

II. The Theoretical Context of Regulation

1. Modern Understanding of Regulation

In both common law and civilian legal systems, regulation has traditionally been thought of as part of the state function, i.e. legal rules that applied to everyone, and were applied by the courts.⁶⁰ In the 1980s, however, new interactions between the private and public sectors became apparent, and it was realized that regulation is more complex as it occurs in companies, large organizations, committees and professions.⁶¹ Regulatory power is even more dispersed in our time, and self-regulation is attractive to various parties.⁶² As a result, the notion of a ‘decentred understanding of regulation’ is softening the traditional state perception.⁶³ In modern theory, two considerations have to be taken into account. First, regulators are confronted with the challenge to find the correct balance between inaction and activism of punishing breaches. The concept of ‘responsive regulation’ basically says that governments should be responsive to the conduct of those they seek to regulate, and in deciding whether a more or less interventionist response is required.⁶⁴ Second, government intervention is often justified due to market failures, which typically occur when market transactions give rise to spillover effects (externalities) on third parties, or when there is information inefficiency in the market.⁶⁵ Thus, regulation addresses not only economic goals, such as monopolies, public goods, externalities, information deficits, coordination and planning; but also non-economic ones, like distributional justice and community values.⁶⁶ Based on these considerations, regulation addresses its goals mainly through government regulation and self-regulation.⁶⁷

2. Definition

Just as theories of regulation evolve over time and are not unified, there is also no fixed definition of the term ‘regulation.’⁶⁸ On the one end of the spectrum, regulation can be thought of as a set of rules pronounced under statute. This is a simplistic and narrow definition as it excludes process, actors and

⁶⁰ Ibid, p. 16.

⁶¹ Highly globalized industries, dominance of multinational companies that engage in significant business activity in many countries and whose products are distributed and marketed worldwide; public-private partnerships, etc.

⁶² Advantages and disadvantages discussed below at A.II.4.; Uche, JFRC, 2001, p. 5.6.

⁶³ Black, 2001, p. 110.

⁶⁴ Pyramid model of enforcement sanctions, see Ayres/Braithwaite, 1995, p. 38. Critics for its weak theoretical grounds, and for not questioning the objective of regulation, see Barton, 2008, p. 2. Even advancing notion to ‘really responsive regulation’, Baldwin/Black, LSE, 2007, pp. 1 ff.

⁶⁵ Uche, JFRC, 2001, p. 5.2.

⁶⁶ Barton, 2008, p. 16.

⁶⁷ “Formal, informal regulation and self-regulation,” Porket, IEA, 2003, p. 1. The term *self-regulation* is inherently slippery and imprecise, combining two apparently conflicting ideas.

⁶⁸ Hertog, 1999, p. 223; Currie, UTS, 2005, p. 2.

differences between regulations from other bodies of rules.⁶⁹ On the other end, regulation may include any mechanism of social control and influence. Whilst this approach is less legalistic, it includes all law; and is, therefore, too wide to define the area of regulation that is subject to this paper. A definition by Black (2001) was already found to be valuable in another area,⁷⁰ and may help within our context. Thus, regulation is understood to be “the international, goal-directed, problem-solving attempts at ordering undertaken by both state and non-state actors.”⁷¹ Just as state-run bailouts, rescue plans and legislative efforts are addressing the roots and dealing with the ongoing GFC,⁷² the private sector and especially financial companies are reconsidering their CG mechanisms and standards for the same reason.⁷³ Accordingly, the goal of regulation is not to be detrimental to markets, or rather it is often necessary to bring markets into existence and to maintain them.⁷⁴ It is also not only put into effect by the state, but it also includes self-regulation by non-state actors. The central point of regulation is the interaction between regulator and policies, law, and regulated and affected parties.⁷⁵ So understood, this paper includes legislative responses to the GFC but also economic instruments, CG mechanisms and self-regulation.

3. Government and Self-Regulation

Taking into account the definition by Black and its underlying theories, regulation “undertaken by the state” refers to government regulation and intervention, which includes all of the government-imposed restrictions and requirements on people, firms and organizations.⁷⁶ Another form of decentred regulation “undertaken by non-state actors” is self-regulation. This is possible in areas where a group can organize itself in order to control the behaviour of its members.⁷⁷

Self-regulation, therefore, involves non-government organizations (SROs),⁷⁸ specific sectors or industries that impose regulation on the collective and those who accept its authority.⁷⁹ Whilst it is not exclusively dependent on the state,⁸⁰ self-regulation can also “occur in the three traditional components

⁶⁹ Barton, 2008, p. 11.

