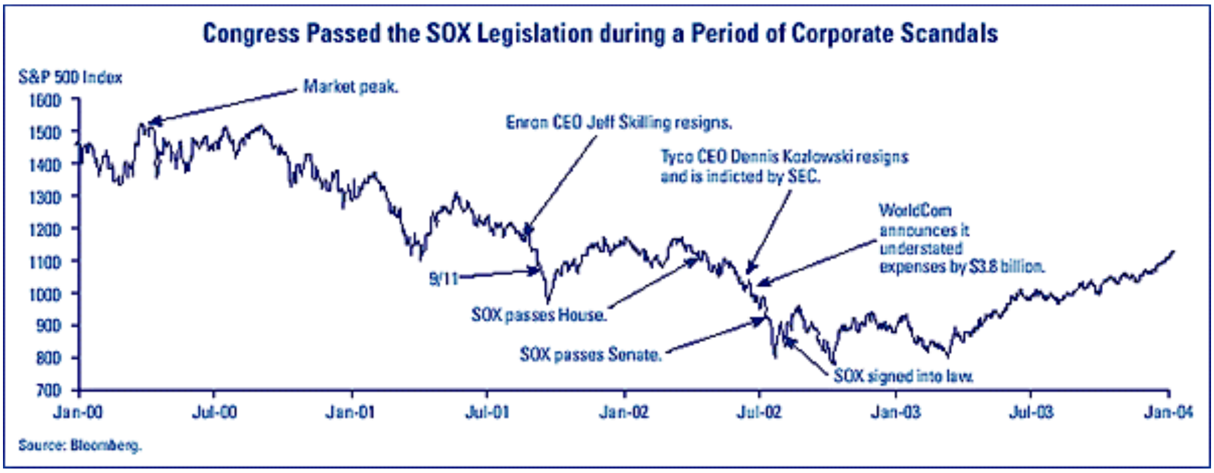
[57] Daniel A. Cohen, Aiyesha Dey and Thomas Z. Lys, "The Sarbanes Oxley Act of 2002: Implications for Compensation Structure and Risk-Taking Incentives of CEOs." *New York University*, New York, NY, 2005.

[58] Roberta Romano, "The Sarbanes-Oxley Act and the making of quack corporate governance", *Yale Law Journal*, 1521-1611, 2005.

The data shows the different stages of the enactment in relation to the trend of S&P 500 index.

Figure 12[59]



The SOX enactment was debatable. On the one hand, It received many criticisms for its greater costs and it complexity. Moreover, many academics argued that its provisions did not improve corporate governance or companies' performances, but it was only a set of recycled ideas.[60]

On the other hand, several studies supported the new Act.

For sure, SOX Act changed radically the structure of corporate governance.

[59] *Source*: Bloomberg

[60] Roberta Romano, *supra* note 58.

2.2.1 The major innovations of the Sarbanes-Oxley Act

As we saw before, the Sarbanes-Oxley act is arranged in 11 titles. It is important to see improvements about corporate governance.

Section 302 of the Act required each periodic report containing financial statements, which is filed to the SEC, being accompanied by the certification of the CEO and the CFO. The two of them should have certified that the company's periodic reports did not contain misstatements or omissions. The signing managers had also the duty of establishing internal control and of controlling the effectiveness of this control. The certification was meant to improve both the effort of those tasks and the truth of financial information. The officers had to disclose to the audit committee of the board any fraud, any significant deficiencies and anything that could be significant for controlling the company.

Section 906 reviewed the CEO's and the CFO's financial responsibility for financial reports. They were responsible of signed reports and if the certification did not meet the criteria of the Section 906, they might have been fined up to 1$ million and imprisoned for up to 10 years. If they willfully continued to ignore the new framework of certification, convictions could have doubled.

The Enron's collapse shifted the regulator's focus on off-balance sheet instruments that were used fraudulently. So, Section 401 of SOX required the disclosure of all off-balance sheet transactions in order to avoid other frauds.

Section 402(a) of SOX prohibited, except in very limited circumstances, corporations to arrange or extend credit to executive officers or directors unless the corporation was a financial institution offering credit as core of its business. Existing loans could be exempted but not renewed.

Figure 13[61]

Sarbanes–Oxley Act of 2002: Summary of Provisions

Sections	*Topics*
101–109	PCAOB's creation, oversight, funding, and tasks
302, 401–406, 408–409, 906	New disclosure rules, including control systems and officer certifications
201–209, 303	Regulation of public company auditors and auditor–client relationship
301, 304, 306, 407	Corporate governance for listed firms (audit committee rules, ban on officer loans)
501	Regulation of securities analysts
305, 601–604, 1103, 1105	SEC funding and powers
802, 807, 902–905, 1102, 1104, 1106	Criminal penalties
806, 1107	Whistleblower protections
308, 803–804	Miscellaneous (time limits for securities fraud, bankruptcy law, fair funds)

Public Company Accounting Oversight Board (PCAOB), quasi-public institution, was responsible for establishing auditing, quality and independence for registered public accounting firms and for overseeing companies' accounting registers. In other words, the PCAOB had to supervise the entire accounting system of the companies.

The improvements concerned even executive compensation. In fact, Section 301 required that the audit and compensation committees must consist entirely of independent directors.[62] Moreover, the audit committee was required to establish a mechanism to receive and treat complaints regarding accounting and auditing matters, and it had to contain at least one director who is a financial expert.

Section 201 of SOX prohibited that accounting firms gave non-audit services to firms that they audited. The banned services included all consultant services. [63]

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[61] Source: John C. Coates IV, "The Goals and Promise of the Sarbanes - Oxley Act." *Journal of Economic Perspectives*, 97-116. Winter 2007.

[62] Oliver Hart, "Regulation and Sarbanes-Oxley." *Journal of Accounting Research* 47.2, 437-445, May 2009.

[63] www.sec.gov.

Overall, the SOX act required for the majority of the provisions that the SEC (Securities and Exchange Commission) implemented rulings on requirements to comply with the law.

At last, one of the highlights of the act was Section 304. This section required reimbursement by CEOs and CFOs of certain compensation, stock sale profits or bonuses received if their company had to restate financial statements due to non-compliance material, as a result of misconduct.

2.2.2 The debate on the Sarbanes-Oxley Act

Many academics and experts of corporate governance harshly criticized the SOX, during its legislative process at the House and at the Senate and when it was enacted. The new structure of corporate governance did not satisfy these experts.

The most important critic of the new act was certainly Roberta Romano, professor of Law at the Yale Law School.

She argued, in her paper, that the Act "may have satisfied a political need, but it will do little to protect investors or strengthen the market".[64] Why would SOX is quack corporate governance for professor Romano?

Analyzing the SOX, she tried to explain how the act would not improve corporate governance or performance. About section 301, which required an independent audit committee for all listed companies, Romano argued that many empirical studies show that independent boards do not improve performances, but, on the contrary, boards with too many independent directors may have a negative impact on company's results. There is no study that proves that complete independence of the audit committee increases performance, whereas many studies show that having a director with financial

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[64] Roberta Romano, *supra* note 58.

skills improves performance. Anyway the expertise is more important than complete independence with respect to the relation between audit committee composition and accounting statement quality. Unfortunately, the presence of a financial expert on the audit committee was not mandatory (it has only a disclosure requirement in relation to financial expertise on the committee). Overall, the studies on the composition of audit committees did not support the idea that committee made of only of independent directors would reduce the probability of financial mistakes, and demonstrated positive results about this topic could be the product of random errors.

Then, she disagreed with the prohibition for accounting firms that provide non-audit services to firms that they audit. In fact, many studies verified that there was no connection between the regulation of non-audit services and audit quality. The audit quality was not in danger by the non-audit services and this is the result of the studies, which used the most sophisticated techniques.

The most important point for professor Romano was the executive certification, in Section 302 of SOX. She argued that, before the enactment of SOX, CEOs and CFOs of largest listed firms had always been required to certify the annual report of companies, and these executives were already responsible for any fraudulent report and for inadequate internal control. So, there was yet this provision before SOX. On the contrary, John C. Coates affirmed that the innovation in SOX was not that CEO and CFO signed financial statements, but that they were required to do so in the wake of new specific requirements.[65]

The certification gave for sure new and positive information to the market; it was a good signal for the investors.

Overall, professor Romano described SOX act as a political compromise, the product of the swiftness of the Congress to answer to the greater corporate scandals during the mid-term elections. Moreover, empirical studies suggested

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[65] John C. Coates, supra note 61.

that this set of mandate rules did not improve audit quality or enhance companies' performance nor protect investors as Congress aspired to.
In his paper Oliver Hart[66] was more moderate. In fact, he conducted a theoretical study on the regulation and the Sarbanes-Oxley Act. Firstly, he summarized the common arguments for regulation and then, he considered how these arguments applied to SOX. The author concluded his paper arguing that none of the theoretical arguments for regulation that he listed at the beginning appeared to be important for SOX. Like Roberta Romano, also Hart accused politically impetuosity for the issues into the Act. Many authors stressed this point: the act passed in the U.S Senate with 99 votes in favor and zero against; in the U.S House 423 favorable and only 3 against. It is alarming when the Congress is uniformly in favor of something, especially in the middle of a political panic.[67]
However, According to Ray Ball, Hart gave a glimmer of hope to SOX, because "we still do not know definitively the 1933 to 1934 Securities Acts were a good thing 75 years after the event!"[68] Analyzing the period after Enron's bankruptcy, Ball also affirmed that the Sarbanes-Oxley Act was a political overreaction to one episode of scandalous financial reporting.
On the contrary, several academics looked in favor to SOX and its innovative rules. They affirmed that the establishment of PCAOB and requirements for auditor-attested disclosure would give a greater protection for investors. Professor Coates, in his paper of 2007, debunked that the Congress has been rushed in the enactment of SOX, because the core idea behind it had developed for years. He argued that rather than pushing for removing SOX, a

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[66] Oliver Hart, *supra* note 62.
[67] Alex J. Pollock, "Sarbanes-Oxley in the Light of the Financial Crisis, American Enterprise Institute for Public Policy Research." *American Enterprise Institute Regulation Outlook*, 1-4. November 2009.
[68] Ray Ball, "Market and Political/ Regulator Perspective on the Recent Accounting Scandals." *Journal of Accounting Research* 47.2, 277-323, May 2009.

better approach would have been to eliminate those prohibitions and requirements that obstruct the SEC and PCAOB activities. [69]

Furthermore, Section 304 had great support from public opinion. It required reimbursement by CEOs and CFOs of certain received compensations and stock sale profits if their company was in restructuring process, as a result of misconduct. However, clawbacks have been rare. According to Gretchen Morgenson[70], journalist of New York Times, the SEC did not attempt to claw back any executive compensation until 2007, and at December 2013 it had brought only 31 cases.

