

research newsletter

Government in Corporate Governance

Introduction

This, the seventh edition of the ECGI Research Newsletter, focuses on 'Government in Corporate Governance' and draws much of its material from the recent Transatlantic Corporate Governance Dialogue (TCGD) Conference at the Securities and Exchange Commission in Washington DC.

On 13 November 2009 as this Newsletter was going to press, the United States government, through the Trouble Assets Relief Programme (TARP) capital purchase programme, had a net position of \$133,814,312,320 in the banking sector, mostly by holding preferred stock with warrants. The TARP has also invested \$75,399,177,711 in the automotive industry and \$69,835,000,000 in AIG.

In Europe, EU Member State governments have been acting individually by subscribing to equity issues of banks, making equity purchases and providing guarantees. The UK position was summarized in a recent speech by the governor of the Bank of England, Mervyn King. He estimated that the UK taxpayer has provided direct or guaranteed loans and made equity investments just short of a trillion pounds or almost two-thirds of the UK's annual GDP. He paraphrased Winston Churchill to say that *"never in the field of financial endeavour has so much money been owed by so few to so many. And, one might add, so far with little real reform."*

These developments came as a surprise. By the middle of this decade, there seemed to be a consensus concerning the right role of government in business. First, government was neither to be the owner of businesses nor their financier. The EU promoted the liberalisation of state-owned enterprise and adopted an extensive system to control government support of local companies. With the exception of its involvement in the financing of home ownership, the US had no history of deep state involvement in the ownership of industry. Second, the government would regulate lightly, relying on markets to work. Now at the close of the decade, the financial crisis has called both of these principles into question, certainly in application and perhaps in principle as well. In both the US and the EU, there is growing momentum in favour of a

much expanded regulatory outlook that extends well beyond the banking sector and into areas of corporate governance, especially executive pay.

Government assistance has come with conditions and restrictions, in particular on executive compensation. There is considerable political pressure to extend these restrictions to the financial sector as a whole and, possibly, to the non-financial sector. Executive compensation is at the core of corporate governance, a central feature of the incentives given senior management. Driven by the example of private equity, the executive compensation structure became increasingly more contingent on stock price, with the expectation that the amounts of compensation and the measures of performance would be monitored by the board of directors. Serious commentators now argue that the directors did not prove themselves up to the task. The financial incentives for non-executive directors and Chairmen themselves have been questioned. As well, concern has been widely expressed that the compensation structure led executives to ignore systematic risk. If directors cannot monitor incentive structures, should other corporate constituencies have a say, like shareholders, creditors or employees? How should compensation be reformed? Is there a role for government to be the monitor?

What should the US and the EU do now? Does government need to take firmer control when it is forced to take ownership or provide credit? Should government ownership persist, declining only slowly in light of the uncertainty concerning the trajectory of recovery and recognising the political difficulty of

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exiting from companies in industries that have not fully recovered? Alternatively, should privatisation take place at the earliest possible moment, for the very same reasons? How should this round of privatisation take place? What regulatory structure should remain in place? How can governments ensure sound corporate governance post-privatisation? Are new laws needed to allow governments to intervene more rapidly in the restructuring of systemically important enterprises? If so, how should "systemically important" be defined and what safeguards are required for shareholders when governments do intervene? How do we ensure co-ordination, not just within the EU, but also across the Atlantic?

Speakers at the TCGD Conference addressed many of these points. Their words are summarised in the Conference report which starts at page 11. Those wishing to watch a video of the Conference proceedings or download speaker presentations should go to <http://www.ecgi.org/tcgd/2009/video/index.php>. In addition to this report, this Newsletter contains digests of five research papers on topics discussed during the conference. The papers themselves and others material pertaining to matters under discussion can be downloaded from the TCGD website at <http://www.ecgi.org/tcgd/2009/cle.php>.

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Research digest

Five research papers on the topics discussed at the TCGD conference in Washington are reviewed by our contributing editor, Lesley Stephenson. This Research digest pulls out some of the key strands from these papers which can all be downloaded from the SSRN website.

Big Deal: The Government's Response to the Financial Crisis

Steven M Davidoff, Associate Professor, University of Connecticut School of Law; Visiting Professor, The Ohio State University Michael E. Moritz College of Law; and David Zaring, Assistant Professor, University of Pennsylvania – The Wharton School of Business (Download available from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1306342)

When the US real estate bubble finally burst with such catastrophic implications for the financial institutions that facilitated property purchases, the credit market, and, eventually, all of the participants in the worldwide financial system, the federal government reacted at first slowly, and then uncertainly, and finally on an emergency and massive basis.

The authors of this paper argue that the government's response was ad hoc and yet at the same time, it also developed a kind of consistency. The government acted as a deal maker, seeing each individual rescue as a different deal but each deal adding to the whole.

When the government's deal to deal response appeared to be failing, the Treasury Secretary, at the urging of the Chairman of the Fed, decided that they had to have a more comprehensive approach and systematic approach to preventing the systemic fallout from the collapse of the housing bubble and continuing and speeding collapse of the financial economy. This holistic approach began as one kind of deal –where the government would purchase distressed assets from financial institutions, and turned into another kind of deal, where the government purchased sizeable stakes in these financial institutions, instead of buying their troubled assets.

The paper shows how these deals were done and how the government stretched, and in some cases, appeared to overstretch, its legal authority to make those deals happen. The authors go on to argue that the government, as a matter of administrative law, was exploring the outer limits of its permissible authority in what it viewed as a time of crisis. In so doing, it conducted the management of the crisis through the two institutions least constrained by the law, the Treasury Department and the Federal Reserve (the Fed).

In the initial stages of the crisis, the government was very reluctant to intervene in individual cases, but when left with no other option as it saw it, it would do so. It appears that the motivation for intervention came from the overarching doctrine of 'too big to fail'. Institutions whose failure came too quickly or

otherwise would imperil the soundness of the entire financial system would be salvaged.

The government was also willing to stretch the law where it could and flex its authority but was not willing to boldly violate it. The government used section 13 of the Federal Reserve Act to buy time for the Bear Stearns deal. Then, the government assisted in structuring the transaction to meet these needs and prevent Bear's shareholders from forestalling them. In doing this the government likely facilitated the stretching if not breaking of Delaware corporate law. However, the government could not fully penalise Bear's shareholders as it wanted to. Instead, it was ultimately limited by the laws it could not break, the requirement for a vote which led to Bear's shareholder achieving some recompense. The government's ultimate purpose was to conclude the deal as quickly as possible and if it could not fully implement its goals in order to do this, like any deal-maker, it would accept such costs.

So why did the government step in to rescue Bear Stearns but not Lehman Brothers which was a larger institution? The authors feel that this was partly because of the fact that the market had had a longer time to get used to the concept of, and therefore be prepared to deal with, Lehman Brothers failing. They also link this to the role of the government as a deal maker. Sometimes, in order to appear strong to the outside world, it is necessary for a deal maker to walk away from a deal. The government needed to show that it was not prepared to rescue any institution regardless of the cost; that it would and could let an institution fail if necessary.

The drastic market reactions that flowed from Lehman's failure ultimately drove the government to adopt a more comprehensive approach to the crisis.

Although the financial crisis was rooted in the decline of the property market, the variety of short term shocks and intermediate emergencies that characterised its day to day and week to week evolution shaped the way the government responded to it. After the failure of Lehman and near failure of the other investment banks contributed to the quick decline in the availability of short term credit, unprecedented problems in the money market sector of the financial industry, and a knock-on effect on a number of other banks, the Treasury and Fed changed course. The two agencies announced a comprehensive solution to the financial crisis would now be required, one that would necessitate the imprimatur of Congress.

The authors posit three reasons for this approach to Congress. First, a significant government action

was necessary to restore confidence in the market and allow for investors to return to the marketplace. Second, foreign regulators were beginning to act in a more holistic manner raising the possibility of capital flight abroad to more stable government-backed financial institutions. Finally, although the Fed had a substantial amount of funds at their disposal, the Treasury Department did not, and none of these institutions had very clearly delineated authority to intervene flexibly and comprehensively in the financial markets.

The lesson from prior panics is that the key to stemming a downfall is leadership and the confidence it provides investors. The goal is to ameliorate the short term interruptions in capital markets as investors, due to information asymmetry and outright fear, transfer assets in a desperate search for safety.

The authors suggest that perhaps the difficulties faced by the government in this crisis suggest that it embraced the deal making role creatively, but imperfectly. The government drove hard, creative bargains, but each deal did not restore the confidence the government thought it would. Instead, in today's complex, interconnected world, each deal seemingly brought on more problems and unintended consequences as it created a world where free riding on government action became the norm. Moreover, the government's so-called guiding principle of moral hazard, seemed to be out of sorts in such a momentous financial crisis. The government nonetheless resisted a comprehensive solution, and continued to structure and initiate deals reactively. It did so until it became clear that this path was no longer appropriate.

In the authors' view, the government's turn to the Emergency Economic Stabilization Act 2008 was a signal that it felt bound by legal restraints, and ultimately could not push past them until it acted to adopt a more comprehensive, confidence building program designed to alleviate the lost confidence, fear and information asymmetry in the markets.

The AIG Bailout

William K Sjoström Jr, Professor of Law, University of Arizona James E. Rogers College of Law (Download available from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1346552)

On February 28, 2008, American International Group, Inc. (AIG), the largest insurance company in the US, announced 2007 earnings of \$6.20 billion or \$2.39 per share. Its stock closed that day at \$50.15 per share. Less than seven months later, however, AIG was on the verge of bankruptcy and had to be rescued

by the US government through an \$85 billion loan. AIG's collapse was caused largely by its \$526 billion portfolio of credit default swaps (CDSs), a type of credit derivative widely used by financial institutions but, up until recently, little known by the general public.

Professor Sjostrom uses the first part of the paper to give a detailed explanation of what a CDS is and how it is used. Put very simply, a CDS is a way for one party (A) to hedge its credit risk exposure. Assume A had \$100 million of bonds in Co B which were due to mature in five years. A could enter into a five year \$100 million CDS agreement with C whereby, in return for a premium paid to C by A, C would compensate A if a specified credit event (such as bankruptcy or a failure to pay) happened. How this is done depends on the terms of the contract. It will either be a physical settlement (whereby C agrees to buy the bonds from A at full face value) or a cash settlement (whereby C and A agree on a market value and then C pays A the difference between market value and full face value). In addition to hedging, CDSs can be used to speculate on a change in a company's credit quality and for arbitrage.