⁷⁰ Even though in the areas of energy and natural resources, see Barton, 2008, p. 13.

⁷¹ Black, J. (2002) ‘Critical reflections on regulation,’ cited in Barton, 2008, p. 13; similar in Black, OECD, 2001, p. 2.

⁷² Government regulation, see below at C.

⁷³ Self-regulation and corporate governance, see below at A.II.4.iii. and B.

⁷⁴ Barton, 2008, p. 17.

⁷⁵ Ibid, p. 14.

⁷⁶ There are, of course, different definitions of each type, but this is beyond the scope of this paper. Deardorff's Glossary of International Economics; Government intervention: “[...]part of government regulation, foremost affect economic activity, resource allocation [...]”.

⁷⁷ Barton, 2008, p. 28.

⁷⁸ Self-regulatory organization; Carson, WB 2009, p. 3.

⁷⁹ Barton, 2008, p. 28.

⁸⁰ Ibid, p. 28; Sheng, 1997, parag. 4.

of legislation, enforcement and adjudication”, and can be as complex as government regulation.⁸¹ Means of how SROs can ‘self-govern’⁸² are generally trade associations, codes of conduct or technical industry standards, for instance standard-form contracts.⁸³

However, even self-regulation is partly dependent on the government, which aims to ensure that SROs remain ‘responsive’ to the public interests.⁸⁴ For instance, the government may require self-regulation, approve industry codes of practice, exercise oversight and control over SROs, or may coerce self-regulation by threatening formal government regulation.⁸⁵

4. Advantages and Disadvantages

i.) Government regulation can protect public interest, and might be advisable for achieving social goals and to fight externalities.⁸⁶ An example of this is the environmental pollution, where statute-backed regulation may reduce both information and enforcement costs.⁸⁷ Regulation by the state as a third party has the advantage of ensuring the maintenance of the separation of power,⁸⁸ and can grant a balanced law-making process, since a point of view other than that of the industry will be considered.⁸⁹ Other authors point out the benefit of standardisation, the psychological effects of restoring trust and ex ante regulation to avoid moral hazards.⁹⁰ The latter are of particular importance regarding the stabilization of the financial sector and the current crisis management.⁹¹

Nevertheless, government regulation is criticized for being inflexible, expensive and “tending to write inefficient rules.”⁹² The latter is stated mainly because of its nature as a third party lacking sector-specific knowledge, which leads to an information problem. In contrast, the capture theory states that regulatory agencies and objectives can be captured by the industry, by interest groups or other political

⁸¹ Barton, 2008, p. 29; Swire, OSU, 1998, p. 7.

⁸² Self-regulation is a part of regulation, see the definition above; self-governance or internal self-regulation are covering the “self” component, meaning the part can be determined by the companies or industries themselves (self-govern).

⁸³ The Federal Act on Stock Exchanges and Securities Trading (“SESTA”). SESTA grants exclusive competences of self-regulation and enforcement to Swiss stock exchanges, see: <http://www.finma.ch/archiv/ebk/e/publik/refer/pdf/20070704_01_e.pdf>.

⁸⁴ See above A.II.1., concept of “responsive regulation.”

⁸⁵ Barton, 2008, p. 29.

⁸⁶ “Social regulation,” Uche, JFRC, 2001, pp. 5–6. Public-interest-theory: Protect the public and provide people with all relevant information necessary for decision-making, see Peltzman/Levine/Noll, 1989, pp. 1 ff.; Sheng, 1997, parag. 11.

⁸⁷ Ogus, 1995, pp. 107–108

⁸⁸ Uche, JFRC, 2001, pp. 5–6.

⁸⁹ Reconsidering the ‘capture theory,’ that argument may not hold when the judiciary is ‘captured’ by the industry; Pitofsky, 1998, p. 1 ff.

⁹⁰ E.g., in the case of rescue packages discussed below at C.II.2.; Zingales, UC, 2009, p. 8–9.

⁹¹ Beales, R. ‘AIG bailout example of moral hazard’, available at: <<http://www.livemint.com/2008/09/17234549/AIG-bailout-example-of-moral-h.html>>.