Other authors focused their attention on the new rules in the light of the recent financial crisis.[71] Surely, SOX's efforts to control risks did not stop the terrific financial bubble and they had clearly no impact on corporate behavior, or - if they had - it was a negative one. Maybe SOX's choice to stress too much the figure of the "independent" was too dangerous. From the CEO's point of view, the ideal board has to contain only independent directors, in this way he is the only person that knows everything and he can do whatever he wants.

2.2.3 In particular: The costs of Sarbanes-Oxley Act and its impact on executive compensation

A. The Sarbanes-Oxley Act received many criticisms about its costs. In fact, although several survey results[72] suggested that the enactment of SOX was beginning to boost investor confidence, compliance cost must be considered. Direct costs consist of PCAOB's creation, companies' compliance and the growth of audit fees. Only PCAOB fees are known and certain, other costs are in relation to each company, but on the average they initially are very high,

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69 John C. Coates, *supra* note 61.

70 Gretchen Morgenson, "Clawbacks? They're Still a Rare Breed." New York Times, 28 December 2013.

71 Alex J. Pollock, *supra* note 67.

72 "FDIC Outlook", *Federal Deposit Insurance Corporation*, Research and Analysis.

but all seem to be falling over time. Moreover, opportunity costs of manager time spent and the risk aversion, called indirect costs, are harder to measure.

There are other costs for those companies that "go private", i.e. they cease to be subject to strict SEC regulation by selling out to managers, concentrated owners or private firms. The U.S. Government Accountability Office registered that 25 percent of companies went dark from 2003 to 2005. The term "going dark" means that they legally cease to be under SEC regulation, either because they became private companies or because they reduced the number of their shareholders below the minimum level for SEC registration.

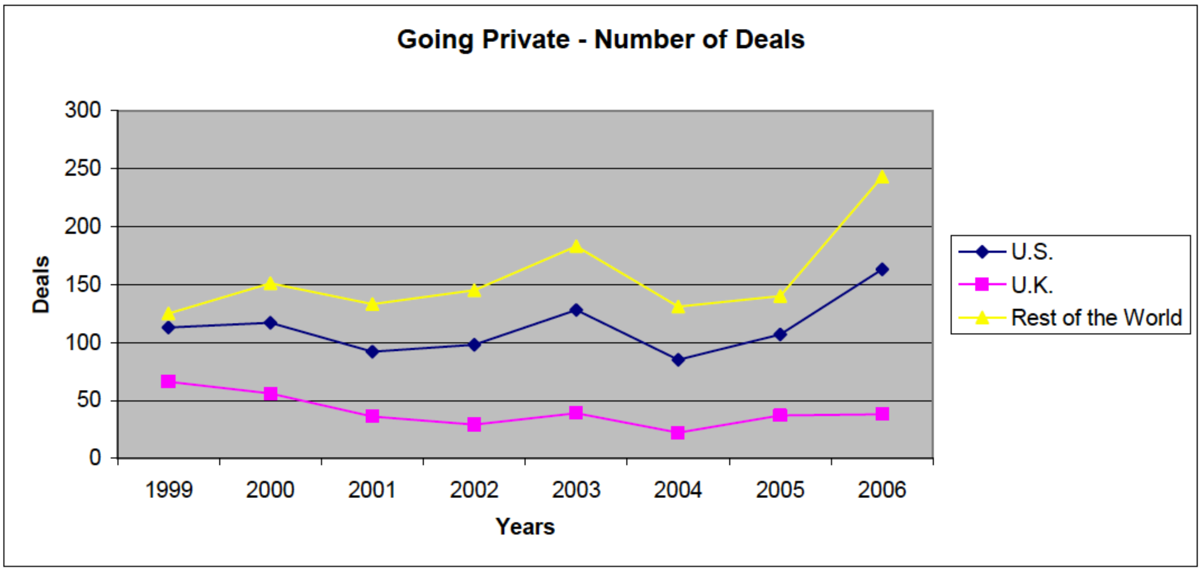
Moreover, an article of the "US Banker" in May 2005 calculated that the costs of complying with the SOX could reach as high as $4 million for banks during 2004. The article concluded that these costs could become a greater factor in decisions to "go private" and avoid SEC reporting requirements.[73]

The costs for "going private" or "going dark" are uncertain and they are impossible to be calculated on the average.[74]

[73] Karen Krebsbach, "SOX Costs prompt switch from public to private." *American Banker*, 2 May 2005.

[74] John. C. Coates, *supra* note 61

The figure 14 reports going-private trends for the U.S., the U.K. and the rest of the world. [75]



Many authors blamed SOX because it hurt the competitiveness of U.S. Stock Exchange in regard to foreign Stock Exchanges. It is undeniable that there was a decline of listed-companies in U.S exchange, but maybe SOX was not responsible. This decline started in 2001,prior to the Sarbanes-Oxley. Professor Zingales, in his analysis in 2006, argued that, if the benefits for being listed in U.S. Stock Exchange remain in the form of 90 basis points under the cost of capital, a company with a capitalization above $230 million will outweigh the costs of compliance with the Sarbanes-Oxley Act.[76]

The problem of this Act was that the costs were substantial and hard to estimate, while the benefits were hidden and difficult to isolate.

Zhang affirmed in 2006 that SOX and its provisions imposed important net costs on firms. His analysis is based on stock returns in relation to the relevant

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[75] Source: Christian Leuz, "Was the Sarbanes-Oxley Act of 2002 really this costly? A Discussion of Evidence from Event Returns and Going-Private Decisions." *Journal of Accounting and Economics* 44.1, 146-165, 2007.

[76] Luigi Zingales, "Is the U.S. Capital Market Losing its Competitive Edge?" *Journal of Economic Perspectives*, 2007.

legislative events. He found greater losses around the enactment of the new regulation, which reflect direct costs and indirect costs for companies' compliance. [77]

Zhang ascribed the major costs to the restriction of non- audit services and to the new requirement of the internal control tests.

The majority of the authors that wrote about SOX's costs agreed with the idea that we do not have evidence to support the conclusion that SOX has been excessively costly. Surely, we have evidence that SOX increased the cost of audit services, but this effect produced also benefits. Unfortunately, the net effects on companies brought by the SOX, remain unclear.

B. Several papers focused their attention on the effect of Sarbanes-Oxley Act in relation to executive compensation. Moreover, the focus was on the new disclosure requirement imposed by SOX that executive option grants must be reported to the SEC within two business days of the grant date. [78]

The grant price is the price at which the managers and employees will be able to purchase the stock. It is an important point because executives may manage the information flow in order to put out options at the best possible moment for them. There are two ways through which managers might alter the grant date: timing and backdating. Executives can modify the grant day by releasing negative information before the scheduled grant date and emitting positive information only after the grant date.

The second way is the backdating. Managers might choose a date in the recent past in which the stock price was lower than the day they actually made the transaction.

After the new requirement implemented by SOX, influencing the value of the option grant through backdating became impossible, because it would be a

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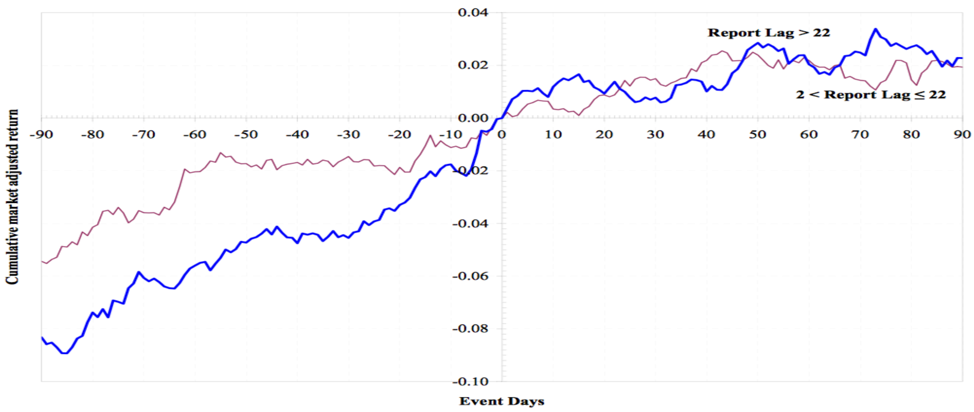
[77] Ivy Xiying Zhang, "Economic Consequences of the Sarbanes-Oxley Act of 2002." *Journal of Accounting and Economics* 44.1, 74-115, 2007.

