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IN DEFENSE OF THE BUSINESS CULTURAL VALUES REFLECTED IN THE ITALIAN SECURITIES MARKETS: WHAT THE U.S. 2008 FINANCIAL MELTDOWN CAN TEACH US

*Maria DiMeo Calvelli**

INTRODUCTION

The argument for corporate governance reform in the Italian capital markets has been driven predominantly by the dual goals of encouraging companies to seek financing from these markets and creating a more attractive Italian equity market for both domestic and international investors. The movement has been driven by the need to: (1) increase investor confidence in the Italian capital markets by providing investors with greater protections against risks of expropriation of company value; (2) implement European Community (EC) directives and regulations; (3) react to corporate scandals; and (4) model the corporate governance methodologies of other developed countries such as the United States.¹

In contrast to the United States, in Italy there are few listed companies that are widely held. The typical Italian listed company is instead governed by dominant individual or family shareholders who, without owning a large percentage of the company's cash flow rights, exercise control over a majority of the company's votes. Often, the controlling shareholder exercises voting control without owning a large fraction of the cash flow rights flowing from ownership.² In such a company, the minority shareholders' security holdings reflect predominantly a right to the flow of company profits. The valuation of the initial investment in the company

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1. Luca Enriques, *Modernizing Italy's Corporate Governance Institutions: Mission Accomplished?* 3, 41-42 (Eur. Corp. Governance Inst., Working Paper No. 123/2009, 2009), available at <http://ssrn.com/abstract=1400999>. See, e.g., Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Economic Consequences of Legal Origins*, 46 J. ECON. LITERATURE 285 (2008) [hereinafter La Porta et al., *Economic Consequences*]; Jonathan R. Macey, *Italian Corporate Governance: One American's Perspective*, 1998 COLUM. BUS. L. REV. 121.

2. See, e.g., Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 486 (1999) [hereinafter La Porta et al., *Corporate Ownership*] (discussing how Fiat's pyramidal ownership structure results in one person or family controlling 20% of the voting rights but only 15.47% of the cash flow rights).

(purchase price) is presumably derived from the limited contractual rights of the security acquired. Interestingly, the difference between the value of voting and non-voting shares of Italian corporations has been found to be one of the highest in the world.³ Such a price differential demonstrates the ability of the market to distinguish between the rights flowing from the purchase of one type of company security and another security of the same company.

Much has been written about the different consequences for corporate governance resulting from different ownership structures.⁴ The literature has focused predominantly on the need to reform governance systems to increase the protection afforded to minority shareholders.⁵ Reforms are meant to address the imbalance between: (1) the cash flow rights available to minority shareholders and voting rights controlled by dominant entrenched shareholders; and (2) the cash flow rights and limited voting

3. See Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 568 Table 6 (2004); Luca Enriques & Paolo Volpin, *Corporate Governance Reforms in Continental Europe*, 21 J. ECON. PERSP. 117 (2007); Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross Country Analysis*, 68 J. FIN. ECON. 325, 327–28, 331–36, 340–41 (2003); Luigi Zingales, *The Value of the Voting Right: A Study of the Milan Stock Exchange Experience*, 7 REV. FIN. STUD. 125, 125–26 (1994), available at <http://faculty.chicagobooth.edu/luigi.zingales/research/papers/votingright1994.pdf> [hereinafter Zingales, *Value of the Voting Right*].

4. See, e.g., La Porta et al., *Corporate Ownership*, *supra* note 2. Note that recent work by Lucian A. Bebchuk and Assaf Hamdani has pointed out the need for a separate methodology to assess the level of corporate governance protection provided to outside investors in both controlling shareholder companies and non-controlling shareholder companies, and has further identified key features that these separate methodologies should include. According to Bebchuk and Hamdani,

any attempt to assess the governance of public firms around the world should depend critically on ownership structure. Some arrangements that benefit outside investors in companies without a controlling shareholder are either practically irrelevant or even counterproductive in the presence of a controlling shareholder, and vice versa.

Because of this fundamental difference between companies with and without a controlling shareholder, any governance-rating methodology that applies a single metric to companies or countries worldwide is bound to produce an inaccurate or even distorted picture.

Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263, 1316 (2009).

5. See generally Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147 (2002); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998); Andrei Shleifer & Daniel Wolfenzon, *Investor Protection and Equity Markets*, 66 J. FIN. ECON. 3 (2002). See also Ross Levine, *Law, Finance, and Economic Growth*, 8 J. FIN. INTERMEDIATION 8, 24 (1999) (discussing how economic growth is supported by the existence of legal systems that protect the outside shareholders); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1139 (1997) [hereinafter La Porta et al., *Legal Determinants*] (surveying 49 countries and finding that smaller and narrower capital markets are associated with countries with lower levels of investor protection).

power available to minority shareholders and day-to-day control exercised by entrenched management.⁶ Hence, the goals of reforms in general have been to hold managers accountable to minority shareholders and to prevent or limit the exposure of minority investors to the opportunism of the inside dominant or controlling shareholders.

Since at least 1998, Italy has begun the actual process of reforming its corporate governance. Much of this work has been in alignment with the corporate governance standards of the U.S. The Draghi Law, for example, resulted in changes to the process used for capital markets offerings as well as takeovers, to the disclosure obligations of corporations, to the functioning of audit firms, and to minority shareholder rights, all in ways intended to mirror the U.S. and U.K. approach to corporate governance.⁷ These developments appear to be aimed at improving buyer comfort with respect to investing in securities listed on the Italian capital markets.

There is no doubt that Italian corporate governance has improved significantly since the passage of the Draghi Law and subsequent reforms.⁸ And yet, there is a general sense that the Italian capital markets continue to lag behind the capital markets of the U.S. and the U.K.⁹ As Italy has improved its corporate governance, these benchmark countries have also continued to move forward with corporate governance reforms. In addition, the political, legal, and business cultures of common law countries continue to be viewed as more favorable to the development of capital markets than those of civil law countries such as Italy.¹⁰ Policymakers and academics, therefore, continue to worry about the competitiveness of the Italian capital markets and their ability to attract investors.

In assessing this competitiveness, much research has focused on the need for additional reform, particularly in the area of increasing investor rights with regard to the ability of controlling shareholders to divert to themselves company value apart from the value of their share ownership.

6. Compare Zingales, *Value of the Voting Right*, *supra* note 3 (stressing that there are economic benefits to control that corporate governance should address) with Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (stressing that the agency theory proposes that governance mechanisms are necessary in order to align the interests of management with those of the owners).

7. See Enriques, *supra* note 1, at 13.

8. See *generally id.* (analyzing the effect of governance reforms and concluding that positive changes have resulted from such reforms though there is still room for improvement).

9. Richard Cartey, *EU Lags Behind US in Entrepreneurial Culture*, EUOBSERVER.COM (Jan. 17, 2005, 5:27 PM), <http://euobserver.com/?sid=9&aid=18157> (last visited Feb. 4, 2011) (concluding that the main reason for the lack of entrepreneurial spirit in the EU is the difficulty in finding financing); *Leaders: Italy's Unfinished Business*, ECONOMIST, Oct. 14, 2000, at 21 (discussing how the reform movement of the 1990s has been ineffective as economic growth in Italy has been the slowest of all the European countries and blaming the lack of political will for this ineffectiveness); *The Real Sick Man of Europe; Italy*, ECONOMIST, May 21, 2005, at 11 (discussing how Italy's economy is stagnant and its corporate governance continues to suffer).

10. See *generally* Enriques, *supra* note 1; La Porta et al., *Economic Consequences*, *supra* note 1.

Many have been advocating reforms directed at neutralizing the power of controlling shareholders.¹¹ While Italy's reform program since the 1990s has focused on increasing the voice of minority shareholders in company matters, improving internal controls, and expanding disclosure obligations, its current challenge remains tackling the problem of the expropriation of corporate benefits by controlling shareholders at the expense of the minority. In response, in April 2008, the Commissione Nazionale Per Le Società e La Borsa (CONSOB)—the Italian version of the SEC—issued a draft regulation (which it formally adopted in March 2010) addressing related party transactions, the effect of which is to provide a check on the power of controlling shareholders.¹²