⁹² Becht/Bolton/Röell, ECGI, 2005, p. 122.

participants they are supposed to regulate.⁹³ Furthermore, studies found little evidence that “government regulation, especially in the form of state intervention, is generally beneficial to the public,”⁹⁴ Moreover, market mechanisms are often able to compensate for inefficiencies.⁹⁵

ii.) Self-regulation has been criticised mainly due to the variety of interests that influence its standards. While the regulation process often excludes input from third parties, it may not always cover all concerns in the industry.⁹⁶ It may also lack sufficient enforcement power compared to government regulation. Finally, the traditional concern regarding self-regulation has been that the industry could harm outsiders by generating a cartel, monopoly or otherwise exercising its market power.⁹⁷

On the other hand, the literature emphasises the benefits of self-regulation. It generally offers a more flexible and faster way of setting standards and integrates sector-specific knowledge of those involved in the industry.⁹⁸ As a result, self-regulation standards may be able to mitigate the above-mentioned information problem, which in turn enhances the industry’s reputation.⁹⁹ Finally, it is more cost-effective, since the costs for the government are naturally much lower without enacting laws and maintaining its large-scale enforcement.¹⁰⁰ Besides, adopting self-regulation reduces the likelihood of government regulation, so that the cost for the industry may therefore be lower than the expected cost of complying with state-imposed directives or laws.¹⁰¹

iii.) According to that, regulation in the financial sector has widely emphasized the rationale of self-regulation, which is generally seen as more cost-effective and preferable to government regulation.¹⁰² The role of CG in this sector is, therefore, even more important in terms of both adopting proper standards for the company and the industry itself, as well as complying with the few rules the state may have imposed. Facing the current GFC, it was claimed that the financial sector had relied too much on deregulation and that companies were not able to make use of the ‘freedom’ associated with self-regulation.¹⁰³ Following up this allegation in order to define an area of possible future regulation, the next chapter reveals important failures in CG and discusses how companies, notably their board of directors, should address them.

⁹³ Critique on the public-interest theory by Stigler, 1971, pp. 3 ff. Peltzman also presents a modification of this model in an earlier paper from 1976.

⁹⁴ Friedland, 1962, pp. 1–16; For “Regulatory Process and Price Cap Regulation,” see Ros, NERA 2003, pp. 270 ff. For patents, see Mansfield, 1981, pp. 907 ff.; Hertog, 1999, p. 232.

⁹⁵ Hertog, 1999, p. 231.

⁹⁶ Uche, JFRC, 2001, p. 5,7.

⁹⁷ Swire, OSU, 1998, p. 10.

⁹⁸ Ogus, 1995, p. 98.

⁹⁹ Very detailed in Bartle/Vass, UOB, 1998, p. 35 ff.

¹⁰⁰ “Administrative cost,” see Swire, OSU, 1998, p. 5.

¹⁰¹ Swire, OSU, 1998, p. 9.

¹⁰² Another era of “self-” or “soft-touch regulation,” see Buiter, VOX, 2009, parag. 1.

¹⁰³ Carson, WB 2009, p. 31; Buiter, VOX, 2009, parag. 1; Ingves, IMF, 2004, pp. 1 ff.

B. Corporate Governance

I. Introduction

The next section disambiguates CG. Considering that conflicts of interest lie at the very heart of CG, I will shortly present the fundamental principal-agent problem. Different CG systems and related codes and standards are shaping the cost and benefits of CG in general.

1. Disambiguation: Corporate Governance

Farrar (2008) used the etymology of ‘Corporate’ and ‘Governance’ to sketch the helpful metaphor of “steering a ship, while holding its course and taking care of good order.”¹⁰⁴ Facing this obvious notion of CG as ‘captaining a ship,’ it is much more difficult to determine a clear-cut and generally approved definition.¹⁰⁵

Traditional views on CG are narrow, focusing on legal relations between managers and shareholders.¹⁰⁶ Broader definitions extend the boundaries of governance to consider the role that various stakeholders have in influencing the firm’s behaviour.¹⁰⁷ Others focus on ‘performance versus conformance’ stating that the “shareholders’ desire is generally to make as much money as possible, while conforming to the basic rules of the society embodied in law and local customs.”¹⁰⁸

Recently Mallin (2007) defined CG and brought together a number of key characteristics. Generally, CG refers to the structures and processes of the direction and control of corporations.¹⁰⁹ It shall (i) guarantee an adequate system of control within an organisation leading to the safeguard of assets; (ii) prevent any individual from having too much power and influence; (iii) set up a proper relationship between a firm’s management, the board of directors, shareholders and stakeholders; (iv) make sure that the organisation serves the best interests of the shareholders and other stakeholders, and (v) promote increased transparency and accountability. According to that, complex relationships inside and outside the company, so-called conflicts of interest, lie at the very heart of CG.¹¹⁰

¹⁰⁴ The Latin words *gubernare* or *gubernator* = steering a ship; the French word *gouvernance*= control; Farrar, 2008, p. 3. For the description of the term *corporation*, see Smith/Walter, 2006, p. 74.