A prominent risk inherent in CDSs is counterparty credit risk, ie the risk that C will be unable or unwilling to make the payment due under the CDS in the event of a credit event happening. To address this, the CDS might require C to post collateral with A equal to a specified percentage of the notional amount of the CDS. If the market spread on the CDS rises above the amount charged by C, the CDS would typically require C to post additional collateral as a rising spread indicates a perceived increase in the probability of a credit event occurring.

AIG operates its CDS business through its subsidiaries AIG Financial Products Corp. and AIG Trading Group, Inc. and their respective subsidiaries (collectively, AIGFP). AIGFP's CDS business consisted largely of selling protection on what it described as 'super senior risk tranches of diversified pools of loans and debt securities.'

To understand what this means it is necessary to understand the concept of asset-backed securities which are created through a securitisation process. In a typical securitisation process, an individual applies for a loan to purchase a home. The lender funds the loan and then sells that loan as well as other loans made during the period to an arranger. The arranger then sells the loans, and often similar loans it has purchased from other lenders, to a newly formed special purpose vehicle (SPV). The SPV funds

the purchase of the loans by selling investors debt obligations representing claims to the cash flows from the pool of residential mortgage loans owned by the SPV. These obligations are referred to as asset-backed securities because they are 'backed' or supported by a financial asset (the mortgage loans). The SPV uses the cash flows from the pool of mortgage loans (primarily, monthly loan payments) to service the debt it issued investors to buy the loans.

Often the SPV will divide the debt securities it issues into different tranches reflecting different levels of payment priority. Obligations to the senior level tranche are paid first, then to the middle level and then to the junior level. If all the amounts owed on the loans are paid on time, the SPV will have sufficient funds to meet its obligations to all three classes. If funds are insufficient, then it is the junior level which is affected first, followed by the middle level. The senior level tranche will only be affected if the SPV's shortfall exceeds the amounts owed to both the junior level and the middle level.

Typically, the SPV will have all but the most junior level tranche rated by one or more of the credit rating agencies. The senior tranche can receive a triple-A rating, even if there are no triple-A assets in the SPV's pool, because it is the first to be paid and thus last to suffer a loss. Its creditworthiness is enhanced by the fact that junior tranches insulate it from some level of losses from the SPV's underlying pool of assets.

Tranching converts a pool of financial assets with a single risk rating into various debt securities with ratings above and below the pool's rating. The higher the credit rating, the lower the interest rate the SPV will need to offer on that particular tranche and vice versa. Thus it meets the needs of both investors who are looking for the presumed safety of a triple A rated security and those who might be prepared to take a risk on a lower rated security to gain higher returns.

The bulk of AIGFP's CDS portfolio is comprised of protection it wrote on what it refers to as the 'super senior' tranche of various types of asset backed securities. AIGFP's risk models indicated that the underlying securities would never go into default. Thus, the CDSs would expire untriggered, and AIGFP would pocket the premiums.

A collateralised debt obligation (CDO) is a type of asset-backed security whose underlying pool of assets consists of tranches of other asset-backed securities (for example, mortgage backed securities) and other debt obligations. A multi-sector CDO is one whose underlying assets consist of tranches of asset-

backed securities with underlying pools of assets from multiple sectors such as residential mortgage loans, commercial mortgage loans, auto loans, credit card receivables, etc. AIG wrote protection on super senior tranches of these CDOs as well as 'high grade' and mezzanine tranches.

\$61.4 billion in net notional amount of AIGFP's CDS portfolio was written on multi-sector CDOs with underlying residential mortgage backed securities whose asset pools included sub-prime mortgage loans. In mid 2007 the US residential mortgage market began to experience serious disruption as defaults on sub-prime mortgage loans began to ripple through the market.

The principal cause of AIG's cash problems was the collateral posting obligations in AIGFP's multi-sector CDO CDSs. The large majority of these based collateral posting requirements on the difference between the notional amount of the particular CDS and the market value of the underlying CDO security. Hence, as CDO values fell, AIG was obligated to post more and more cash collateral. For example, from 1 July 2008 to 31 August 2008, declines in the CDO securities on which AIGFP wrote protection together with rating downgrades on these securities resulted in AIGFP posting or agreeing to post \$6.0 billion in collateral, representing approximately 34 percent of the \$17.6 billion in cash and cash equivalents AIG had available on 1 July 2008 to meet the cash needs of its operations.

In addition, under its securities lending program, AIG Investments loaned securities from the investment portfolios of AIG's insurance companies to various financial institutions. AIG Investments would then invest the collateral in debt securities to earn a return which would serve as compensation for lending securities. At one point, AIG Investments had loaned \$76 billion in securities to US companies.

As borrowers became aware of AIG's write downs and collateral posting obligations, they became concerned and decided to return the lent securities and get their collateral back. Unfortunately, AIG Investments had invested a significant portion of the cash in residential mortgage backed securities which had plummeted in value and liquidity. As a result, the program lacked sufficient funds to satisfy collateral-return obligations and AIG was forced to transfer billions in cash to the program, cash which was immediately paid out to these borrowers.

By September 2008 AIG realised its cash situation was dire and tried to raise additional capital from

Sovereign Wealth Funds, private equity firms and other investors but without success. On 15 September 2008, the credit rating agencies downgraded AIG's long-term debt rating. These downgrades triggered in excess of \$20 billion in additional collateral calls because the collateral posting provisions contained in many of AIGFP's CDSs also took into account the credit rating of AIG, with a credit downgrade triggering additional posting obligations.

The following day, it became apparent that no private sector lending facility was forthcoming. Because of AIG's size and interconnectedness and the fact that financial markets were already under serious distress, it was feared that AIG's failure would lead to the collapse of the entire financial system. The federal government was unwilling to take this risk and therefore provided an \$85 billion revolving credit facility to "facilitate a process under which AIG will sell certain of its businesses in an orderly manner, with the least possible disruption to the overall economy".

Notwithstanding the government bailout, AIG's securities lending program continued to greatly impair its liquidity. In addition, one of the intentions of the original loan was that AIG would sell off some of its \$1 trillion in assets and use the process to pay off the Fed Credit Facility. With the markets continuing to be in turmoil few, if any, buyers were in a position to make acquisitions and it was feared that AIG would go bankrupt with the loss of thousands of jobs and the irretrievable loss of billions of dollars in shareholder value.

Accordingly, on 10 November the Fed announced that the government was restructuring its aid to AIG "in order to keep the company strong and facilitate its ability to complete its restructuring process successfully". The restructuring consisted of three components: an equity purchase, changes to the Fed Credit Facility, and creation of additional lending facilities.

On 2 March 2009, the Fed and Treasury jointly announced that the government was again restructuring its aid to AIG "in order to stabilise this systemically important company in a manner that best protects the US taxpayer". This restructuring also consisted of three components: a share exchange, creation of an equity capital commitment facility, and further modifications to the Fed Credit Facility.

The initial decision to bail out AIG had to be taken very quickly and was based on incomplete information. One could conclude from the fact that the government has twice restructured the bailout

after having weeks and months instead of 48 hours to make a decision indicates that AIG's bankruptcy truly did pose significant systemic risk but in the end, no-one will never know for sure whether the \$200 billion in aid and nationalisation of the largest US insurance company was the right thing to do.

Perhaps not surprisingly, since the AIG collapse there have been a number of proposals suggested for regulating CDSs and other credit derivatives. However, Professor Sjoström suggests that regulators should not lose sight of the important function served by CDSs in the financial markets and the tendency of regulation to inhibit financial innovation. He argues that any regulation of CDSs should be measured and flexible enough to adapt to the constantly evolving financial markets.

Treasury Inc: How the Bailout Reshapes Corporate Theory and Practice

J W Verret, Assistant Professor of Law, George Mason University School of Law, & Senior Scholar, Mercatus Center Financial Markets Working Group. (Download available from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1461143)

Corporate law theory and practice considers shareholder relations with companies and the implications of ownership separated from control. The US government's bailout of the financial and automotive sectors has thrown a new dimension into the equation.

The Treasury Department and the Federal Reserve (Fed) are generally controlling shareholders, even in spite of relatively low minority interest in particular companies. Second, they are controlling shareholders that also enjoy sovereign immunity from the federal securities laws and state corporation law.

As a result of this perfect storm, a thorough investigation of the implications of the government's ownership via the Troubled Asset relief Program (TARP) reveals a number of uniquely unforeseen consequences to the theory and practice of corporate and securities law.

Taking the issue of control first, control is an elusive concept, but it forms an important part of corporate and securities law. It triggers fiduciary duties for control shareholders under state corporate law, as well as a number of applications under the federal securities laws.

In some areas, the securities laws take a direct approach and prescribe a certain percentage of ownership as constituting control, such as the Investment Company

Act of 1940's presumption that a 25% ownership position in a company constitutes control. However, control is not necessarily just an issue of how many shares are owned and what contractual rights are associated with them, it can also be defined as shareholder power.

The US government is a substantial creditor of the companies in addition to owning positions in them, and also holds the ability to substantially affect the bank's underlying business through its discretion in setting capital requirements and limiting bank operations.

For the purposes of state corporation law, shareholders deemed to be in control of the corporation owe fiduciary duties of care and loyalty to minority shareholders. In using its control over Citigroup to cause it to end dividend payments to preferred stockholders, Treasury implicitly pressured the other preferred shareholders to convert their shares into common equity.

Another concern with the US government as control stakeholder in banks, is that other governments could alter their policies toward international branches or divisions of that bank in order to extract diplomatic concessions from the US government.

An additional unintended consequence of Treasury's bailout has been that customers have gravitated to bailed-out institutions, giving those institutions which participated in TARP a competitive advantage over competitors that were, ironically, safer prior to the bailout. This dynamic is likely to continue as long as Treasury holds stakes in banks, particularly in light of the observation that government owned banks receive regulatory preferences and are more likely to obtain government backing than non-government owned institutions.

It is possible that the government as a shareholder may have a political interest in pursuing goals that directly harm the interest of other shareholders in the corporation. And yet, one of the novel circumstances of the government's holdings under TARP is that it has substantial sovereign immunity from liability as a controlling shareholder.