In the United States, the current fundamental problem of corporate governance is how to deal with the conflict of interest between dispersed minority shareholders and powerful controlling managers. This problem, which is a product of the separation of ownership and control,¹³ has resulted in what many consider to be excessive managerial risk-taking, incentivized by the structure of management compensation awards.¹⁴ Articles in the mainstream media put at least part of the blame for the full market meltdown occurring in the second half of 2008 on excessive risk-taking by corporate executives.¹⁵ Pay for performance compensation packages (equity-based compensation—most prominently in the form of awarding stock options) have been criticized for incentivizing senior executives to manipulate earnings and increase risk-taking in the name of short-term

11. See Enriques, *supra* note 1, at 8–9.

12. See CONSOB Resolution, 12 marzo 2010, n. 17221, in Gazz. Uff. [G.U.] 25 marzo 2010, n. 70 (It.), available in English at <http://www.consob.it/mainen/documenti/english/laws/reg17221e.htm>.

13. ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 119–125 (1933). See generally Jensen & Meckling, *supra* note 6.

14. E.g., Press Release, U.S. Dep't of the Treasury, Statement by Treasury Secretary Tim Geithner on Compensation (June 10, 2009), <http://www.ustreas.gov/press/releases/tg163.htm> (stating that “compensation should be structured to account for the time horizon of risks”); Lucian A. Bebchuk, Alma Cohen & Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 27 *YALE J. ON REG.* 257, 261 (2010) (analyzing the compensation of the top-five executive teams of Lehman Brothers and Bear Stearns during the 2000–2008 period and concluding that “given the structure of executives’ payoffs, the possibility that risk-taking decisions were influenced by incentives should not be dismissed, but rather, should be taken seriously”). See also Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers’ Pay*, 98 *GEO. L.J.* 247, 249 (2010) (suggesting there is wide recognition that pay packages which focus excessively on short-term results produce incentives for excessive risk-taking and stating “[e]xcessive risk-taking in the financial sector has played an important role in the major financial crisis of 2008-09”).

15. E.g., Leo Hindery, Jr., *Why We Need to Limit Executive Compensation*, *BLOOMBERG BUSINESSWEEK*, Nov. 4, 2008, http://www.businessweek.com/managing/content/nov2008/ca2008114_493532.htm (describing how excessive CEO pay is at the center of America's economic problems); Matt Townsend, *Lehman, Bear Officials Made \$2.5 Billion, Study Says (Update 1)*, *BLOOMBERG*, Nov. 23, 2009, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aLS5o0JQrykE> (executive pay may have encouraged risk-taking).

gains so as to maximize payouts available from exercising their options.¹⁶ The result was a system-wide failure to manage and control risk and to use risk management to inform management decision-making.

To date, the Italian reform process has been necessary and effective, modeling the approach of common law countries such as the U.S. The 2008 financial crisis, however, clearly demonstrates that there continue to be significant governance risks and issues associated even with the U.S. approach. This Article argues that, while certain reforms relating to controlling shareholders may still be necessary in order to improve the attractiveness of the Italian market to investors, careful consideration should be given to the potential positive aspects that derive from the existence of controlling shareholders. It is time, therefore, to consider whether Italian reforms should now focus on improving the business cultural advantages inherent in the current Italian capital markets system, as opposed to moving solely in the corporate governance direction of the U.S. and the U.K.

Part I provides background information on the business culture of Italy with particular emphasis on the corporate structure of listed companies. Part II is a summary of the corporate reforms implemented by Italy since the early 1990s; the emphasis of which, in conformity with changes in U.S. corporate governance laws, has been predominantly on improving minority shareholder rights with respect to their companies.

Part III is a discussion of the 2008 U.S. financial crisis, which occurred despite the fact that the U.S. had earlier engaged in shareholder rights and other corporate governance reforms and despite the fact that corporate ownership in the U.S. is characterized by institutional shareholders who are supposedly more inclined and more likely to monitor corporate decision-making. Part III explores the idea that at least part of the meltdown was the result of uncontrolled managers who were incentivized by compensation pay packages to focus on short-term gains instead of long-term company goals. This Part further theorizes that this type of managerial expropriation is at least as dangerous to shareholders as the issues that arise as a result of the business culture of Italy.