¹⁰⁵ Mason/ O’Mahony, JCC, 2008, p. 31; Grandmont/Grant/Silva, DB, 2004, p. 5.

¹⁰⁶ Ibid; Solomon/Solomon, 2004, pp.54 ff.

¹⁰⁷ “Stakeholdertheory.”[...] a set of relationships between a company’s management, its board, its shareholders, and other stakeholders”– OECD Principles 2004, p. 2. Like employees, customers, financiers, suppliers, purchasers, auditors, corporate regulators, the community at large and the government. CCH, NZ, 2004, p. 5; Mason/O’Mahony, JCC, 2008, p. 31.

¹⁰⁸ One of the oldest definitions by Milton Friedman, Spedding, 2008, p. 347; Robert/Monks/Minow, 2008, p. 28; Ioana/Rodica, 2004, p. 204; CCH, NZ, 2004, p. 5.

¹⁰⁹ Mallin, 2007, pp.1 ff.

¹¹⁰ Biswas, 2008, p. 8.

2. Principal-Agent Problem

The basic dilemma in CG is how “suppliers of finance to corporations assure themselves of getting a return on their investment.”¹¹¹ This problem is the consequence of separation of ownership and control in modern corporations.¹¹² It arises in situations characterized by asymmetric information between the principal (owner) and the agent (manager).¹¹³ The agent is usually better informed than the principal and as a result has an incentive to cheat and maximize only his personal benefits, thereby possibly damaging the principal.¹¹⁴ The economic difficulty is to ensure that the agent acts in the interests of the owner.¹¹⁵ The shareholder is the owner because he bears the risk of the firm’s performance and is thus the ‘residual claimant,’ while the stakeholders obtain returns depending on their contract.¹¹⁶ Hence, the solution to the principal-agent problem is first and foremost to design a contract that gives the agent highly powered incentives so that his interests are the same as those of the principal, so that the manager acts as if he were the owner.¹¹⁷

Taking into account these theoretical considerations as well as the above-mentioned survey on the GFC, one can argue that one of the main causes of the subprime mortgage collapse and the following GFC was a fundamental principal-agent problem: Bankers are supposed to manage the funds they receive from the shareholders. However, bonuses and large incentive mechanisms caused bankers to forget about the shareholders’ interest and at the same time ruined companies and even distressed whole economies. The challenge now is to create monitoring mechanisms to ensure that the manager acts in a manner that maximizes long-term profit, which is assumed to be the only interest of the owner and a precondition for the efficient allocation of the firm’s resources.¹¹⁸ However, efforts to mitigate principle-agent problems are costly,¹¹⁹ and the approach itself has been criticized for leaving out major dimensions of CG.¹²⁰ Furthermore, the importance of the principal-agent problem depends on the CG system in which it occurs.¹²¹

¹¹¹ See above B.I.1.; Definition by Shleifer/Vishny, 1997, pp. 737 ff; Boersch, 2007, p. 14.

¹¹² Macey/O’Hara, 2003, p. 95.

¹¹³ Boersch, 2007, p. 14; Falaschetti, FSU, 2008, p. 9.

¹¹⁴ Macey/O’Hara, 2003, p. 95; Boersch, 2007, p. 14.

¹¹⁵ Boersch, 2007, p. 14; Macey/O’Hara, 2003, p. 95.

¹¹⁶ Ibid, p. 14.

¹¹⁷ Other factors reduce the principal-agent costs: market for managers, competition in product markets and capital markets. Macey/O’Hara, 2003, p. 95. Executive compensation is a central function of the board of directors, which will be discussed below at B. II. 5.

¹¹⁸ Board composition, executive compensation and related issues will be discussed below at B. II. 3. and 4.

¹¹⁹ Agency costs refer to the decline in the firm’s value due to the agent’s behaviour, which are in divergence with the owners (see below at B. I. 4.). Biswas, 2008, p. 3.

¹²⁰ E.g., employees, creditors, suppliers, other firms, and the larger public; often not clear who is the principal and who is the agent. Macey/O’Hara, 2003, p. 95; Boersch, 2007, p. 14; Falaschetti, FSU, 2008, p. 9.

¹²¹ The CG systems of the advanced economies can be roughly categorized into stakeholder/insider and shareholder/outsider system. Adding the “Collective capitalism/Asian model” by saying that it was influenced by the German and the US systems. Farrar, 2008, pp. 528–529; Boersch, 2007, p. 14; Gregory, DM, 2001, p. 7.