It is possible that shareholders who believe the value of their shares have diminished as a result of government action in its role as shareholder could seek redress under the Tucker Act on the grounds that it constituted a taking under the Fifth Amendment but takings clause cases are particularly difficult to win.

One interest group criticism of Treasury's TARP holdings amounts to a suggestion that labour, management,

and government will collectively conspire against the interests of taxpayers and shareholders, as well as the long term interests of a firm's constituents.

Another criticism for government owned firms is that the threat of bankruptcy or takeover, which would otherwise discipline management, is not present. This criticism supplements the view that governments will re-orient the company's objective from profit maximisation to other goals like employment maximisation. When the government's interest is only partial many of these problems remain. When other shareholders lose confidence in management, they sell their stock, but when governments lose confidence in management they inject more capital into the firm meaning that the bankruptcy constraint is minimised.

Governments as shareholders, with their unique willingness to ignore profit maximisation in the value of their shares and bailout the debt of entities in which they hold an interest, seriously threatens the function of outside ownership.

If Treasury is a control shareholder in the companies participating in TARP, including the nation's 8 largest banks, 200 more banks, Chrysler, GM, and AIG, it may result in each of those companies being considered affiliates of each other as part of a controlled group. This would then mean that any member of the group who sold securities held in any other member of the group may be required to abide by the strictures of Rule 144 in those transactions to avoid additional and burdensome prospectus and registration requirements.

Another issue with Treasury is as an inside trader. It has a much larger position in TARP firms than most companies. For instance, in Citigroup it holds a 34% position. Treasury will trade in large blocks, making the effect on liquidity much more pronounced. This will be true whether Treasury sells its shares into the general market or back to the company. Either way, it will affect either the short-term liquidity of the company in its ability to meet short-term obligation, or it will have a more significant impact on the liquidity of the market. Since Treasury will not be able to keep its sales from becoming public knowledge, the effect may be more pronounced than much smaller inside trades occurring continuously over a longer period of time.

Finally the author offers three suggestions for reform. First, he recommends that the government eschew its voting common equity, and even its non-voting preferred shares, in favour of frozen options. Those

options would be designed such that the government would never be permitted to exercise them but would be permitted to sell them into the market and allow other non-governmental shareholders to exercise them. This should serve as a significant buffer to the analysis that the federal government holds a control position in TARP companies.

Secondly, the Treasury and the Federal Reserve should hold their ownership in trusts set up to create an explicit obligation on those entities to maximise long term shareholder wealth in the invested TARP companies. This would be accompanied by a waiver of the federal government's sovereign immunity with respect to state corporate law, as well as a waiver of its immunity under section 3(c) of the Exchange Act and attendant immunity provisions of the Emergency Economic Stability Act.

Thirdly, the federal government, as a shareholder, should execute a 10b-5 trading plan similar to the type filed by executives to protect against liability for insider trading. This plan should be binding on the Treasury by law, with appropriate ranges of trade amounts to leave a reasonable measure of discretion for Treasury bureaucrats on each trading date, to minimise the threat of insider trading by the Department and cement a near term exit date by the government from its positions in private businesses.

The Pay Divide:

(Why) Are US Top Executives Paid More?

Nuno Fernandes, Professor of Finance, IMD International; Miguel A Ferreira Associate Professor, Faculdade de Economia, Universidade Nova de Lisboa; Pedro Matos, Assistant Professor of Finance and Business Economics, USC Marshall School of Business; Kevin J Murphy, Kenneth L. Trefftz Chair in Finance, USC Marshall School of Business. (ECGI Finance Working Paper No. 255/2009 – download available from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1341639)

It is a commonly held belief that US executives are paid significantly more than their foreign counterparts, and receive a greater share of their compensation in the form of stock options, restricted shares and performance-based bonuses.

Attempts to document empirically the precise magnitude and determinants of the alleged US 'pay premium' have been plagued by international differences in rules regulating the disclosure of executive compensation. While the US has required detailed disclosures on executive compensation since the 1930s (with significantly expanded disclosure

rules introduced in 1978, 1993, and 2006), the majority of other countries have historically required reporting (at most) the aggregate cash compensation for the top-management team, with no individual data and little information on the prevalence of equity or option grants. Cross-country studies of the US pay premium have largely been based on aggregate cash pay, small-sample comparisons where individual data are available, or countrywide estimates provided by consulting firms.

However, the disclosure situation has improved markedly in recent years. In this paper, the authors use data from the recently expanded disclosure rules to conduct a comprehensive international comparative analysis of the 2006 compensation for chief executive officers (CEOs) in 4,164 firms in 27 countries representing more than 80% of the market capitalisation of all firms in these countries.

US CEOs received total compensation (including grant-date values of options and restricted shares) that was, on average, 170% higher than that received by their foreign counterparts, and 118% higher after controlling for firm size and industry. The US pay premium was reduced to 43% after also controlling for firm performance, stock-price volatility, institutional and insider ownership, board structure and corporate governance, and reduced to 40% after also controlling for CEO biographic characteristics, for example, education, industry experience and career paths. The authors found, not surprisingly, that pay is higher for CEOs who have previous experience abroad and who have held more board positions in the past at other firms.

A significant part of the observed US pay premium reflects differences in the structure of compensation. The average CEO in US receives 42% of his pay in the form of options or stock, more than the double of the average in other countries which is closer to 20%. Once controlled for the ratio of incentive compensation to total compensation, the US pay premium falls to a statistically insignificant 12%.

Differences in pay structure are driven by country factors (rather than by firm or individual CEO characteristics) such as the economic, law, and institutional environment of each country. The use of equity-based incentives is highest in common-law countries with high levels of law enforcement (including enforcement of insider-trading rules) and strong security market regulations.

The US pay premium is declining amid a broad convergence in international pay practices. In particular the US premium (after controlling for company, industry, and CEO characteristics, but before

controlling for the structure of pay) was reduced from 187% to 43% between 2000 and 2006.

The positive relationship between pay and firm size documented in the US is pervasive across countries, but the elasticity of CEO pay to firm size is higher in the US than in other countries. In addition, compensation is higher when foreign sales (as a fraction of total sales) are higher, and when these foreign firms are cross-listed on US exchanges or are part of the MSCI World index.

Typically US CEOs are running larger corporations with different characteristics to their foreign counterparts and accordingly command different compensation. Board composition and ownership structure also help to explain why US executives are paid more. The authors found that larger boards tend to be associated with higher CEO pay, consistent with the idea that larger boards are poorer monitors. CEO pay is negatively related to insider ownership but positively related to institutional ownership.

The significant differences in the structure of pay between US and foreign executives have important consequences for the interpretation of the US pay premium. Because a larger proportion of US CEO pay is typically paid in stocks or options, which are riskier than straightforward salary, everything else being equal, CEOs with more equity based pay structures will expect to receive higher levels of pay to compensate for the increased risk.

Finally, many critics of CEO pay have argued that executive pay is excessive because there is no real market for executives who can effectively set their own pay levels. The relatively high pay of US CEOs in relation to their foreign counterparts is often cited as evidence for this assertion. In contrast, the evidence in this paper shows that pay practices are converging – especially among firms with operations abroad, firms with access to international capital markets, and firms cross-listed on US exchanges and suggests an increasingly important international managerial labour market for CEOs.

Understanding Directors' Pay in Europe:

A Comparative and Empirical Analysis

Guido Ferrarini, Professor, Faculty of Law, Università degli Studi di Genova; Professor Niamh Moloney, Department of Law, London School of Economics; Maria-Cristina Ungureanu, Researcher, Università degli Studi di Genova (ECGI Law Working Paper No. 126/2009 – download available from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1418463)

Executive remuneration has recently become characterised as a regulatory issue, with flaws in

executive remuneration structures being linked to insufficient regulation. Public outrage, particularly over the financial crisis and with respect to 'rewards for failure', has led to pressure for visible action and retribution.

The need for firms to focus on long-term rather than on short-term performance is a recurring theme of the reform movement, whilst the new swathe of reforms similarly emphasises the need for remuneration to be symmetric with effective risk management. The remuneration model which led to the financial crises caused perverse incentives that amplified excessive risk-taking, which, in the end, threatened the global markets. The emerging remuneration model is likely to include incentives which encourage better risk management and penalise failure.

The authors' research on the degree of conformity of European firms with the European Commission's 2004 and 2005 Recommendations and with international best practices reveals, in particular, that disclosure of directors' remuneration, which is central to the effective monitoring of remuneration, varies significantly from country to country. Disclosure practices appear to be strongly dependent on local rules. Only a few core requirements are followed by the majority of firms.

Requirements for more detailed disclosure with respect to directors' terms of contracts and qualitative information regarding performance-linked remuneration have not generally been implemented. Although disclosure has somewhat improved following the 2004-2005 EC Recommendations, a clear and comprehensive overview of companies' remuneration has not been achieved. Overall, the Recommendations have not led to a proper understanding of remuneration structures in European companies. In fact, given the increased complexity of remuneration structures, understanding, in practice, has weakened.

Enhancing disclosure does not simply mean providing more details about remuneration packages. Remuneration disclosure must be published in a clear and exhaustive manner and allow for easy assessment of the performance link and, ideally, easy industry comparison.

The effectiveness of executive remuneration is also related to board independence. The independent director has a role to play in both dispersed and blockholding systems. In dispersed ownership systems, shareholders are unable to monitor management closely. Non-executive directors, however, can close the information and monitoring gap to which

shareholders are exposed. This depends, however, on the independence of the non-executive directors from the executive board.

In blockholding companies, controlling shareholders have the power to monitor and influence management as they have easier access to information and strong ties to the board. But minority shareholders need to be protected and conflicts of interest can be avoided by non-executive directors who are independent from the controlling shareholders.

The remuneration governance matrix also includes shareholder voice and the engagement of shareholders in the pay-setting process. The 'say on pay' mechanism, supported by effective disclosure, might be regarded as fundamental to effective remuneration governance, although the authors found that it is regarded as being of widely varying importance. Shareholder rights to monitor remuneration policy or to participate in its design differ across Europe, reflecting different ownership structures and the diverging role of the general meeting.

The impact of shareholder votes on remuneration policies is not as yet clear, particularly where the vote is advisory only. Nevertheless, a connection in principle between shareholders and corporate remuneration policy is, at least, created where the mechanism exists.