[78] M.P. Narayanan and H. Nejat Seyhun, "Effect of Sarbanes-Oxley Act on the Influencing of Executive Compensation." *Working Paper*, University of Michigan, 2006.

violation of the reporting requirement. The only available solution might be the timing. In fact managers could camouflage the violation by not reporting the grant date immediately, in order to create a separation between the revelation of the grant and the activity they timed.

Narayanan and Seyhun studied the impact of SOX on the possibility of the managers to influence their compensation by using an enormous database of over 569,000 option grants reported by all managers of public listed companies.

Figure 15[79]



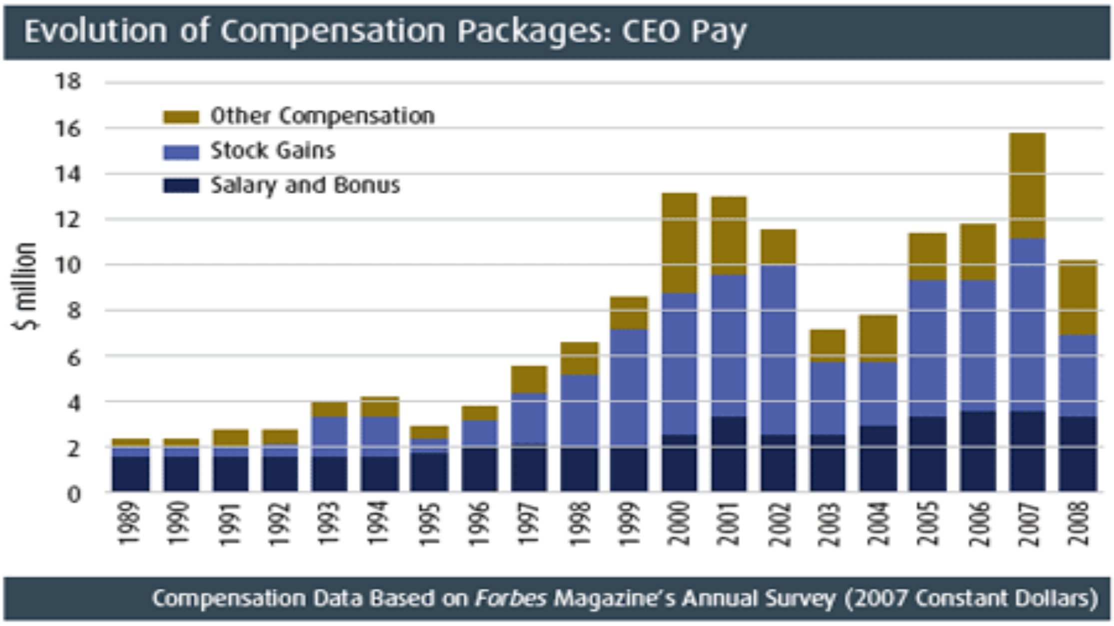
Their findings show that there is a decrease of executive influence after SOX, however they found evidence that managers continued to use backdating and timing in order to camouflage distortions also after the enactment of SOX. Moreover, they argued that the most important element was that the post grant date stock returns are greater in the late reported post SOX than before. In fact, the figure 4 shows market-adjusted abnormal stock returns around the day that the SEC received the report of grant information from managers (day 0) for two sub-samples of grants that are reported after 2 business days: grants

[79] Source: M.P. Narayanan and H. N. Seyhun, *supra* note 78.

that are reported after 2 but within 22 business days from the grant date and grants that are reported after 22 business days.

The paper of Cohen, Dey and Lys focuses on incentive compensation. They start from two hypotheses: firstly, managers alter the incentive compensation to fixed salary in order to create a sort of insurance, in this way they bypass the additional liability imposed by SOX on them; secondary, there is a decline in risky investments by managers.

Figure 16[80]



Their findings demonstrate that there was a change in executives' compensation structure: more fixed salary and less incentive-based compensation. This behavior is a response of the managers, who want to insure them from the related risks, to the new provision in SOX, which requires that executives need to reimburse incentive-based compensation following accounting mistakes by restructuring compensation plans. Other results confirm the decline in risky investments by firms in the period post

80 *Source*: Forbes Magazine's Annual Survey, 2007.

SOX. The motivation could be the new additional liability imposed on managers by the new legislation.[81]

In conclusion, the Sarbanes-Oxley Act did not prevent the crisis, but it does not seem entirely wrong. It is clear that the Act was a political solicitation in the election period, to obtain favorable votes. However, as many authors observed, the new rules tried to impose more transparency to financial market and to avoid that executives had too much freedom in the management of company. Unfortunately, it did not demonstrate its positive aspects because with the beginning of the crisis the entire financial system collapsed and after a few years the Congress had to enact a new legislation, the Dodd-Frank Act in 2010.

2.3 Italy: The first years of the new century

At the beginning of this century Italy was shocked by several financial frauds that created huge losses for Italian investors. Three are the main events: Argentina's financial default, the bankruptcy of Cirio and the one of Parmalat, two leader companies in the consumer goods sector. Moreover, maybe Parmalat scandal had the biggest impact on the evolution of Italian corporate governance.[82] The Tanzi family controlled the company through a pyramidal structure. The accounting scandal that brought in down in 2003 was, like the Enron case, the largest case of false accounting in Europe.[83]

After that, maybe investors lost their faith in Italian bonds, as happened in the U.S.

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[81] Daniel A. Cohen, Aiyesha Dey and Thomas Z. Lys, *supra* note 57.

[82] Guido Ferrarini and Paolo Giudici, "Financial Scandals and the Role of Private Enforcement: The Parmalat Case." *ECGI-Law*, *Working Paper* No.40/2005, May 2005.

[83] Pepper D. Culpepper, "Eppure, non si muove: Legal Change, Institutional Stability and Italian Corporate Governance." *West European Politics* 30.4, 784-802, September 2007.

Since 2003, the companies could choose among three options of board structures: the traditional Italian system, the German dual board and the British-type one tier board. Unfortunately, the last two types of structures did not collet many supporters. This law contains an expressed provision of the role the independent director in the board.
Directive 2006/46/CE introduced the duty of European listed companies to write a report about corporate governance. In Italy the directive has been implemented in D.Lgs 173/2008, and Consob now can sanction managers for their behaviors. The directive assigned a “power/duty” of enforcement to audit companies. They have to verify companies’ financial reports. Controls on banks were intensified to verify compliance with the legislation on transparency.
In conclusion, these new remedies aimed to ensure the access and the accuracy of disclosure.
In 2004 financial stability was one of the main topic addressed by international organizations. We have seen how the United States too tried to impose more stability through SOX Act. In July 2004 the European Commission enacted a new Directive on new capital adequacy requirement for banks and investment companies. The Directive was implemented into Italian law.
Italy’s banking system was in line with those of the other main countries regarding to concentration and geographical distribution. It was characterized by a high presence of listed banks. There were several mergers, in order to rationalize the system.

Table 2[84]

THE STRUCTURE OF THE ITALIAN FINANCIAL SYSTEM

	31 December 2003			31 December 2004		
	Number of Intermediaries			Number of Intermediaries		
	Group members	Non-group	Total	Group members	Non-group	Total
Banking groups			**82**			**83**
Banks	**225**	**563**	**788**	**227**	**551**	**778**
limited company banks	*197*	*47*	*244*	*198*	*44*	*242*
cooperative banks (banche popolari)	*18*	*20*	*38*	*18*	*19*	*37*
mutual banks (banche di credito cooperativo)	*10*	*435*	*445*	*11*	*428*	*439*
branches of foreign banks		*61*	*61*		*60*	*60*
Investment firms	**35**	**97**	**132**	**25**	**90**	**115**
Asset management companies and SICAVs	**66**	**87**	**153**	**69**	**93**	**162**
Financial companies entered in the register referred to in Article 106 of the Consolidated Law on Banking	**206**	**1,288**	**1,494**	**213**	**1,306**	**1,519**
of which: entered in the special register referred to in Article 107 of the Consolidated Law on Banking	*98*	*261*	*359*	*99*	*277*	*376*
Other intermediaries (1)	–	–	–	–	**2**	**2**

(1) Bancoposta and Cassa Depositi e Prestiti.

In 2004 the Italian financial system comprised 778 banks and 653 investment firms, asset management companies and other financial institutes. As we can see from the Table 1, there were 83 banking groups[85].

If we consider that at the beginning of the 1990s banks did not play a significant role in Italian financial system, especially in companies' ownership, in the first decade of the 2000, we have seen a greater growth from 29% of the share capital in 1990 to 56% in 2007.

Moreover, the most important Italian banking groups increased their penetration in European markets. At the end of 2004, 25 Italian groups were established abroad, with many branches and subsidiaries.

[84] *Source*: Bank of Italy, Annual Report, Ordinary General Meeting of Shareholders, 2004.

[85] Bank of Italy, Annual Report, Ordinary General Meeting of Shareholders, 2004.

2.3.1 Corporate Governance Code ("Codice di Autodisciplina")

The Italian model of corporate governance for listed companies is characterized by a high ownership concentration. The structure of companies is usually pyramidal, with limited protection of minority shareholders.[86]

In contrast to U.S., in Italy there is a limited separation between ownership and control firms.

The Italian corporate control structure was broadly similar to the continental European one, but there was a significant difference: in Italy ownership concentration was extremely high, inducing a limited effect of control. Control structures were characterized on the one side by the strong role of the State, on the other by the important presence of family firms; so, control-enhancing mechanisms were widespread. In other words, the stock market was extremely small compared to all the other countries.