Part IV explores the idea that the time has come for Italian reforms to cease mirroring those of the U.S. and the U.K. Instead, Part IV argues that Italy should look to the future and focus its reforms so as to maximize the potential benefits that may flow from the existence of a controlling shareholder, including the ability of a controlling shareholder to “manage” management. Emphasis should be placed on this positive role and, moving forward, regulatory reform should seek to balance the need for changes which increase investor confidence and investor protections with the potential positive role inherent in the existence of a controlling shareholder. This Part further supports the existing cry for additional reforms to the

16. See *infra* Part III.

Italian capital markets in the areas of greater transparency in the workings of controlling shareholders and improvements in anti-fraud enforcement.

PART I: BUSINESS CULTURAL ENVIRONMENT IN ITALY

Industrialization came late to Italy. By the end of the 1800s, Italy lagged behind with an economy that was primarily agricultural. The first phase of industrialization in Italy occurred from 1896 to 1914 when universal banks, Banca Commerciale Italiana and Credito Italiano, provided financing for entrepreneurial initiatives in the transportation (train engines and automobiles) and mining industrial sectors. Even so, early on the Italian government's intervention was necessary to rescue certain of these entrepreneurial companies. In 1911, for example, the Italian government rescued the entire steel industry. Until 1990, when the state began to actively divest itself of its corporate holdings, the Italian state actively controlled the economy through its role as controlling shareholder of many of the for-profit companies. State intervention in the economy continued to expand through the creation of state agencies, such as the Istituto per la Ricostruzione Industriale (IRI) in 1933 and later Ente Nazionale Idrocarburi (ENI) in 1952, which managed the portfolio of companies controlled by the banks. This continued intervention by the state replaced the role of private financing and stifled the development of the Italian capital markets. Instead, the state played an inordinately extensive role in capitalizing companies and bailing out financially troubled companies. As the largest shareholder in the capital-intensive sectors of the economy, the state placed little emphasis on, and had little concern for, investor protection. In this environment of state intervention and low investor protection, the economy was characterized by state control in capital intensive industries and private family capitalism for which the capital markets held no attraction.¹⁷

The economy of Italy began to change dramatically after the end of World War II. From an agriculturally-based economy where large sectors were controlled by the state, it has now developed into an industrial country ranked in 2009 by the World Bank as the world's seventh largest economy based on GDP comparisons¹⁸ and the world's tenth largest in terms of purchasing power parity.¹⁹ Today, Italy's economy derives in large part from the processing and the manufacturing of quality consumer goods—primarily in small and medium-sized family-owned firms—which typically

17. See generally Alexander Aganin & Paolo F. Volpin, *The History of Corporate Ownership in Italy*, in A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FROM FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS 325 (Randall K. Moreck ed., 2005) (detailing a complete historical review of the economic and regulatory policy of Italy and its role in limiting the growth of Italian capital markets).

18. Gross Domestic Product 2009, WORLD BANK, <http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf> (last revised Dec. 15, 2010).

19. Gross Domestic Product 2009: PPP, WORLD BANK, http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP_PPP.pdf (last revised Dec. 15, 2010).

face significant international competition.²⁰ Most Italian corporations continue to be privately owned and privately controlled. There are few listed companies in Italy, though this number has begun to increase in recent years, and of the companies listed very few have shares that are widely held.²¹ The economy and business culture of Italy seems to be dominated by single-owner or family-owned firms.²²

Those Italian companies which are listed are typically characterized by the existence of a dominant or controlling shareholder—usually a family—who controls voting power. One common model is where the controlling shareholder exercises voting control without owning a significant fraction of the cash flow rights.²³ The separation of control from cash flow rights is often accomplished in one of three ways: use of a pyramidal structure,²⁴ cross-shareholding structures or dual share structures in which voting shares are retained by the controlling or dominant shareholder,²⁵ and restricted voting (or non-voting) shares issued to outside investors.²⁶ In 1995, 15% of the twenty largest listed companies in Italy were controlled by an individual (family control)²⁷ and 20% of the twenty largest listed companies were

20. The World Factbook: Italy, CENTRAL INTELLIGENCE AGENCY, <https://www.cia.gov/library/publications/the-world-factbook/geos/it.html#Econ> (last visited Feb. 5, 2011).