Despite current tensions, the UK market has generally responded well to the essentially self-regulation-based requirements which govern executive remuneration (primarily through the Combined Code on Corporate Governance), with active discussions between companies and investors on remuneration. Communications between companies and investors have also been enhanced by the introduction of a binding disclosure obligation concerning remuneration disclosure and the mandatory, if advisory, vote on remuneration policy.

By comparison, the Continental European approach has often been criticised for poor compliance with best practice and low levels of enforcement of legislative requirements. Nevertheless, there is concern across the board regarding remuneration at present and reforms are likely to be widespread.

The differences in approach between the UK and Continental Europe will probably become less visible once new rules are in place. Practical evidence also shows that differences in compliance with the Commission's Recommendations in the Member States are related to the ownership structures of the companies – dispersed and blockholding ownership – and to the board models.

Remuneration policy also failed to penalize directors for failures; firms' losses were borne entirely by the firms, its shareholders and society. Individual institutions cannot change their systems of remuneration on their own, as they face the risk of losing talented staff to the competition so regulators may have to step in. The financial crisis has exposed the need for a new set of objectives as well as the link between effective corporate governance, executive remuneration, and risk management.

Firms that voluntarily adopt a more rigorous corporate governance structure are rewarded with a positive effect on their firm value. But poor levels of compliance in practice by market participants has made the current approach of European policy makers more stringent. The latest wave of reforms, certainly at Member State level, envisage more binding rules rather than flexible 'comply or explain' guidelines. The Commission has also warned that the two 2009 Recommendations represent the 'first stage' in a series of proposals to realign remuneration incentives with 'sustainable long term performance' and has suggested that it will be presenting proposals which will empower national supervisors to compel financial institutions to implement policies consistent with effective risk management. Although the current wave of reforms is focusing on the financial sector, momentum dynamics and public hostility are such that wider application, through binding legislation, cannot be ruled out.

The paper discusses in some detail the current situation in each Member State looking at the position with regards to the role of the remuneration committee, individual director's pay, say on pay, disclosure, contractual terms, package design, the remuneration of non-executive directors, share based incentive schemes as well as looking at the main recent national reforms.

In 2006 a number of changes were made to the UK Combined Code on Corporate Governance, complementing the earlier 2002 company law reforms (now in the 2006 Companies Act) which introduced the advisory 'say on pay' and required more detailed disclosure through a remuneration report requirement. The Code is also complemented by the industry ABI guidelines on policies and practices for executive remuneration and the ABI/NAPF Joint Statement on Executive Contracts and Severance, which recommend a closer link between incentives and the achievement of targets. They focus on the importance of rewarding performance.

A law regulating the transparency of executive pay came into force in Germany in 2006, under which

companies are obliged to publish the amount and structure of the remuneration of individual directors. Further amendments were made to the German Corporate Governance Code in 2008 which strengthen the responsibility of the supervisory board for management board compensation.

In Italy the new Corporate Governance Code was published in March 2006. This Code contains many changes to its predecessor, eg: the definition of the remuneration structure and terms distinguishes between executive and non-executive directors; the duties of the remuneration committee are also specified.

In Spain, the new Unified Corporate Governance Code was published in May 2006. It provides that the remuneration report should be submitted to the AGM for an advisory vote and that the remuneration of individual directors should be disclosed in the remuneration report.

France's MEDEF/AFEP issued two recommendations concerning the compensation of executive directors in 2008, aimed at enhancing disclosure and introducing guidelines on a clear link between remuneration and performance in the area of incentive-based pay and severance payments.

The Dutch Corporate Governance Code, as amended in 2008, aims to align remuneration closely with the company's strategy and related risks and encourages a remuneration policy that creates long-term value.

The new 2009 Belgian Corporate Governance Code pays most attention to the recommendations concerning executive remuneration, advocating complete transparency about remuneration and severance to shareholders.

Several other European corporate governance codes have been amended in the period following the 2004-2005 Recommendations. The revisions generally emphasise increased transparency, new guidelines on remuneration and greater shareholder power over the remuneration process.

Most Member State corporate governance codes require that a remuneration committee be established and apply this requirement on a 'comply or explain' basis. The authors found, however, that the wording of different corporate governance codes reveals differences in the importance attached to, and composition of, the remuneration committees. The composition of the remuneration committee across the Member States is also influenced by the different definitions that the different codes adopt with respect to the independence of directors. Each country's

best practice guidelines adopts its own definition of independence.

The EC's 2007 evaluation of the implementation of the 2004 Recommendation shows that the recommendation on remuneration policy disclosure is followed by about 60% of the Member States, although half of these Member States only follow the Recommendation in part and in a number of the Member States the specific disclosure requirements are not specified. Most Member States do not specifically require companies to produce a separate remuneration report and there are extremes at both ends of the spectrum, for example, the UK requires that a separate Directors' Remuneration Report is produced but Greece has no specific requirements whatsoever.

The financial crisis has led to particular rules being adopted across the Member States for remuneration within banks and has led to regulators and supervisors becoming more involved in the banking remuneration system. The Commission has adopted new general principles applicable to remuneration policy in the financial services sector which are designed to ensure that financial institutions have remuneration policies in place for risk-taking staff that are consistent with and promote effective risk management.

Having reviewed the regulatory basis across Europe, the authors then looked at 295 of Europe's largest listed firms by market capitalisation across 16 European countries, 14 of which were in the EU. They studied the annual financial statements or corporate governance reports – where separate from annual reports – for the financial year ending December 2007 or March 2008. Overall, they found that firms' application of the different disclosure criteria depends on the level of transposition of the Commission's 2004 and 2005 Recommendations in the different Member States and, moreover, on the way these recommendations are applied: whether through mandatory legislative provisions or through best practice guidelines.

Almost 83% of the firms reviewed have established either separate remuneration or joined remuneration and nomination committees. But only 60% of all firms have remuneration committees composed of non-executive, in the majority independent, directors.

More than 90% of the firms have a remuneration statement in their report. However, there were great differences in the presentation of the remuneration statement. At the lowest level of disclosure, firms present a rather boilerplate statement, with insufficient bespoke coverage. At the upper level, firms provide clear principles and guidelines on their remuneration

policy, including details of any recent changes or future changes.

Disclosure of the performance parameters for bonus schemes is provided by 64% of the firms in the data, while performance targets for share-based incentive schemes is provided by only 56% of the firms. When the authors looked in addition at what information was provided on the achievement of targets, only 30% of firms provide sufficient information on the link between remuneration and performance. The highest levels of disclosure are provided by UK, Dutch and to some extent German firms, while Belgian, Spanish, Italian and Swiss firms are the lowest performers.

Firms tend to apply only the basic requirements of national regulations, hence the significant differences in the application of disclosure provisions. Furthermore, they generally conform mainly to legally-binding rules and do not usually go beyond what is required by these rules.

A further explanation of variations in the application of the governance and disclosure principles reflects the persistent differences in corporate ownership across Europe, as mentioned above

Remuneration disclosure, central to effective remuneration governance, should be simple and transparent. On the basis of their research the authors conclude that only a separate remuneration report, providing a bottom line evaluation of the different compensation elements, can provide a consolidated, clear and comprehensive overview of the remuneration policy. It is also essential if shareholders are to receive reasonably full information on which to base their voting decisions.

Nonetheless, few national regulations have transposed this requirement and even fewer firms have applied it. This failure is likely to become the focus of future reforms.

Transatlantic Corporate Governance Dialogue

The New Role of Government in Corporate Governance

The sixth ECGI Transatlantic Corporate Governance Dialogue conference was held on 17th September 2009 at the Securities and Exchange Commission in Washington DC.

With the recent financial crisis, governments on both sides of the Atlantic have taken a much more

interventionist role in business, holding major ownership stakes in various banks and businesses and therefore playing a very different role in the corporate governance debate. Executive pay in particular is under the spotlight and there appears to be growing support for more regulation, not just in the financial and banking sectors but across the board.

This event therefore focussed on the new role of government in corporate governance. It asked what that role should be, not only in the companies that are now government owned but also through regulation in the economy in general.

Following introductory remarks by ECGI Chairman Antonio Borges, Karen Dynan from The Brookings Institution and Conference Chairman Professor Ronald Gilson from Columbia and Stanford Universities, Mary Schapiro, Chairman of the Securities and Exchange Commission gave the first keynote speech of the day.



Keynote Speech

Chairman Schapiro started by commenting on the timeliness of the conference. *"On a global basis, I can think of no other time in history when the interplay between governments, businesses, and providers of capital has been as integrated and essential as it is today.*

"Kofi Annan, former Secretary-General of the United Nations said that arguing against globalisation is like arguing against gravity. While this is undoubtedly so, understanding the inevitability of globalisation is just the first step. In a speech to the World Economic Forum in Davos, he also said, 'Globalisation is a fact of life. But I believe we have underestimated its fragility. The problem is this. The spread of markets outpaces

the ability of societies and their political systems to adjust to them, let alone to guide the course they take. History teaches us that such an imbalance between the economic, social and political realms can never be sustained for very long'.

"Although the Secretary-General gave this speech over a decade ago, we continue to learn this lesson. Much of the world's economic turmoil during the past 18 months is directly attributable to the fragility of globalisation – that is, the inability of the world's governments to keep pace with the changing and evolving markets.

"Since the collapse of Lehman Brothers, governments around the world have been analysing the events and factors leading up to the financial crisis, in order to prevent reoccurrence in the future. There are many failures that have been identified, both on the part of market participants as well regulators who are charged with the oversight of markets and financial institutions. The list of problem areas includes credit rating agencies, derivative markets, lack of transparency in financial statements, and excessive risk-taking, to name just a few.

"The fact that these problems are shared by the US and the EU is evidence of the seriousness of the problems we have faced over the past year. However, given the extent of globalisation in the financial markets, these problems also require common solutions that we should seek together. A number of such efforts are underway, in organisations such as IOSCO, the Financial Stability Board, and the G20, to name a few. We at the SEC are committed to working with our counterparts around the globe toward common solutions and approaches wherever possible.

"It is within individual companies and firms that extreme risks were taken, putting our markets on the verge of collapse. In particular, boards of directors did not thoroughly question the decisions of senior management to take on risks. Of equal concern, boards often appeared to misunderstand the gravity of risks taken. Senior management took higher returns at face value, without questioning why such higher returns were possible for supposedly safe investments and strategies.