The Code was modified in 2002 and then in 2006, after the financial scandals.

Each article of the Code is divided into three sections: the "principles" that explain the general provisions, "Application criteria" containing detailed information on how apply the principles, "Comments" that intent to clarify the aim of principles and criteria and that often contain practical examples.

The articles from 1 to 5 focused on the role of the board of directors. The board is the "heart" of the governance. The primary responsibility of the board is to set the company's aims and to ensure they are achieved. Moreover, the board is collectively responsible for verifying the existence of the controls needed to supervise the company's performance. The directors have to give information reports to shareholder on the company's strategies. More important is the composition of the board: it has to contain executive directors and non-executive. The non-executive directors should bring their specific expertise in order to contribute to increase the firm's performance.

[86] Luca Enriques and Paolo Volpin, "Corporate Governance Reforms in Continental Europe." *The Journal of Economic Perspective* 21.1, 117-140, 2007.

The Code, like the Companies' Reform, suggested that the board should form a committee on remuneration and stock option plans, especially for significat banks in term of size and complexity. The committee, composed by a majority of non-executive directors, has to submit proposal to the board for the remuneration of the managing directors.
Then, the Code recommended a set of processes aimed to monitor the performance of the company, the accuracy of financial information, compliance with regulations and the level of risk. Furthermore, the board of directors becomes responsible for the internal control system.
The code was applied to all listed companies, although there were just a few cases of non-compliance.

2.3.2 The innovations in the Italian scenario

One of the most important changes in Italian corporate governance life was in 2005 when Antonio Fazio, Governor of the Bank of Italy, resigned from his position, in the wake of evidence that he had used his office for his personal interests. Mario Draghi was appointed Governor of the Bank of Italy. He eliminated the veto power of the Bank of Italy over proposed takeovers, tool which had allowed the former Governor Fazio a greater influence on the course of merger activities. The Draghi regime was surely more inclined to follow market logic than was its predecessor.[87]
The problem in Italy is that a small number of shareholders exercises control over most of the listed companies. As Meoli[88] wrote, "in Italy controlling

[87] Tony Barber, "The Good News: Non-sweaty Shoes and Shareholders Rights." *Financial Times*, 20 March 2006.
[88] Michele Meoli, Stefano Paleari and Giovanni Urga, "When Controlling Shareholeders "live like kings". The Case Of Telecom Italia." *Cass Business School*, *Working Paper*, London 2006.

shareholders live like kings". Pyramidal ownership structures allow large blockholders to leverage their stakes to control companies. The strength of family firms may create additional fear that encourages shareholder does not invest.

The evidence in Italy shows that the political majority is hostile to make institutional changes.[89]

Bianchi and Enriques argued that the most active institutional investors in Italy are tied to Italian banks and insurance companies. This may generate potential conflicts of interests, when the banks and insurance companies try to play the same role of activist investors.[90] Banks in fact by offering multiple services, and by using their mutual funds can exercise strong oversight power over owned companies in order to avoid alienating those companies who are also their clients.

The annual reports of the Bank of Italy in those years were encouraging. The Italian banking system appeared sound, with a good quality of loans, despite the weakness of the real economy. Furthermore, the profitability of banks had improved, benefiting from the good borrower selection techniques.[91]

While the development of the banking system, also in terms of banks size, improved the financial system's competitiveness, small banks continued to play a fundamental role in the local economies, in fact the presence of large intermediaries is important to keep the advanced financial services available at low cost.

In 2002 the "Ministero dell'Economia" established a commission, called "Galgano Committee", to study the public companies' transparency. This commission argued that Italian corporate governance had to adopt the U.S.

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[89] Pepper D. Culpepper, *supra* note 83.

[90] Marcello Bianchi and Luca Enriques, "Corporate Governance in Italy after the 1998 Reform: What Role for Institutional Investors?" *Consob, Quanderni di Finanze: Studi e Ricerche*, 1-50, January 2001.

[91] The Governor's concluding remarks, Ordinary General Meeting of Shareholders, Bank of Italy, 31 May 2006.

and EU provision about the transparency, to improve its corporate governance system.
Several authors argued that the Italian law looked at SOX with a sort of admiration, but the American Act hid several "traps".[92]

2.4 Conclusions:

From corporate governance's scenario exposed in this chapter, nobody would have predicted the financial crisis that involved the American and European banking systems a few years later.
For sure, in United States the Sarbanes-Oxley Act received many criticisms and the American financial market were weakened yet, by the Enron's bankruptcy. However, it was hard to understand, also for financial and banking experts, the global financial market, in which many variables work, and to predict the financial crisis. In Italy, despite several financial scandals, the banking sector expanded its influence in the rest of the Europe and corporate governance regulation was well improved.
However, in those years, banks started to sell new financial products (CDOs) that increased the opaqueness of the yet complex banking system.
In conclusion, despite several signs of weakness, it would not be correct to argue that SOX and other regulations played a significant role in the beginning of the crisis.

[92] Ugo Mattei and Filippo Sartori, "Conflitto Continuo. A un anno da Enron negli Stati Uniti e in Europa," *Rivista di Diritto Bancario*, September 2003.

Chapter 3: Governance reforms after the financial crisis

3.1 After the financial crisis

As we have seen before, each financial crisis leads changes in the financial regulation. Like in 2002 after Enron's collapse and other corporate scandals, even after the financial crisis in 2007-2009, corporate governance law needed improvements. In fact, having seen governments bail out several companies, like Bear Stearns and AIG in the U.S, and supply over one hundred billion dollars into big banks of the entire world in 2008, people started to assert that the existing regulatory frameworks could be unable to supervise the largest financial institutions. Almost no one had ever heard of financial instruments, like CDOs, before the collapse of the major financial markets and many still do not understand the entire process of these securities, but all lost the faith in markets and asked for an adequate regulation system.[93]

As for the Sarbanes-Oxley Act in 2002, the United States was the first country to enact a new regulation in 2010, the Dodd-Frank Wall Street Reform and Consumer Protection[94], the response to this desire of innovation.

In Europe, to contrast the financial crisis and to establish a new structure of bank governance, the Capital Requirements Directives (CRD) IV was formally published in the Official Journal of the EU on 27 June 2013.[95] It is a European legislative package covering rules for banks and investment firms. Furthermore, it has introduced a supervisory framework in the EU, which reflects the Basel III rules on capital standards. A few years before, in 2011,

[93] David Skeel, "The New Financial Deal: Understanding the Dodd-Frank Act and its (unintended) consequences." *John Wiley & Sons Inc.*, 2010.

[94] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 2010.

[95] Directive 2013/36/UE, of the European Parliament and of the Council of 26 June 2013.

the European Banking Authority (EBA) enacted a new set of Guidelines to improve internal governance in the banking system and to solve bank's issues. Each Member State started in the last years to transpose the Guidelines and the new Directive in to national law.
In Italy, the Bank of Italy adopted the CRD IV with the Circular n.285 on 17 December 2013, which required that from the 1 of January 2014 banks had to follow the new European dispositions.

3.2 The United States: The Dodd-Frank Act – Wall Street Reform and Consumer Protection

The Financial crisis of 2007 was the worst American financial crisis since the Great Depression in 1929. With the collapse of Lehman Brothers, one of the most important financial firm in the world, the failures of Fannie Mae and Freddie Mac, the major mortgage lenders, the bail out of the largest banks like Bank of America and Citigroup, American investors lost their faith in the financial market and pushed for new regulations. The populist outrage drove the Congress to pass the Dodd – Frank Act Wall Street Reform and Consumer Protection (Dodd – Frank Act by now) in 2010, to restore faith in the financial market and to improve the supervision over the financial sector.[96]
When President Barack Obama signed the Act into federal law on 21 July 2010, a new era of regulation started. The old era came from the 1930s, when President Roosevelt enacted the "New Deal" to limit the largest Wall Street banks and to protect investors' deposits. As his predecessor, even Obama promised that never again investors would have lived other periods of crisis in

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[96] Stephen M. Bainbridge, "Dodd – Frank: Quack Federal Corporate Governance Round II." *Minnesota Law Review* 95, 1779, 2010.

unregulated markets and have lost their life savings in other cases of banks' failures.[97]

The Obama administration was forced to "do something", after the defeat of his candidate for the Senate's seat in Massachusetts. In fact, only two days after the defeat in Massachusetts, President Obama decided to support a proposal by the former Federal Reserve chairman Paul Volker[98] that would reform banking sector. The ultimate shove was a suit by the SEC against Goldman Sachs. This important investment bank was accused to be the first cause of the financial crisis. Moreover the popular magazine "Rolling Stone" described this firm like " a great vampire squid wrapped around the face of humanity".[99]

In this wave of agitation the congressman Barney Frank presented the proposal of legislation through the Financial Services Committee and then through the House. Several months later, Senate passed the proposal, presented by Senate Banking Committee Chair Christopher Dodd.

In other words, the Dodd- Frank Act is the response to criticisms and turmoil for a new law framework.

3.2.1 The roots of the regulation: Federal law and Delaware law

In the United States the federal law has been an active regulator of corporate governance since the New Deal, but it is a State law that has the core of the matter. In fact, it is state law that determines the rights of shareholders and the directors' powers and duties. Moreover, there are several groups of interests that play a significant role in corporate governance regulation, like managers,

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97 David Skeel, *supra* note 93.

98 Paul Volcker was Chairman of the Federal Reserve under Presidents Jimmy Carter and Ronald Reagan from August 1979 to August 1987. He was the Chairman of the Economic Recovery Advisory Board under President Barack Obama from 2009 until 2011.