"A number of jurisdictions are now taking steps to address these corporate governance lapses. In some countries, high compensation for senior executives in the financial services sector is being seriously questioned, particularly where it is not linked to long-term performance. Greater attention is being paid

to the skills of directors, particularly in the area of managing risk.

"Another area of concern is increasing the transparency of the governance of financial institutions so that investors can more easily judge the skill sets of directors and find out about the links between risk-taking and compensation. While each jurisdiction may have a different legal structure and approach to corporate governance, these are common themes with which we are all grappling."

Commissioner Schapiro then set out the five key areas which the SEC is currently looking at with a view to reforming. These include curbing unfair trading practices such as abusive short-selling. She noted that the Commission also is considering other market structure issues, such as dark pools, alternative trading systems and high-frequency trading as well as proposed rules to ban flash orders, through which select traders see investors' orders before they are sent to a wider marketplace.

Secondly, the SEC is working to improve the performance of those market intermediaries upon whom investors rely, such as ratings agencies and investment advisors, in particular looking at the so called "pay-to-play" practices by investment advisers to public pension plans. This summer the SEC proposed rules that are designed to prevent an adviser from making political contributions or hidden payments to influence their selection by government officials.

Thirdly Commissioner Schapiro discussed the Commission's examination of the accountability of corporate managers to their owners. *"Corporate governance is about maintaining an appropriate balance of accountability between three key players: the corporation's owners, the directors whom the owners elect, and the managers whom the directors select. Accountability requires not only good transparency, but also an effective means to take action for poor performance or bad decisions."*

"I believe that the most effective means of ensuring corporations are accountable is to ensure that the shareholders' vote is both meaningful and freely exercised. That is why the SEC proposed rules which would remove obstacles to shareholders' ability to nominate candidates for the boards of directors of the companies that they own. Under the proposal, shareholders who otherwise are provided the opportunity to nominate directors at a shareholder meeting would be – subject to certain eligibility and procedural requirements – able to have their nominees included in the company proxy that is sent to all voters."

"Shareholders would also have the ability to use

shareholder proposals to modify the company's nomination procedures or disclosure about elections, so long as those proposals do not conflict with state law or Commission rules.

"The Commission has also proposed a series of additional measures seeking to improve proxy disclosure and the process by which shareholders exercise their vote. These new disclosures would include expanded information about the relationship between a company's overall compensation policies and the company's risk profile; the qualifications of directors, executive officers and nominees; the Board's leadership structure; and potential conflicts of interests of compensation consultants."

Then there is the question of enhancing the strength and integrity of important investment products. In June, the SEC issued for public comment a comprehensive set of proposals to strengthen the regulatory regime around money market funds. The proposals focus on tightening the credit quality, maturity and liquidity standards for money market funds to better protect investors. This would have the effect of making money market funds more resilient to risks in the short-term securities markets.

Turning, finally, to improved market transparency Commissioner Schapiro reported that, in July, the Commission approved for public comment proposals that would provide municipal securities investors with more complete and timelier information about material events that affect their investments, as well as more information about variable rate demand obligations previously exempt from certain disclosures.

Government as Investor

The first plenary session looked at the role of governments as investors and the issues surrounding that. It was moderated by **Professor Jaap Winter, a Partner at law firm De Brauw Blackstone Westbroek**. He started the session by commenting on the fact that a couple of years ago, EU finance ministers had had fierce discussions around their concerns about Sovereign Wealth Funds (SWFs). They were worried that SWFs would not act as normal shareholders, but might have political motives to move companies in certain directions. He pointed out the irony that those same EU Finance Ministers now found themselves in a position of owning all or a proportion of key national financial institutions. They now had to divide themselves in their role as shareholder, as policy makers, regulators, creditors, guarantors of all the debts.

Professor Gerard Hertig, Professor of Law at ETH

Zurich gave a European perspective. Historically governments primarily invested in companies to ensure continuing access to utilities or for motives related to the specific fiscal and industrial policies of the particular jurisdiction. In the current crisis, governments' investing revolved around motivations directly arising from market failures, to keep lending going, minimise the cost of restructuring failing industries or firms and to protect jobs.

The nature of Europe, with its individual jurisdictions, posed different problems than might be found in the US. There was concern that individual Member States might take the opportunity to introduce protectionism and the European Commission acted to prevent this. It emphasized that first of all, any state aid should be temporary. Second, state support should preserve a level playing field and have no negative effects on other Member States. Third, management should be punished and compensation should be kept within limits. And fourth, shareholders, not the taxpayer should bear the financial burden; in particular, state aid should not be used to pay dividends to shareholders.

Professor Hertig felt that overall these criteria had been met. He then looked at four different case studies to illustrate how multidimensional the whole situation was.

He started by looking at Lloyds TSB within the UK. The British Government had taken a 43% holding in a business which had a very widely spread shareholder base. It insisted that the Chairman and all non-executives who had been involved in past decisions which had brought the bank into trouble had to go. Looking at compensation, it insisted on changes to the planned programme of bonuses. It required a more equal sharing of the bonus pool amongst all the staff, accepting that it could not change guaranteed bonus arrangements but insisting where possible on deferred compensation, subject to some quite heavy constraints, including claw-back clauses. This, said Professor Hertig, was neither necessarily good nor bad but importantly nothing other than you might expect any controlling shareholder to do, government or not.

Professor Hertig moved on to the case of Fortis, a complex group of financial entities with two banking subsidiaries, one of which was bought by the Belgian government and one by the Dutch government. The effect of this was for the parent's share price to go down, leading to an outcry by its shareholders who argued that they should have had a say in the decisions whether or not to sell the subsidiaries. This went to court in both Belgium and the Netherlands

resulting in two opposite decisions. One of the reasons for Belgian courts to require the issue to be put to a shareholder vote, suggested Professor Hertig, was that shareholdings were more widely dispersed in Belgian, making it very difficult for the courts to ignore grassroots' protests.

The sale of Opel by General Motors has been widely covered in the press and Professor Hertig drew out some of the salient points. The German government was concerned about the 15,000 jobs at stake if Opel plants located in Germany were closed down. At the same time, it also wanted to minimise the burden for taxpayers, and did not want to spend too much by way of state aid in view of the possibility that Opel could eventually fail anyway. This led to complex negotiations with the two main bidders for Opel, a core issue being how to structure the deal so that job losses would occur at plants in Belgium, Spain or the UK rather than in Germany while remaining in compliance with EC state aid rules. Such an issue may also have arisen in the event of a takeover by another corporate, but would certainly not have reached that magnitude.

Finally Professor Hertig considered UBS in Switzerland. The Swiss authorities had higher levels of capital adequacy requirements than other jurisdictions (the so-called Swiss finish). This did not prevent UBS from needing state aid. The Swiss government and central bank provided financial support aimed at impaired assets, but did not want to have a representative sitting on the UBS board. The Swiss government was recently able to exit, and this with a handsome profit of Swiss Francs 1.2 billion. Two points come from this example. Firstly, having higher capital requirements does not necessarily reduce the risk of financial distress. Secondly, even though the government has now withdrawn from UBS, the political pressure regarding capital requirements and compensation has remained unchanged and new requirements are in the process of being implemented in both those areas.

Professor Jeffrey Gordon, Alfred W. Bressler Professor of Law at the Columbia Law School then gave a US perspective. He looked at how the US Government first decided to intervene and then the structure of the eventual investment. He then looked at the consequences for governance, of importance primarily in cases where the government had a longer-term interest (such as GM, Citibank, and Bank of America) rather than cases where the government had made a quick exit. Finally he considered distinctions between the US and EU intervention models, arguing that the results were surprisingly similar.

There had been no clear policy process behind the US government's decisions whether to intervene. Each decision was sparked by a crisis and the particular set of circumstances. Taking as an example the AIG case, AIG was regarded as well-run insurance company with a particular financial products subsidiary that took extraordinary risks. To the Federal Reserve (the Fed), as it invoked its emergency authority under the 1932 Banking Act, this meant that its \$80 billion loan was fully collateralised, given AIG's valuable insurance business assets. This was in contrast to Lehman Brothers, where a Fed loan would not have been fully collateralized by the available financial assets.

As part of the credit agreement with AIG, the Fed received a special class of preferred stock which carried just under 80% of the economic claim on AIG, together with equivalent voting rights. This preferred stock was put in trust to mitigate the Fed's conflict between its regulatory role and its position as a dominant investor. Trustees were appointed to act for the interests of the Treasury – the beneficiary of the trust.

Professor Gordon pointed out that the AIG intervention was in effect an acquisition, not a loan, and that similar to the Fortis case discussed by that Professor Hertig, this was done without an AIG shareholder vote. He also pointed out that there had been some tension between the CEO and the trust over whether (and how) the company should be run for the benefit of all the shareholders, not just the 80% shareholder, versus the trust's concerns as to how best to protect the Treasury's interests. How this might be resolved will be interesting to see.

Moving on to the automotive industry, Professor Gordon said that the decision whether to invest was not purely a financial decision. It was not a question of whether the demise of General Motors (GM), for example, would disrupt the world financial system. Of course it was important, even critical, that many jobs were at stake, but also important was the further question of whether the US could afford to lose the capability of running a manufacturing set up like GM. So, in this instance the decision was not a financial decision but an industrial policy decision.

On the issue of the governance impact, in both sectors, financial and automotive, there was a common set of motives and concerns. Since the government controls the board, appointing the directors and the CEO, and is unassailable because of its ownership position and other clout, what happens to the other shareholders' interests? Is that a good model of governance? For example, the government claims that they want to

operate GM as a normal business, trying to maximise for the shareholders but has it made a credible commitment with respect to the exercise of its control rights to behave in that way?

Finally, Professor Gordon made some observations based on comparisons on automotive industry bailouts in the US and the EU. In the 70s and early 80s, there were marked differences between the two jurisdictions in the treatment of employees, management, and shareholders; much more 'convergence' today.

"In the EU, these bailouts went more smoothly than in the US. In the US, there were many frictions; they all had to be done individually. I think the reason is that in the EU, there was a lot of state ownership, the economic models was a "coordinated market economy," and so the government bureaucracy that could handle such interventions already existed. In the US, starting from a different economic model, you needed a one-off because you were inventing from scratch. The watershed of convergence in how such bailouts are now addressed was the privatisation movement of the 1980s, which began in the UK and spread. No government in the EU now is set up as formerly to handle the role of the government as owner. Now, like the US, EU governments are jury-rigging -- doing one-off deals themselves. When you look at the pattern the differences are really not so great between the US and the EU as one might have predicted." Professor Gordon also noted the stabilizing force of the EU's anti-protection rules. States might favour important local firms through the fact and form of their intervention, but the involvement of the Commission restrained state behaviour.