99 Matt Taibbi, "The Great American Bubble Machine." *Rolling Stone Magazine*, 9 July 2009.

shareholders, unions and consumers.[100] In detail, the most important State of incorporation for public companies is surely Delaware. It is the leading regulator of corporate governance, its bar is the dominant interest group in corporate governance decisions, and it is highly sensitive to the interests of corporate managers and investors.[101] The bar has an active interest keeping the efficiency and attractiveness of Delaware corporate law. Many studies found that Delaware corporations have a higher Tobin's Q than other corporations. These findings suggest that Delaware law increases shareholder wealth.

On the contrary, at federal level we find other interest groups, like national public opinions and lobbies, which temper the influence of the interest that dominate Delaware. In ordinary times, federal law has more important matters to deal with than corporate governance, so the state law can focus on corporate governance, but when a financial bubble burnt the investors' billion dollars and many accounting scandals came to light, a populist pressure pushes Washington for a new regulation of corporate governance. So, many political factors may influence banking system.

In these cases, the regulatory action shifts from state law (especially Delaware) to federal law in an impetus of regulation. Many authors asserted that this is a typical phenomenon in American law, since the New Deal. [102]

3.2.2 The Structure of the Dodd-Frank Act

The Dodd – Frank act consists of sixteen titles. It changes the existing regulatory structure, increasing oversight of specific institutions regarded as a systemic risk, promoting transparency and other changes. The act has two

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[100] Stephen M. Bainbridge, *supra* note 96.

[101] Mark J. Roe, "Delaware's Politics." *Harvard Law Review* 118, 2491-2543-, 2005.

[102] Larry E. Ribstein, "Bubble Laws." *Hous. L. Rev.* 40, 77-97, 2003; Roberta Romano, *supra* note 58.

distinct aims: the first is to limit the risk's exposure of financial companies; the second is to limit damages for investors that the failure of a financial firm could provoke.

The act focuses its attention on particular financial instruments: derivatives. It is a complex contract that based its value on changes in the price of an interest rate or on the happening of a specified event, like a company's collapse. For many academics these instruments were the main element that led to the financial crisis. To limit the risk's exposures, the new law tries to better regulate these derivatives. The goal is double: on the one hand, to improve the clearness of the contract in order to reduce the risk for each contractual party; on the other hand, to improve the transparency of the derivatives' market in order to reduce indirectly the risk for the financial system.[103]

To reduce the risk, the legislation focuses on bank holding companies (BHC), that have specific capital requirements, at least $50 billion dollars, and also non-bank financial companies like investment banks or insurance companies. The act requires that these firms must have a larger capital, to cover the possible losses.

Strong capital requirements are fundamental to support the stability of banking companies and the financial market as a whole. As we have seen during the financial crisis, the previous capital requirements were not sufficiently tough. However, it is even true that it is not sufficient a single capital measure to cover companies' risks and trading losses. [104]

Another provision requires that also hedge funds must be registered, so now they have duties of disclosure and oversight. Usually, the characteristic of hedge funds were theirs exclusion from regulation. Furthermore, to maximize bank safety and financial stability, Section 619 of the new framework, known

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[103] David Skell, *supra* note 93.

[104] Daniel K. Tarullo, "Dodd-Frank Act." *Board of Governors of the Federal Reserve System*, 14 February 2013.

as the “Volcker rule”[105], prohibits that a bank engages in proprietary trading or has specific relationships with a hedge funs or private equity fund.
Talking about the incentives, Section 956 established the incentive-based disclosure and it also requires that financial firms does not adopt incentive-based compensation policies that encourage excessive risk taking or that may lead executive managers to take hazardous investments that lead the companies to financial losses.
Furthermore, Section 951 introduces the “say on pay” mandate for executive compensation disclosure. It requires that companies’ reporting include a resolution in their annual statements that give to shareholders the authority to participate in a consultative, non-binding vote on executive salary.[106]
Companies’ reports have to include a proposal indicating when the votes on the “say on pay” resolutions will occur. Ever in section 951, it is provided also a consultant, non-binding shareholder vote on each golden parachute agreement connected to mergers and acquisitions. The reform establishes a compensation committee, indeed the board of directors, to determine the salaries of managers, the board of directors and all of the employees of the firm. To keep executive compensation under control, in addition to the voting rights, the Dodd – Frank Act requires companies to appoint only independent directors to the compensation committees of the board of directors.
Moreover, like in the Sarbanes – Oxley Act, even in the new framework there is a requirement related to clawback policies. In fact, Section 954 requires listed companies to adopt these policies, so a company with financial problems could recovery with the incomes from any current or former executive officers.[107]
Section 952 contains a number of rules relating to compensation committees, including one directs to the SEC to adopt listing standard requirements for all

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105 Named after former Federal Reserve Chairman Paul Volcker.
106 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, Section 951, 124 Stat. 1376, 1899-900.
107 Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 954.

companies that each member of a compensation committee have to be independent.[108]

The majority of the provisions of the new act are not directly effective, they require to be implemented by the SEC and the Federal Reserve.

In fact, Section 972 requires that the SEC adopts new rules about disclosure standards, whether the same person, or different ones, holds the position of CEO and Chairman of the company.[109] In other words, the board of directors should be encouraged to split the seat of chairman and CEO, or should explain why they adopted a different model. The *ratio* is that this provision brings benefits to companies because the Chairman has to monitor CEO's decisions in order to improve the supervision inside the company.

3.2.3 Criticisms over the new Act

The major criticism to the new set of rules is the one-size-fits-all public companies. Unfortunately, corporate governance is not a field in which one size fits all. Different firms have difference governance needs. The companies should be free to choose the best governance structure for their own interests without being guided by mandatory provisions. Once again, after SOX, the mandate lacks the support in empirical evidence.

Moreover, for many academics, we can find the requisites of quack corporate governance in the Dodd-Frank Act. Usually, quack governance is supported by institutional investors, who are more powerful at the federal level than state.[110]

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108 Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 952(a).

109 Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 972.

110 Stephen M. Bainbridge, *supra* note 96.

The first problem is the government collaborates with the biggest banks and financial institutes. This partnership could distort American finance, possessed of many politicians. As we saw before, the Dodd- Frank Act creates a group of "special" companies, banks with $50 billion of assets and non-bank companies designated by the Financial Stability Oversight Council [111], that has competitive advantages compared to other financial firm. For example, this group of banks can borrow money more cheaply than others. So, it seems like if the Wall Street giants, those financial institutes "too big to fail", are less controlled; on the contrary, they appear larger than before.

Secondly, the *ad hoc* interventions by the regulator constrain the system. All the provisions of the new framework are designed for specific situations and for specific institutions. In this way, it is difficult to apply these provisions to all banks.

Nobel Prize winner in economics Joseph Stiglitz asserted that the largest banks should be broken up because they are too big to be regulated and because they can influence the financial market excessively.[112]

Several academics argued that the Act will not prevent future bailouts, its provisions that intend to end bailouts and ad hoc interventions will do nothing of these purposes.[113]

The explanation could be that the same regulators, which bailed out Bear Stearns and AIG, made the Dodd – Frank Act. David Skeel in his book mentioned a good analogy: banks have usually two branches: in one, loan officers make loans; in another department, the workout group re-negotiates the loans if the borrower has some difficulties to pay. In the banking sector they know that they need a fresh set of eyes after things went wrong.[114]

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[111] Dodd – Frank Wall Street Reform and Consumer Protection Act, Section 165(i)(2).
[112] Ben Moshinsky, "Stiglitz says banks should be banned from CDS trading." *Bloomberg*, 12 October 2009.
[113] David Skeel, *supra* note 93.
[114] David Skeel, *supra* note 93.

In practice, the act ignored this principle of sound business. The same persons that made, during the financial crisis, *ad hoc* bailouts and were bank-friendly, played an important role in the creation of this new set of rules.
So, several academics argued that it is impossible that the things will change.
The good points in the new framework are the new transparency of derivatives and the new power given to the consumers. Now they can be the watchdogs of their savings.
Another goal of the Dodd-Frank Act was to reduce the possibilities of moral hazard by modifying the relationship between executive compensation and long-term performance.
The "say on pay" vote is just consultative and non-binding, so it is unable to shift control over executive compensation to shareholders. It seems only a symbolic provision. Moreover, many studies focused their attention on the effectiveness of the "say on pay" system and their findings show that increasing shareholder participation rights, does not necessarily lead to more significant shareholder participation, and in any case the influence of shareholder approval votes on compensation is limited.[115]
Nevertheless, the introduction of this system should encourage long-term incentive compensation plans, with several benefits for shareholders and for company's performance. Say-on-pay votes can provide some benefits to shareholders in public traded companies, and it might make directors more attentive to shareholders' views. However, this consultative vote will not eliminate managers' incentives to take excessive risks.[116] As Professor Bebchuk argued "simply because shareholders of bank holding companies voted in favor of a pay structure, and those pay structure might consequently be set with the prospect of such a vote, does not indicate that pay structure will avoid incentives that encourage excessive risk-taking. John Coffee, in his

[115] Jeffrey Gordon, "Say on Pay": Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In." *Columbia Law and Economics, Working Paper* No.336, 2009.
[116] Lucian A. Bebchuk and Holger Spamann, "Regulating Bankers' Pay." *Georgetown Law Journal*, Vol. 98, 247-287, 2010.

study, explained well the problem of compensation, mentioning Bebchuk's thinking.[117]

However, Coffee supported this new Act

For Coffee, the practical experience confirms that shareholder pushed managers to take greater risks, so it seems counterproductive that the Dodd-Frank reforms corporate governance to enhance the shareholders' power to pressure managers.[118] In other words, the risk of say-on-pay vote is that executive compensation is uncoupled from the firms' financial performance.