Two panellists added their thoughts on the issues raised by the speakers.

Professor Charles Calomiris, Henry Kaufman Professor of Financial Institutions at the Columbia University Graduate School of Business, started by

looking at the government's subsidisation of mortgage risk in the US market. The government had direct involvement as owner of this risk through two private institutions, Freddie Mac and Fannie Mae whose debts it implicitly (and now explicitly) guaranteed and through the FHA which is a directly government owned programme that insures credit risk in the mortgage market. The government wanted to own the risk because it saw that as the way to subsidise risk in the mortgage market; the decision was motivated by political issues.

In 2004 Freddie Mac and Fannie Mae decided to enter aggressively into the market for no-documents (or self-

certified) mortgages. Between them they currently own half of the outstanding sub-prime mortgage exposure; of the three trillion dollars outstanding, they own 1.6 trillion dollars worth. The situation might not have deteriorated to such an extent if, in 2006 when the US housing market began to stall, they had amended their lending policies, but instead they continued to make record numbers of mortgage originations in the later half of 2006 and the first quarter of 2007.

In addition, the government had established new standards for not enforcing foreclosures on mortgages in the late 1990s and early 2000s so that whereas in 1996, 75% of mortgages that were 90 days overdue ended in foreclosure, by 2002 that figure was down to 25%. The emphasis was on renegotiating rather than foreclosing.

On top of all of this, the government then introduced a Bill which encouraged the ratings agencies to be more lenient in their ratings of mortgage backed securities. Once again, this was an example of the government acting with a political agenda, not a risk management agenda.

Professor Calomiris finished by referring back to some of the examples cited by the previous speakers and arguing that when the government gets involved, good governance principles of transparency, disclosure and shareholder protection don't seem to matter anymore, despite the lip service paid to them by the SEC.

Professor Xavier Vives, Professor of Economics and Financial Management at the IESE Business School, looked at the regulatory environment which has developed in order to protect the system, to protect the investors, and to maintain competitive markets, in particular within competition policy rules. He argued that, although some common problems had been solved, there had also been side effects and distortions which helped the economy to get into the state it was in. In particular, the concept of an entity being too big to fail and the generous blanket insurance schemes available basically encourages institutions to take risks, safe in the knowledge that should things go wrong the taxpayer will pick up the bill.

But where did the failure actually come from? Was it a failure in corporate governance? One of the tenets of corporate governance is that ultimately shareholders will hold the boards of the companies they invest in to account in order to protect their investments and to increase shareholder value. But where the effects of risk are mitigated by, basically, taxpayer funded insurance schemes or guarantees, shareholders too are prepared to take increased risks in the hope of increased returns.

Professor Vives feels that State ownership is basically distortionary, mainly because the State is on both sides of the regulatory relationship leading to the conflicts of interest mentioned earlier and the fact that political objectives and incentives will ultimately take precedence. His view is that the government should exit from the interventions it has made as swiftly as possible. He does also feel though that, whilst it does have a role as a major shareholder, it should use the rights that are associated with that role effectively by nominating independent directors who have financial and management expertise, with a transparent process so that everyone can see how and why directors have been chosen.

"Finally", argued Professor Vives, "we are entering a new, probably long, phase of tighter regulation and public control so we really need advocates for competition, and in particular advocates for entrants in the financial industry. I think all the political and economic incentives are moving towards protecting incumbents. We need someone else, maybe the competition policy authority, to try to push for new fresh entries, who will hopefully be more efficient and prudent, in the financial sector."



Keynote Speech

Professor Mario Monti, President of Università Bocconi and Former European Commissioner for the Single Market, Financial Services and Taxation, and for Competition Policy gave the second keynote speech.

Governments have made enormous interventions in

the crisis and this has brought about departures from the principles of a market economy. The feeling of the conference appears to be that eventually governments will make an exit from these interventions and that in retrospect this will have been a huge but temporary oscillation and things will go back to normal. Professor Monti though was not so sure.

"My impression is different. Allow me to view the topic through the lens of a former enforcer of market rules, particularly those pertaining to competition. Vigorous enforcement has never been an easy or a popular task in the area of competition or elsewhere, nor has competition as such ever been acclaimed by the crowds as their loudest request to government. But since the day after World War II, when antitrust began its journey from the US to be gradually introduced around the world, never in my view was there a time when the threats to competition had been so severe as today. This is due not only to the seriousness of the threats, but also their unexpected origin. This crisis changes the nature of the challenges not just to competition policy, but I would assume to market policies as a whole", he said.

He explained that pressures on competition policy have always been exercised by other policy objectives, in particular industrial policy.

"It is the very principle of the market economy that is profoundly challenged. I'm not sure that an economy where there are massive and rather chaotic interventions by government in response to the crisis, and where there is considerable blurring of borders and responsibilities between the State and the market, between government and companies, still qualifies as a market economy. The confidence in the market economy has been shaken by the crisis.

"In the US, Europe, and elsewhere, governments' response to the crisis has put severe stress on traditional principles of competition markets. State aid, government supported consolidation in the financial sector, derogations to normal merger control rules have been the most visible manifestations. In addition, there are calls to push usual antitrust concerns to the side, as if competition were a luxury, unaffordable in times of crisis."

Professor Monti feels that as the economic and social consequences of the crisis unfold, the calls for a suspension or weakening of antitrust enforcement are likely to become louder but he is very clear that those calls should not be listened to. Not only would consumers be penalised, but the longer-term prospects for economic growth and employment would also be

compromised. Referring back to the Great Depression, he said that the suspension of antitrust enforcement contributed to the depth and the duration of the crisis. The return to vigorous enforcement in 1938 was a cornerstone of the New Deal.

He went on to consider the intersection between competition policy and corporate governance. What should the criteria be behind competition policy decisions? What should the guiding standard be? Professor Monti's answer was that in all areas it should be consumer welfare. During a crisis, some people argue that stakeholder welfare, employees and shareholders, should also be considered. Professor Monti is not of this view.

"I remember cases in which, for example during my years, big mergers were authorised because in the end it would not cause harm to consumers. But very soon either the merged entity showed itself to be unmanageable because of its size, or the cultural differences of the two merging parties could not be brought to a synthesis. And the merger, although authorised by the competition authorities, ended up being a shareholder value destructive merger."

If the case of institutions which are 'too big to fail' are brought into the equation, this complicates matters even more because it could be argued that competition criteria would end up being one of a joint consumer/taxpayer interest.

Professor Monti then argued the case for the single European market which he said depended upon two necessary conditions. Firstly the nationals of the Member States of the EU must stop seeing the single market as a strait-jacket, which is the general public perception at the moment. It is essential to find ways to re-engage Member States giving more emphasis to the social aspects rather than just the market aspects of a serious single market policy.

Secondly, and even more difficult, he asked, how long can one part of the world, ie Europe, be the only one where the behaviour of governments is constrained in their ability to: (a) grant financial support to companies; and (b) block foreign takeovers which they do not like?

"It was not easy at all," he explained "for Neelie Kroes to overcome French and Luxembourg resistances against Mittal taking over Arcelor in the very same days in which, in the US, it was relatively easy to block the attempted acquisition of Unocal by CNOOC, equally for State aid.

"So the G20 does well to concentrate its minds on financial regulation because it was there that the

problem exploded. But I think reflection and eventually policy actions will be needed on the fundamental aspects of how to govern a market economy as it integrates globally."

Reforming Compensation

The penultimate panel session was moderated by **Gregory Ip, US Economics Editor of The Economist.**

Dr. Maria Cristina Ungureanu, Researcher at the University of Genoa who has conducted in-depth research on executive remuneration with Professor Guido Ferrarini, University of Genoa's Professor of Business Law and Capital Markets Law, began the session by giving an overview of regulation on executive remuneration in the European Union following the emergence of the financial crisis in 2007.

The European Commission's Recommendations on executive remuneration adopted in 2004-2005 aimed at the overall corporate sector primarily addressed the importance of disclosure of firms' remuneration policy and the role of the remuneration committees. The Recommendation as regards the regime for the remuneration of directors of listed companies published in April 2009 extends the Commission's focus towards the structure of directors' remuneration and the process for determining remuneration. The objectives of the new reforms are to ensure the sustainability and risk-adjustment of the remuneration policy, to provide incentives based on long-term performance criteria and to avoid 'rewards for failure'.

Several reforms of executive pay in the financial sector have emerged from the crisis.

In February 2009, the high Level Group on Financial Supervision in the EU chaired by Jacques de Larosière published a report that adopted International Institute of Finance principles. The report underlines principles related to transparency and alignment with shareholder interests and long-term profitability. It makes additional proposals including the setting of multi-year framework bonuses, the banning of guaranteed bonuses and the application of these principles not only to senior bankers but also to traders and asset managers.

The Committee of European Banking Supervisors (CEBS) adopted its 'High-Level Principles on Remuneration Policy' in April 2009. These emphasize the importance of external transparency towards stakeholders as well as the adequacy of internal disclosure. The CEBS principles address the oversight and decision-making processes of setting remuneration; the performance measurement and the

forms of remuneration; the proportionality between basic pay and variable pay; the deferral of incentives and risk management consideration when adopting incentives.

Within this swathe of reforms, the Commission adopted the Recommendation on remuneration policies in the financial sector. As far as the structure of pay is concerned, the Commission advocates an appropriate balance between basic pay and bonus levels and the adjustment of underlying performance for risk, for the cost of capital and for liquidity; it also makes provisions for the deferral of bonuses and clawback. The Commission addresses recommendations with regards to governance, disclosure and supervision of remuneration at financial institutions.

The above-mentioned reforms are all principle-based but they do lead to certain legal initiatives, such as the current revision of the Capital Requirements Directive (CRD), which applies to banks and investment firms. The Directive, to become effective by the end of 2010, enables supervisory authorities to impose capital sanctions on banks which are found to adopt remuneration policies that generate unacceptable risks.