Furthermore, also business groups, like the Business Roundtable and the U.S Chamber of Commerce, have long opposed this system.[119]

Then, the requirement of Section 952 that the members of compensation committees have to be independents may reduce company's profits. Many studies support the idea that an independent compensation committee will not ensure better risk management.[120] Most empirical studies rejected the idea that compensation committee independence is positively correlated with firm's performance or with the improvement of CEO's compensation practices.[121]

As Larry Ribstein wrote in his paper[122] "bubble laws often impose regulation that penalizes or outlaws potentially useful devices and practices and more generally discourages risk-taking by punishing negative results and reducing the rewards for success". As we have seen with the Sarbanes-Oxley Act, even the Dodd-Frank seems the same quack regulation that could have real failing economic consequences.

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117 Lucian A. Bebchuk and Holger Spamann, *supra* note 115; Lucian A. Bebchuk et. *a*l., *supra* note 24.

118 John C. Coffee, "The Political Economy of Dodd-Frank:Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated." *Cornell L. Rev*. 97, 1019, 1051-1056, 2011.

119 Del Jones, "CEOs Openly Pull Against Say-on-Pay." *USA TODAY*, 16 July 2009.

120 Sanjai Bhagat and Bernard Black, "The Uncertain Relationship Between Board Composition and Firm Performance." *The Business Lawyer*, 921-963, 1999.

121 Iman Anabtawi, "Explaining Pay Without Performance: The Tournament Alternative." *Emory L.J* 54, 1557, 2005.

122 Larry E. Ribstein, *supra* note 102.

Then, unlike state law, we have seen that federal regulation often makes quack corporate governance. The reasons could be various: first of all, the government enacted federal law in a climate of political pressure that does not facilitate the analysis of the situation; moreover, federal law is driven by populist anti-corporate feelings and by politics interests.[123] The uniformity imposed by federal law precludes experimentations with different models, that it is the core of the states law. When firms may freely select the best regulation among multiple competing rules, there is a sort of race to the top of regulation, and the worst one becomes obsolete.

Professor Roberta Romano, in her paper, wrote about the quack governance: "Finally, a more general implication concerns emergency legislation. It would be prudent for Congress when legislating in crisis situations, to include statutory safeguards that would facilitate the correction of mismatched proposal by requiring, as in a sunset provision, revisiting the issue when more considered deliberation would possible."[124]

However, in enacting Dodd-Frank Act, Congress may have ignored that advice of the Professor Romano. Furthermore, Coffee concluded his recent study[125] arguing that the Dodd-Frank Act could have worst effects than SOX, because the effective implementation of the Act requires a greater regulation effort. Nevertheless, Coffee supported this new regulation and he disagreed with Professors Romano[126] and Bainbridge[127].

However, for now it is still soon and difficult to predict the possible consequences of the Act.

123 Stephen M. Bainbridge, supra note 96.
124 Roberta Romano, *supra* note 58.
125 John C. Coffee, *supra* note 117.
126 Roberta Romano, *supra* note 58.
127 Stephen M. Bainbridge, *supra* note 96.

3.3 Europe: The CRD IV

After a financial crisis, as we have seen, there is the will to reform the governance system in order to restore trust in the investors. As the U.S. with Dodd-Frank Act, even the European Union wanted to overhaul the banking regulation after the last financial crisis, and it enacted the Fourth Capital Requirements Directive (CRD IV) in 2013.[128]

The starting points of this new Directive are certainly the principles of Basel III, but the aim is to create a European legislation more comprehensive and flexible in cases of emergency.

To avoid other financial crises, the CRD IV introduces new liquidity requirements starting from 2015: banks have to hold cash in such a way as to cover possible losses in a period of 30 days in financial stress conditions.

The principal measure will be the Liquidity Coverage Ratio, which will be increased from 60% in 2015 to 100% in 2018.

Great attention is focused on the executives' bonuses: they are strictly regulated, in order to not exceed the basic salary, and furthermore, the shareholders are more involved in the process of decision about executives' remuneration.

The aim of the European Directive is even to increase the transparency of financial companies, in order to promote competitiveness, credit and potential risks and to strengthen the monitoring role of the board.

3.3.1 The provisions about corporate governance

The purpose of the new provisions is to reduce excessive risk taking by firms and the accumulation of excessive risk-taking in the financial system.

To change the structure of corporate governance, the CRD IV focuses its attention on the board. According to Art. 88(2), firms, which are "significant"

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128 Directive 2013/36/EU.

in term of their size, internal organization and nature, have to establish a nomination committee, composed of non executive managers, with the aim to identify and to suggest candidates to the Assembly for the vacant board's seats.

For the CRD IV, a huge mistake in the "old" board's structure was the lack of diversity within it. This consideration is based on the idea that an organized board with different persons will better control managers' decisions. [129]

So, the Directive imposes diversity as one of the criteria to identify board's members. In detail, the board should be composed by members sufficiently diverse as regards age, gender, educational and professional background and geographical provenance.[130]

To improve the disclosure, the CRD IV requires that each bank must report each year several specific information about the company and its performance.[131] In particular, the new Act identifies the "return on assets" like the key measure to evaluate company's financial condition.

Overall, the board members must have specific qualities as a good reputation, sufficient knowledge, skills and experience to exercise their functions.[132] Moreover, non-executive directors have to act with honesty, integrity and independence of mind to effectively evaluate management decisions.[133]

Actually, the CRD IV stresses more the role of non-executive managers, regulating their tasks, the number of them inside the board and their qualifications.

Then, from Art.92 to Art.96, the Directive regulates the remuneration policies and remuneration committees. Moreover, more attention is focused on the structure of remuneration linked to risk. The CRD promotes safe risks and it imposes that the risk-taking has not to exceed the level of tolerable riskiness of

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129 CRD IV Art 91 (10).
130 CRD IV recital 60.
131 CRD IV Art. 89.
132 CRD IV Art. 91 (1).
133 CRD IV Art.91 (8).

the company.[134] Internal auditors monitor executives' remunerations every year[135], and the Directive imposes a rating of long-term risks to control risks.[136]

Moreover, the Directive imposes specific disclosure for individuals earning more than €1 million per year.

The variable bonuses for executives cannot exceed 100% of the fixed salaries[137]; only in particular situations[138], the managers can increase the variable part up to the 200% of fixed salaries.[139]

In addition, the shareholders will be more involved in the determination of the bonuses. The shareholders' meeting will have a consultative vote in the assignment of the incentives.

To keep executive compensation under control, especially in significant banks in term of their size, the CRD requires the establishment of a remuneration committee inside the board, with the purpose of preparing proposals on remuneration policies and executives' incentives based on risks, equity and liquidity.[140]

According to CRD IV, the bank's Board is responsible for the overall risk strategy and management and for the quality of disclosure.

134 CRD IV Art.92 (2) (a).
135 CRD IV Art. 92 (2) (d).
136 CRD IV Art. 94 (1) (b).
137 CRD IV Art. 94 (1) (g) (i).
138 The capped ratio is set at 1:1, buti t may be raised to 2:1 only with shareholders' approval.
139 CRV IV Art. 94 (1) (g) (ii).
140 CRD IV Art 95 (1).

3.3.2 Significant Improvements and Criticisms

Many academics saw the new Directive with skepticism. They argued that the CRD IV is a missed opportunity in terms of restoring confidence in financial markets and improving banks' stability.[141]

Overall, the first criticism is the complexity of the package. The 1600 pages of text are full of details and many sub-chapters. Detailed and complex regulation is easier to elude and it becomes less effective and less stable over time. The system needs simple, clear rules, a few sets of rules that can be adopted by all banks.

Andrew Haldane of Bank of England[142] argued about this complexity: "as you do not fight fire with fire, you do not fight complexity with complexity". In other words, a sound regulation requires simple rules and tools, aimed to be effective and more stable.

However, CRD IV does not choose to apply a leverage ratio and leverage cap to financial companies, even if many studies confirmed that a leverage ratio is simple, robust and it is a better predictor of banks' default than other risk measures.

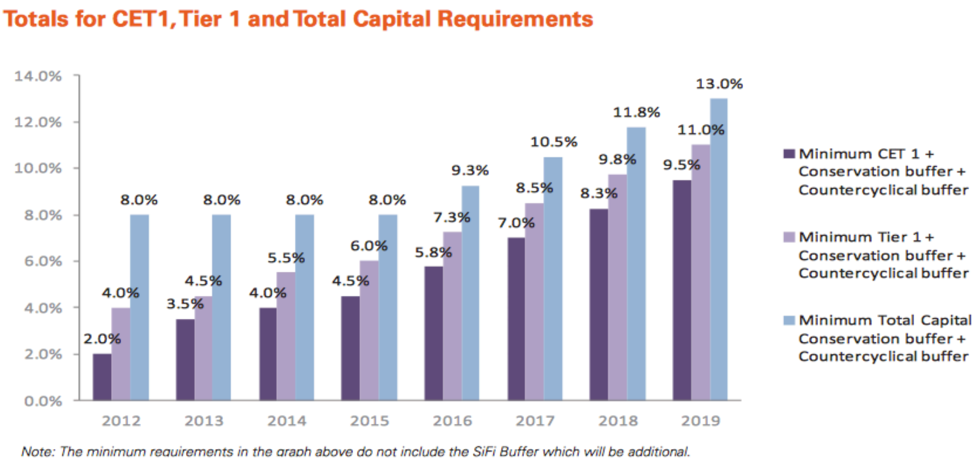
However, the CRD IV aims to increase both quality and quantity of capital, choosing higher capital requirements; in fact the Directive contains various measures aimed at increasing the loss-absorption capacity of regulatory capital in the event of liquidation and at increasing the quantity of capital required. Moreover the graph in figure 1 sums the components of the bank minimum capital requirements from 2012 to 2019. It shows the totals for CET 1, Tier 1 and Total Capital, including the capital conservation buffer and the

[141] Finance Watch Committee, Finance Watch statement and opinion on the CRD IV/CRR, *Finanzausschuss im Deutschen Bundestag*, 3 May 2013.