A number of reform initiatives have been ongoing at Member State level. In February 2009 the UK Financial Services Authority (FSA) drafted a Code on remuneration practices, the first in the world of this kind, which comes into effect on 1 January 2010. The main principle of the Code is the alignment of remuneration policies with effective risk management. FSA does not intervene in setting remuneration levels, which is considered a matter for banks' boards. The UK Turner Review issued in March 2009 advocates remuneration policies that avoid incentives for undue risk taking. The Walker Review of July 2009 stresses the importance of governance in the remuneration process, including the role of the Remuneration Committee and the importance of disclosure.

At the Community level and in a number of Member States rules have been introduced to limit executive pay, particularly in banks where governments have taken equity stakes.

The UK Government imposed certain conditions on remuneration policy for those banks which used public funds, namely Lloyds and Royal Bank of Scotland. Participation in the recapitalization scheme imposed an obligation on both banks to address the remuneration of senior executives. For 2008 no cash bonuses were paid to executives; for the future remuneration policies, incentives would be reviewed

and would be linked to long-term value creation, taking account of risks and restricting the potential for 'rewards for failure'.

In Germany restrictions are set by the Financial Market Stabilisation Fund, which provide for an annual salary cap for top executives of €500,000 for the financial years of 2008 and 2009, with no payment of compensation upon termination and no bonus payments that are not legally required.

In France compensation for senior corporate executives of State-aided companies is also subject to certain conditions. Bonuses are only authorized for a period not exceeding one year, and no bonuses are to be paid out if large-scale layoffs are necessary in the bank. The allocation of stock options and free shares are prohibited and there is a cap on severance pay of a maximum of two years' compensation.

In the Netherlands, on 8 September 2009 the Association of Dutch Banks adopted a provisional Banking Code, to take effect on 1 January 2010. The Code provides for specific measures on compensation, including a cap on annual variable pay which should not exceed 100% of annual fixed pay. Several principles regard variable remuneration that should be based on the performance of the individual, of the division and of the bank as a whole. The Code makes specific provisions that award banks' supervisory boards discretionary powers to adjust variable pay.

However, how effective are all these principles? Dr. Ungureanu reported that undergoing research revealed that most financial institutions which received State aid did not in fact award annual variable pay in 2008. Perhaps more interestingly, several financial institutions which did not resort to government assistance also waived annual bonuses. Several banks committed to align future remuneration policies with the latest reform principles. It remains to be seen whether these were exceptional measures given the circumstances, or whether they prove to be long-term commitments. Another outstanding issue is whether compliance would be better achieved through a prescriptive or a principles-based regulatory model.

Joseph E Bachelder, Founder and Senior Partner, Bachelder Law Firm then looked at the recent developments in this area in the US.

Government intervention in executive pay is not a new thing in the US. In August 1971 a pay freeze was imposed and for about three and a half years after that there were mandatory pay controls.

The Troubled Assets Relief Programme (TARP) was enabled through legislation passed in two parts, in

October 2008 and February 2009. TARP assistance has been given to about 670 financial institutions as well as to Chrysler and General Motors in the Automotive industry.

Another tranche of government intervention with executive compensation has been the SEC itself, which, in the executive compensation area, has had an impact primarily in its rules on disclosure as well as its impact on accounting treatment through its work with the Financial Account Standards Board. In addition, from time to time, the SEC has investigated where it considers there may have been improper conduct in connection with executive compensation.

A third tranche is tax. From 1984 to the present, there have been a number of significant regulations that have impacted on executive pay including the parachute tax which imposed a 20% excise tax on certain payments in connection with changes in control. In 1993, there was a \$1 million cap imposed on deductions by employers for non-performance based compensation paid to certain key employees. In 2004, an additional income tax of 20% was imposed on certain forms of deferred compensation.

In addition there are specific provisions in the Sarbanes-Oxley law, such as a provision which prohibits personal loans to certain senior executives of covered companies. Other interventions include periodic government investigations such as that made by Attorney General Andrew Cuomo into ten TARP companies. He reported his findings in July.

The American Recovery and Reinvestment Act (ARRA), which passed into law in February, included some strict limitations on executive pay including limits on bonuses to be paid to up to 25 most highly compensated employees of TARP beneficiary companies. (The actual number, up to 25, is determined by the amount of TARP aid received by the TARP company.) It also prohibits severance payments to the top ten executives.

So have all these regulations really made any difference? It could be argued that, given the economic climate, senior executives would probably have been paid less even if TARP had not been introduced. Will TARP provide only a temporary respite given that once companies pay back their TARP funds, they will no longer have to abide by the restrictions? Is there a danger of fragile TARP companies losing top talent to other financial institutions, including foreign companies, not subject to TARP constraints on compensation? Is this a case of the stronger getting stronger at the expense of the weaker? And finally, is TARP having a perverse effect on executive pay

practices? Has it gone overboard in encouraging salary and discouraging performance-based pay such as short-term incentives? To illustrate that final point, Mr Bachelier observed that John Stumpf's salary at Wells Fargo has increased from \$900,000 a year to \$5.6 million because salary increases under TARP are not subjected to the same limitations as incentive pay.

Professor Lucien Bebchuk, Professor of Law, Economics, and Finance at Harvard Law School considered briefly how executive pay might have contributed to bringing about the crisis, how compensation structures might be fixed, and what role, if any, the government should play in bringing about compensation reforms.

(See **Pay Without Performance: Overview of the Issues** by Lucian A. Bebchuk and Jesse M. Fried, **Harvard Law School** – http://papers.ssrn.com/sol3/papers.cfm?abstract_id=761970)

The executive team being fully exposed to the upside of a decision but being insulated from the downside could lead to excessive risk taking. Professor Bebchuk argued that there are two separate distortions which can occur. The first being insulation from some of the losses that the shareholders might bear and the second being insulation from some of the losses that other stakeholders might bear. These two distortions need to be kept separate because each of them provides a different conceptual basis for government intervention and more importantly because each of them calls for a different form of government intervention.

Taking the first instance, compensation structures in the past have enabled executives to reward themselves in such a way that, even if the share value subsequently reduces and the shareholders lose wealth, there is no mechanism for clawing any of the money back. This problem has been widely recognised now and there are moves to put some restrictions on equity-based compensation. There have been calls that executives should hold onto their stock until retirement but that could produce perverse incentives to retire early. A better answer is to have fixed number of years after vesting during which executives are unable to cash out equity incentives.

The second instance is not as well discussed or understood. Assuming that the executives are focusing on long-term results, the question is long-term results for whom? If they are focusing just on long-term results for shareholders, then they are insulated from some of the losses that taking of risks might impose on preferred shareholders, on bond holders, on taxpayers as providing insurance to depositors.

So as long as there is this form of insulation resulting from the fundamental moral hazard problem that exists in financial institutions, there may be excessive risk taking from the perspective of society at large. There may be optimal risk taking from the perspective of shareholders, but excessive risk taking once you take into account the broader interests.

Professor Bebchuk feels the solution is to structure the compensation so that the executives have a slice of the full capital structure. He suggest this can be achieved by, for example, instead of tying the payoffs of executives to a fraction beta of the value of the common shares, tying them to a fraction alpha of the value of the common shares plus the preferred shares plus the bondholders plus other elements.

He then moved on to look at the role that the government ought to play. For non-financial firms, he feels the focus here should be on improving internal governance arrangements rather than overt intervention. Greater board scrutiny and monitoring, say on pay, stronger independence of compensation committees are all arrangements that basically improve internal governance and will help to produce pay arrangements that are more closely tied to long-term shareholder interest. If corporate governance is fixed, if shareholder rights are strengthened then compensation choices will be improved.

However, in the case of financial firms he feels the government does have a more direct role to play because the failure of them will impose some costs on taxpayers and various stakeholders.

It can be argues that that there are occasions where shareholders' interests can be served by excessive risk taking which is why there is a large body of regulation in place which intervenes with respect to investing, lending, and reserve decisions. However, experience has shown that this body of regulation has not been perfect because the regulators are often one or more steps behind. Even by directly regulating choices it is still not always possible to constrain excessive risk taking.

Therefore, just fixing internal governance might not be enough because if the interest of shareholders is sometimes for taking excessive risks, it also follows that the interest of shareholders might sometimes be in having incentive arrangements in place that would encourage excessive risk taking.

The role of the government should be limited to focusing on the structure, not the amount. The amount is a corporate governance concern.

Common arguments against pay regulation are that

the government does not have a legitimate right to tell shareholders what to do with their money and that they do not have the same level of information and knowledge that private decision makers have. However, in the current climate the government does have a legitimate interest. And the same legitimate interest in safety and soundness and in limiting the externality provides the government with a legitimate interest in thinking about pay structures. As far as the relative levels of knowledge and information are concerned, that may well be true but there is still a need for government scrutiny because those private decision makers don't necessarily have the incentives to get those decisions right.

Finally, Professor Bebchuk looked at the role that compensation structures may have played in the financial crisis. He referred back to several years ago when there were also criticisms of compensation structures. The standard response then was that maybe the structures were imperfect but there had been such a great bull market for so long that surely credit should be given to those executive compensation packages? As a minimum they should not be tinkered with.

Those same people who stated that compensation structures should take credit for the bull market should realise that if compensation structures were so important in producing decisions then, they have probably also contributed to the biggest destruction of stock market wealth in living memory.

Professor Steve Kaplan, Neubauer Family Professor of Entrepreneurship and Finance at the University of Chicago Graduate School of Business took a slightly different view. He is not of the opinion that poorly designed top executive compensation for the top people fuelled the financial crisis.

(See **Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?** by Steven N. Kaplan and Joshua D. Rauh, Northwestern University and NBER - http://papers.ssrn.com/sol3/papers.cfm?abstract_id=931280)

He started by looking at how much CEOs were paid and pointed out that average pay in 2008 is actually lower than it was in 1998 when adjusted for inflation, a fact that has not received much coverage to date. A recent paper which looked at pay around the world from 2000 to 2006 also showed that the rest of the world was catching up, with the US pay premium dropping from 187% to 43% over the period when controlled for firm characteristics. When controlled for pay structures, the premium effectively goes away.

Professor Kaplan then looked at how CEO pay had compared to other groups such as private equity investors, bankers, athletes, entertainers and lawyers. Increases in these professions were at least as large as the increases for CEOs. Importantly, for these other sectors pay is negotiated in arm's length transactions where it is very hard to argue that agency problems or managerial power exist. This casts doubt on the theory that a reason CEO pay is as high as it is can be directly related to agency problems and the influence and power that CEOs exert on their boards. CEO pay is driven much more by the market, by technological change, by greater scales in operations and globalisation.