[142] Andrew G. Haldane is Chief Economist and Executive Director, Monetary Analysis & Statistics at the Bank of England. He is a member of the Bank's Monetary Policy Committee.

countercyclical capital buffer.[143] It is clears the there will be a considerable increase of the minimum capital in these years.

Figure 17[144]



Focusing on corporate governance, it is clear how the CRD IV tries to apply a "one size" fits all types of banks like the Dodd-Frank Act in the U.S. This tendency could lead to a petrification effect that reduce banks' adaptability to changes.[145]

In particular, analyzing the board of directors, we have seen as the CRD IV supports the diversity inside the board of directors. Several European countries had already this kind of provision inside their jurisdictions. For example, Norway promotes board diversity and all Norwegian listed companies must reserve a 40% gender quota for female directors since 2008.[146] Diversity can have positive effects on bank performance, bringing flexibility to the firm, which can be positive if the bank' business change or become more complex.

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143 KPMG, "CRD IV: Single Rule book for EU Banking Regulation, Changes and Implications." May 2013.
144 KPMG, *supra* note 42.
145 Luca Enriques and Dirk Zetzsche, "Quack Corporate Governance, Round III? Bank Board Regulation Under the New European Capital Requirements Directive." *ECGI-Law Working Paper* 249, 2014.
146 Jakob de Haan and Razvan Vlahu, "Corporate governance of banks: A survey." *Netherlands Central Bank, Research Department, Working Paper* N.386, July 2013.

However, many studies[147] on diversity show that this is convenient only for several firms, the effect of diversity is complex and it depends on context, so the real results of a diversity requirement in the CRD IV will be unpredictable. Furthermore, it is unclear what can kind of benefits produce a diverse board in banks' performance. In fact, it is discussed in several studies if women are more risk-averse than male directors; in addition, some authors[148] concluded that there is no evidence that gender diversity influences risk-taking.
The CRD IV tries to specify the duties of bank directors in Art.91. Unfortunately, the result is vague; there is only the provision that each board member shall act with honesty, integrity and independence of mind. The task of defining better these concepts is left to the guidelines issued by EBA[149].
As we have seen before in the Dodd-Frank Act, the CRD IV too requires the separation of Chairman and CEO.[150]
We have seen in the first chapter that often in the financial companies' boards CEOs also held the title of Chairman of The Board. [151]
The chairman of a bank has to supervise management's decisions, and he has to not exercise simultaneously the functions of a CEO within the same firm. Only in authorized cases he can occupy both seats (i.e. CEO duality[152]).
Nor for diversity, there are no significant studies that prove the benefit of this split of seats and there is no conclusive evidence that financial institutions without this separation had done worse in the financial crisis. The main identified disadvantages of CEO duality in the literature are the negative

147 Jerry Goodstein, Kanak Gautam & Warren Boeker, "The Effects of Board Size and Diversity on Strategic Change" *Strategic Management Journal* 15.3, 241-250, 1994; S. S. Webber and L.M. Donahue, "Impact of highly and less job-related diversity on work group cohesion and performance: A meta-analysis." *Journal of Management* 27.2, 141-162. 2001.
148 Vathunyoo Sila, Angelica Gonzalez & Jens Hagerdorff, "Women on Board: Does Boardroom Gender Diversity Really Affect Firm Risk?" *Working Paper*, 2014.
149 European Banking Authority (EBA) is a regulatory agency of the European Union.
150 CRD IV Art. 88(1) (e)
151 Page n. 33
152 CEO duality was very common in the 90s, when this duality held in almost 80% of U.S. firms

impact on board's monitoring activities[153] and the increase of managerial power over board decisions[154].

On the other hand, the CEO duality may provide a clear sense of direction for the company[155] and may increase stability for a firm, by reducing conflicts between managers and the board of directors. Moreover, empirical findings show that this duality is more efficient for the largest company.[156]

In addition, each bank is different, with specific costs and many variables, maybe the regulation should leave more freedom in the choice of company's structure.

The CRD IV requires also that members of bank's board do not hold more than one of these two combinations of directorships: one executive and two non-executives; four non-executives. In this way, directors should devote sufficient time for their mandate.

The topic of the non-executive is always controversial. Moreover, the question is mixed and unresolved. For sure, an outside director cannot have the experience of a seasoned director with a long previous experience in banking sector. The imposed limit does not mean a reliable and good supervision on the CEO's decisions, but maybe this provision may eliminate the problem of the "busy directors", i.e. directors that serve on many board and not be able to devote sufficient effort to any one board.[157]

In addition, introducing a limit on directorship only for bank boards may lead to isolate the market of bank directorships from the market for directorship in

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153 Meziane Lasfer and Mara Faccio, "Managerial Ownership, Board Structure and Firm Value: The UK Evidence." *Cass Business School Research Paper*, August 1999

154 Julian Franks, Colin Mayer and Luc Renneboog, "Who disciplines management in poorly performing companies?" *Journal Of Financial Intermediation* 10(3), 209-248, 2001

155 C.A. Anderson and R. N. Anthony, "The New Corporate Directors: Insights for board members and executives." John Wiley and Sons, New York 1986

156 James A. Brickley, Jeffrey L. Coles and Gregg Jarrell, "Leadership structure: Separating the CEO and Chairman of the Board." *Journal of Corporate Finance* 3.3, 189-220, 1997

157 Renée B. Adams, Benjamin E. Hermalin and Michael S. Weisbach, "The Role of Boards of Directors in Corporate Governance: A conceptual Framework and Survey" *National Bureau of Economic Research*, *Working Paper* No. W14486, 2008.

general. In fact, to avoid the limit, many directors will choose to not accept the seat of director in bank. Recruitment for banks will become more difficult than before the CRD IV.[158]

The CRD IV seems to not be able to reduce the complexity and the opaqueness of banking system. Furthermore, the Directive does not try to reduce the problem of the "too big to fail"; this was indicated by many authors like the real problem of banks.[159]

In regard to executives' compensation, we saw in the previous paragraph the provisions about it. The CRD IV introduces a capped ratio on the fixed and variable component of remuneration, that it is set at 1:1, but it may be raised to 2:1 with shareholders' approval.

There are two risks in this case: on the one hand, when the CEO has much power inside the company, he could use this power to influence shareholder in order to approve the increase the ratio of the remunerations at 2:1. On the other hand, when shareholders have decision-making power, they are inclined to take excessive risks. Moreover, this provision will apply only to specific members of the management and the CRD IV left the task of developing qualitative and quantitative criteria to identify such staff. So, the provision[160] is still vague, we do not know who are exactly the members that are recipient of this rule.

Many doubts surround the remuneration committee too, especially in banks with an authoritative CEO. In fact, both inside board and outside board members are often recruited and nominated by management, and the CEO can influence these elections. Many studies demonstrate that higher CEO pay is

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158 Luca Enriques and Dirk Zetzsche, *supra* note 126.

159 Klaus J. Hopt, "Corporate Governance of Banks and Other Financial Instituions after the Financial Crisis - Regulation in the light of Empiry and Theory." *Journal Of Corporate Law Studies* 13.2, 2013.

160 CRD IV Art. 94 (2).

correlated with higher board pay (including remuneration for compensation committee members).[161]

Several authors argued that the remuneration problem was an issue in the crisis that received too much attention because excessive pay was a convenient political target. Moreover, the new rule appears not be able to make a good contribution to improving the safety of the banking sector.

The total capital, liquidity and other regulatory requirements contained in CRD IV should be proportional to the size and systemic risk of banks of different dimension, structure and business model.

3.4 Italy: Disposizione di Vigilanza per le Banche

The CRD IV is not directly applicable at the national level, but each state have to implement the Directive in its jurisdiction.

In Italy, the Bank of Italy started to implement the CRD IV on 17 December 2013 with the Circular n.285, and its provisions started to be in effect from the 1 January 2014.

On May 6 of 2014, the Bank of Italy made the first update, introducing the fourth title, relating to corporate governance, internal control and risk management. Italian banks have to adopt these new provisions within June 30 of 2017.

The danger is another case of gold-plating[162]. In Italy, gold-plating has often been used as a device to pass though European provisions.

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161 Ivan E. Brick, O. Palmon and J.K. Wald, *CEO compensation, director compensation and firm performance: evidence of cronyism*, Journal of Corporate Finance 12.3, 403-423, 2006

162 Gold-plating is a term used in European Union Law to describe the incorrect transposition of a European directive.

3.4.1 The implementation of the provisions of corporate governance of the CRD IV in Italy

The first chapter of the Title IV of the "Dispositions for the supervision of banks" [163] regulates corporate governance.
The Italian set of rules distinguishes three kinds of bank: significant banks (as for the CRD IV), minor banks and intermediate banks.[164] As the European Directive's provisions, also in Italy several provisions have effect only for significant banks.[165]
The Circular refers often to the TUB[166] and the Italian civil code.
Banks can choose among three systems of different administration and control: the traditional one, the two one and the one-one.[167] In fact, banks choose among these three systems, on the basis of an internal estimate; in this way, it should be easier to identify the more suitable system for each bank.
The law imposes general principles to the board of directors and to the board of auditors, specifying the way to apply these principles.
The aims of the Circular are to increase the clarity in the power assignment inside the board of directors and to promote uniform of the company's strategy.
As in the CRD IV, in the Italian transposition it is stressed the concept of "diversity"[168] for the members of the board of directors.
Moreover, it is specified that the directors must be banking experts.[169] The non-executive directors must supervise executives' decisions. In the significant banks, it is established a nomination committee, which plays a

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[163] Disposizioni di Vigilanza per le Banche, Circolare n.285, 17 December 2013.
[164] Circolare n.285/12/2013, Definizioni.
[165] Circolare n.285/12/2013, Destinatari della disciplina.
[166] Testo Unico Bancario, D.lgs 1 September 1993, n.385.; Revised Version D.lgs 4 March 2014, n.53.
[167] Circolare n.285/12/2013, Section II (1).
[168] Circolare n.285/12/2013, Section IV (2) (b).
[169] Circolare n.285/12/2013, Section IV (1).

consultative role for identifying adequate candidates for the Board of Directors.[170]

As the Act explains, an adequate number of non-executive member favors the disclosure inside the company.

The Circular requires that small banks have to avoid the appointment of the CEO and the General Director, except extraordinary cases.

To avoid interferences between the board of directors and the board of statutory auditors, the tasks and the duties for each organ have to be disclosed. Furthermore, members of the supervisory body cannot have others monitoring roles in different companies.

The board of statutory auditors uses the flow of information inside the company to control board's decisions. For the importance of its tasks for the company's monitoring, the supervisory board has to inform immediately the Bank of Italy for each anomaly in the company management.

The Circular requires that the boards inside the company are not excessive numerous, because many members could reduce the incentive of each member to perform his tasks.

The new framework imposes the establishment of other committees, like the risk one and the remuneration one, reflecting the European rules.[171]

Furthermore, significant banks, in term of size or complexity, have to establish three committees specialized on "appointment", "risks" and "compensation". Each committee has 3 or 5 members, all of them have to be non-executive and the majority of them have to be independent. These committees have important roles inside the company, in order to keep the financial stability of the firm.

Then, each bank's organ has to make a process of auto-evaluation. The procedure is formalized by internal regulation.

[170] Circolare n.285/12/2013, Section IV (2) (d).

[171] Circolare n.285/12/2013, Section IV (2.3.1) (a).

The Italian provision, reflecting the CRD IV, imposes the separation of CEO duality. Furthermore, the Chairman of the board has the task to monitor the directors' decisions.

In addition, the Italian law imposes specific duties to cooperative banks.

Overall, the Italian transposition reflects entirely the European legislation, and by a first analysis I did not find cases of gold-plating. In fact, with regard to gold-plating, in 2013 the Italian government enacted a new law in order to stop this phenomenon.[172] So, it is difficult that the Italian law moves away from the European legislation.

3.5 Conclusions:

"A good crisis should never go to waste". With these words, John Coffee started his papers on the analysis of Dodd-Frank Act.[173]

At first sight it seems that the Dodd–Frank Act and CRD IV did not increase the regulatory and public transparency of shadow banking markets, especially regarding to securities financing transactions.

Even with the enactment of these new sets of rules, the global financial market remains vulnerable. Surely, many provisions are in favor to the shareholders, and these may affect the overall balance of power between shareholders and directors. However, many provisions of both are totally disconnected from the empirical evidence and the background of the financial crisis.

The financial crisis sparked renewed interest in banking corporate governance, especially in executives' compensation practices. Both the Dodd-Frank Act

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172 Direttiva del Presidente del Consiglio Dei Ministri,16 Gennaio 2013, GU Serie Generale n.86 del 12-4-2013.

173 John C. Coffee, *supra* note 117

and the CRD IV impose new structures for executives' compensation, and however both received many criticisms.

Remuneration structures should require the mix of cash, equity and other form of compensation to be consistent with risk alignment. A huge proportion, more than fifty percent, of variable compensation should be awarded in shares or stock options, as long as to create incentives related to long-term value creation and the time horizon of the risk.

Moreover, disclosure should identify the relevant risk management and control system and, in this way, facilitate the work of supervisors.

The main aim should be the alignment of managers' incentives with shareholder wealth maximization. It should be fundamental the alignment of bonuses with sound risk-taking. The deferment of variable compensation could be the key to controlling risk taking, as many studies showed.[174]

The post-crisis reforms focus on requiring long-term incentives, however this was the practice for most financial companies before the crisis, including firms that collapsed.

The regulations of bankers' pay should be delegate in the details to boards of directors and financial supervisors the tasks of defining the incentive structures applicable to each bank and monitoring the same. The new structure of executive pay may enhance the risk-taking of financial firms and affect their financial stability. Moreover, performance-based compensation linked to long-term performance might be a good tool to reduce agency problems by aligning managers' and shareholders' interests.

Furthermore, to encourage more prudent decisions, executives' compensation could be organized in compensation based on the value of a wide set of securities representing a larger part of the corporate system. In detail, executives' compensation should be tied to a set of percentage of the aggregate value of common shares, preferred shares and other bonds. This

[174] Patrick Bolton, Hamid Mehran and Joel Shapiro, "Excutive Compensation and Risk Taking." *Federal Reserve Bank of New York*, Staff Report No. 456, 2010

structure could reduce the risk taking, because payoffs would expose to possible negative consequences of risks taken. [175]

To give power to shareholders, even when executive pays are regulated, they should vote directly the directors who appoint and fire executives. In this way, for sure, the interests of directors should be aligned with the shareholders' interests.

The reforms reflect a political compromise between the various interest groups, incorporating traditional criteria and adapting the same to new situations. In Europe, the member states should keep more flexibility when implementing the Directive in their national jurisdictions.

In addition, the hope to avoid bank crises is absurd, because banks' failures and scandals will recur in the financial market, but good bank governance may contribute to reducing the possibilities of danger of financial crises.

Furthermore, ownership and remuneration structures may mitigate agency problems and may affect bankers' incentives for excessive risk-taking. We have found many conflicts in literature on the role played by different corporate governance mechanisms and on the relation between executives' compensation and banks' risk-taking. These conflicts support the idea that no a single regulation can be forced on all financial companies, but the regulation have to be flexible, in this way each bank can apply the regulation for its own organization.

In other words, the two reforms missed a great opportunity to restructure and to give a strong impulse of innovation to corporate governance, and it is unclear how effectively these two reforms will improve companies' risk management and whether its provisions will prevent other crises.[176]

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175 Lucian A. Bebchuk and Holger Spamann, *supra* note 115

176 Kristin N. Johnson, "Addressing Gaps in the Dodd – Frank Act: Directors' Risk Management Oversight Obligations." *U. Mich. J.L. Reform* 45, 55-95, 2011.

Conclusions

The research pointed out that new bank governance reforms started a new era for corporate governance, but these new regulations do not eliminate the risk of others collapses. Unfortunately, the new reforms have not a good impact on bank risk-taking and on executives' compensation.

The **first chapter** of this study has underlined the role of corporate governance in the financial crisis. It is still a controversial topic. As most often the truth is in the middle. Surely, false incentives, board deficiencies and internal control failures actively contributed to make complex and opaque banks' structure. After the collapse of the more important financial institutes, investors lost their faith in financial markets, having lost their savings. However, there were many others and more important elements that led to the financial crisis.

As highlighted in **Chapter 2,** the governance scenario before the crisis was diversified. In United Stated, several authors argued that the Sarbanes-Oxley Act was an example of quack governance. The Bush government, pushed by the political pressure after the Enron's bankruptcy, had to enacted a new act to regulate corporate governance. Nevertheless, the act tried to impose more transparency to the market and to avoid that executives had too much freedom in the management of company. In Italy, after several financial scandals, bank governance was improved by several reforms, to increase efficiency and transparency. Nobody would have predicted the financial crisis that involved the American and European banking systems a few years later.

In Chapter 3, I focused my attention on the current reforms. After the crisis, to restore faith in financial markets was inevitable enacting new forms of legislation to discipline bank governance and to improve the control over the financial sector. The Dodd-Frank Act imposed new disclosure requirements for executives' compensations and for banking transactions, in order to make the banking system clearer. The uniformity imposed by mandatory law precludes experimentations with different models of governance and so the firms cannot freely select the best regulation for themselves.

In Europe, the CRD IV's purpose is to reduce excessive risk taking by firms and the accumulation of excessive risk-taking in the financial system. Even with the enactment of these new sets of rules, the global financial market remains vulnerable. Surely, many provisions are in favor to the shareholders, and these may affect the overall balance of power between shareholders and directors. However, many provisions of both regulations are totally disconnected from the empirical evidence and the background of the financial crisis. The main goal of these reforms should be the alignment of managers' incentives with shareholder wealth maximization. Even, it should be fundamental the alignment of bonuses with sound risk-taking. The deferment of variable compensation could be the key to controlling risk taking, as many studies showed.

The reforms reflect political compromises between the various interest groups, incorporating traditional criteria and adapting the same scheme to new situations. The regulation should be flexible; in this way it could better adapt to markets' changes.

That being said, the author of this analysis concludes that it is unclear how effectively these new reforms on corporate governance will improve companies' risk management and whether its provisions will prevent other crises.

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