It is important to differentiate between ex ante pay and realised pay. Realised pay is what CEOs get when they realise the share options that they are granted and when the share price is increasing, these can be very large indeed. But when the share price is falling, so too do the returns to the CEO. It is estimated that the wealth of the S & P 500 CEOs dropped by about 43% last year and that it is likely to decline again in 2009, suggesting that there is actually a powerful link with shareholders and that realised CEO pay is strongly related to performance.

On this basis, there is no need for new or greater regulation. Shareholders can already propose say on pay resolutions in the US but they usually fail. In April 2008 there were say on pay proposals for Citibank, Merrill Lynch and Bank of America and they were all rejected. Mandated say on pay, or worse actually capping pay, would have no benefits and real costs.

Regulation essentially increases the attractiveness of alternatives for the most talented executives. When the TARP came in there were significant movements of very good people to boutiques, to private equity, and to firms that are not affected by TARP. Increased regulation is likely to lead to an increase in these kinds of movements.

Finally, executive compensation is not to blame for the financial crisis, there are a lot of reasons which contributed, as some of the previous speakers have pointed out including accommodative monetary policy, a global mismatch between savings and investment, accommodative regulatory policy, financial innovations, ratings agencies providing ratings which were too high, encouraged by legislation, poor risk management. It's not clear that changing the compensation structure would have had any effect on these areas. What is needed is to do a better job of monitoring bank capital and leverage, set higher capital requirements, make them pro-cyclical, as was

done in Spain where they have much less of a problem. And generally much more work needs to be done on risk management.

The Future of the Government Involvement

The fifth panel session was moderated by **Chrystia Freeland, United States Managing Editor of the Financial Times.**

Professor Jordi Canals, Dean of the IESE Business School, at the University of Navarra started by looking at the lessons that could be learnt from the past, but also said that it was important not to forget that entrepreneurship is vital to the functioning of a modern economy. The future is about building new institutions and new organisation, not so much about protecting the past. Having said that, over the past 30 years we have learned that government intervention can be good provided it does not end up by stifling competition and rivalry. Time constraints should be set up for government interventions, very clear exit strategies should be designed so that companies that have been under the government control could get back to normal functioning with normal market measures. And those that need to be liquidated could be liquidated.

Looking towards the financial services industry where Professor Canals has specific experience, he feels that part of the problem has to do with diversification, with financial conglomerates which government regulation was simply not able to control. He would like to see a return to the notion of retail banking, of narrow banking for those institutions which have an explicit or implicit guarantee by the government. Those institutions should be treated like public utilities. They should be expected to have normal returns but their executives should not be allowed to undertake risk that would put the whole system into disarray.

In a modern economy, you can have other specialised institutions that do other things, but both investors and the general public should know that those institutions may fail. So if they want to invest in those institutions, it's their responsibility and there will be no government bailouts for them.

Finally, governments should beware of reacting to public pressure and regulating just for the sake of being seen to be doing something. From the evidence which was provided at the conference, it is clear that there is not enough empirical evidence to say that some governance solutions are going to be better than others. There is a pedagogical need for both governments and senior leaders to explain to society

in a very clear way that regulation, unfortunately, is not going to solve corporate governance problems.

"It's very important," he concluded "not to forget that, especially in non-financial institutions, it's the responsibility of boards of directors to make decisions and the responsibility of investors to engage or to sell the shares of those companies if they are not happy."

Jim Millstein, Chief Restructuring Officer at the US Treasury's Office of Financial Stability spoke next in his own capacity, not as an official representative of the US Treasury which he had recently joined.

Since the Great Depression, US intervention in actually owning private companies has been very ad hoc and episodic. What has happened now is the first sustained, systematic approach, even if it looked pretty ad hoc in its invention, but it is systematic in the sense that it's a system-wide approach to intervention in the ownership structures.

However, the US government is a very reluctant shareholder in its financial institutions and in the automotive sector. The current situation is not viewed as a long-term instrument of policy but rather as a short-term necessity to deal with the instability of the financial system which was done primarily with the goal of stabilising the financial system.

Having said that, enormous investments of taxpayer money have been made in the sectors and the Treasury is duty-bound to try and get as much of that money back as possible to protect the taxpayers.

After a lot of deliberation, the Paulson Treasury Department and the Bush Administration finally settled upon buying preferred stakes which are largely non-voting. They have rights to appoint directors in the event dividends are missed for four consecutive periods, which is a typical provision of a preferred stock.

In certain circumstances, AIG among them, the government took an immediate voting stake. But again, the government has been exercising their voting stake largely as a kind of activist investor. No government employees have been put on the board of AIG. They have used their voting stake to repopulate the board and to try and create as strong a board as possible.

Government intervention is not one of active government intervention in the ownership and control and management day to day in private corporations, but rather in furtherance of the policy goal of financial stability, with as much respect for corporate governance as possible in these circumstances.

The next speaker, **Damon Silvers, Associate**

General Counsel AFL-CIO, and Deputy Chair of the Congressional Oversight Panel for TARP made it clear before he spoke that the opinions he was giving were his own rather than of the AFL-CIO.

He set out the different types of government intervention which were going on in the US and which therefore had different corporate governance implications.

He started with the least intrusive intervention, apparent private transactions that are in fact publicly funded, meaning that liquidity or credit was made available to facilitate those transactions, such as the acquisition of Bear Stearns by JP Morgan Chase.

Then there are what he called normal equity infusions under the Capital Purchase Programme (CPP) into several hundred banks which were deemed to be healthy and where the equity infusions are preferred stock without voting powers.

Thirdly, he considered radical equity infusions in the banking sector, the second level investments that were made in Citigroup and Bank of America. In these two firms there was not just one layer of CPP infusion but another layer, done initially on an ad hoc basis but then later put into a program called the Targeted Investment Program (TIP). The result is substantial government holdings in these two firms.

Then there is the case of AIG where effectively, through the trust mentioned earlier, the government is the 80% equity holder and where it radically diluted the existing company shareholders.

Finally, at the far end of the intervention scale are the growing number of small to medium sized banks such as Washington Mutual and IndyMac Federal where the government took control without taking ownership.

Mr Silvers went on to differentiate the interventions in the automotive industry from the financial services industry. The automotive industry now had balance sheets that worked – they just had to find the products that worked. The government bailouts had put them in a position whereby they could continue to function effectively, albeit with major and possibly painful changes. The financial service sector balance sheet by comparison was still broken. For all the calls for early exits by the government, there can be no early exits because if the funding was withdrawn, the sector would collapse.

“Three out of four of this country’s largest banks are living off of CPP money. We can’t let them return it, they’ll be too unstable if they do. I think these discussions about how capitalism would be better and capitalism wouldn’t involve this stuff are just hallucinations,

they’re pieces of ideology disconnected from what is actually happening in the world. And I think that what we ought to do is have a conversation about what we actually are dealing with here,” he concluded.

Jim Millstein addressed this point during the panel discussion. He said, “If all we’ve done is put capital in and hope to get it back then we’ve not really done what we came to do. What we’ve got to do is clean up the system and cure the excesses and provide the government with tools other than putting capital to work, which is resolution authority, to deal with the structures that develop that we don’t have.”

Summing up

In the final summing up session, **Marco Becht, ECGI’s Executive Director**, reminded the audience that comparisons of corporate governance and regulatory approaches have undergone swings of overconfidence in the United States, the United Kingdom and continental Europe. During the last 18 months Europe and America have both been humbled by the failures in the transatlantic financial system and by the crisis that we are starting to recover from today. This collective difficulty poses an important question for scholars *“How can we explain the joint failures in the countries of the European Union and in America that have occurred despite of the differences in corporate governance structures and different regulatory systems we have traditionally emphasised?”*

Speakers and the audience at the Conference suggested some but by no means all the answers. It is quite clear that the public authorities, as one of the speakers suggested *“have been making it up as they went along”*. The challenge now is to determine how best to move forward from here. One issue all conference participants seemed to agree on is the need for a special resolution regime for dealing with insolvent banks. Moral hazard is a real problem for corporate governance. Europe and America should not devise a new regime in isolation. They must share a common view and a common solution.

Ethiopia Tafara, Director of the Office of International Affairs, US Securities and Exchange Commission drew two points out of the discussion, stressing that they were his personal views and not those of the SEC.

“Certainly, any new regulatory framework must address the issue of increased systemic risk. But it must do so without suppressing risk-taking per se. This is crucial if we are to address problems yet not undermine economic innovation. And to sustain the experimentation and

innovation needed to drive modern growing economies, financial capital must be able to take risks.

"As a corollary, we need a regulatory framework that provides prudent regulation for those financial intermediaries that are too big to fail. Surely the essence of our financial system is to let people take chances with their money and to enjoy most of the benefits and to endure most of the pain associated with taking risks?"

"However, if we are in a world where financial entities are too big, too indebted, or too interconnected to fail, we know that those entities will have an incentive to take on excessive risk at the ultimate expense of the public. But from a policy perspective, I think we want to end up in a world where in fact we can afford to let financial entities fail if they make bad decisions."

On his second point he said, "As we consider regulatory reform, we should not lose sight of the differences between market regulation and the supervision of financial institutions. Banking and securities regulators historically have a common interest in maintaining the health and soundness of financial firms, for example, by requiring the firms to maintain capital reserves. And all functional regulators have an interest in enforcing the law.

"But there are also differences. For example, the inherent tension between consumer protection and systemic stability often means that enforcement activities of banking supervisors are negotiated and conducted more discretely. This happens because banking supervisors are concerned that public enforcement activities will lead depositors to lose faith in the firm involved, possibly leading to a run on the bank.

"By contrast, securities regulators tend to have aggressive and public enforcement programs, with punishment meted out in the public square, as it were. Securities regulators are focused on investor confidence. Trust is the lubrication that keeps the wheels of the capital market from grinding to a halt, it is the faith that a buyer is buying what he or she expects, and the faith that the seller will see the payment promised at the time promised. And this faith has never been blind. In small markets, this trust is based on personal interaction.

"With the anonymous trading that characterises modern capital markets, this personal faith has been replaced by a surrogate -- clear and useful and timely

information about the products bought and sold, rules on fair dealing between buyers and sellers, and vigorous enforcement by regulators with the powers and resources necessary to do the job."

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