21. *Compare* Companies Admitted to Listing from January 1995 to January 2011, BORSA ITALIANA, http://www.borsaitaliana.it/borsaitaliana/ufficio-stampa/dati-storici/listing2011.en_pdf (last visited Mar. 2, 2011) (listing 357 companies on the Borsa Italiana Exchange), with Press Release, NYSE Euronext, NYSE Announces New Contract for Dick Grasso Through May 2007 (Aug. 27, 2003), <http://www.nyse.com/press/1061982038732.html> (indicating that between 1995 and May 2007 alone, 1,549 companies were added to the already 2,800 companies listed on the NYSE). See also La Porta et al., *Corporate Ownership*, *supra* note 2, at 492 tbl. II.

22. Macey, *supra* note 1, at 141–42.

23. Enriques & Volpin, *supra* note 3, at 117–19.

24. “The separation of ownership from control” as affected by the use of the pyramidal structure is demonstrated by “Telecom Italia, one of the world’s largest telecom companies.” Enriques & Volpin, *supra* note 3, at 119. The ownership structure of Telecom Italia in 2005 was pyramidal in nature with Marco Tronchetti Provera controlling 18% of the votes in Telecom Italia while holding only 0.7% of the cash flow rights. *Id.* Tronchetti was by far the largest shareholder of Telecom Italia and his controlling interest is owned through a series of subsidiary relationships owned and controlled ultimately by the Tronchetti family through the GPI, Camfin, Pirelli, and Olimpia companies. *Id.* at 119–21. Control by Tronchetti with respect to the voting power in Telecom Italia is further reinforced through a voting “agreement with other large shareholders” of the Pirelli subsidiary. *Id.* at 120. As a result, Tronchetti controls 46.1% of the votes in Pirelli (25% directly held by Tronchetti’s holding company, Camfin, and an additional 21.1% as a result of the voting syndicate), Pirelli controls 50.4% of the votes in Olimpia and Olimpia controls 18% of the votes in Telecom Italia making Provera by far the largest shareholder of Telecom Italia. *Id.* at 120–21.

25. See Lucian Arye Bebchuk, Reinier Kraakman & George G. Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash Flow Rights*, in CONCENTRATED CORPORATE OWNERSHIP 299–301 (Randall K. Morck ed., 2000).

26. See *id.* at 297–301.

27. La Porta et al., *Corporate Ownership*, *supra* note 2, at 492 tbl. II.

controlled through at least one publicly traded company (pyramidal control).²⁸

This family or dominant shareholder control of a company is not necessarily bad. In fact, research shows that, on average, a family controlled company is better managed than one where shareholdings are widely dispersed.²⁹ Such control may more closely align shareholder interests with those of management. A controlling shareholder, for example, commonly has both the incentive to monitor management and the opportunity to do so.³⁰ This shareholder holds a significant enough number of shares to empower him to participate in the running of the company through both formal channels (such as by choosing management) and informal channels (exerting influence). Since family or dominant shareholders are in a better position to utilize resources to monitor managers and to influence the decision-making of the firm so as to maximize share value, the existence of such shareholders can help protect all shareholder interests from management abuses. These benefits of control accrue, through the action of the dominant shareholder, to all shareholders.³¹

On the other hand, controlling shareholders in pyramidal structures—such as those found in Italy—both limit outside shareholders' ability to influence decision-making and pose the threat of expropriation of private benefits, which favor the dominant shareholder at the expense of these minority shareholders. The controlling shareholder may extract corporate resources from the corporation which serves the shareholder's own exclusive benefit yet may have adversely effect the value of the minority's shares. These private benefits include management perks such as excessive compensation to management owners, managerial deference, and self-dealing transactions—such as “tunneling”³² and the transfer of assets and profits from a company to controlling shareholders—as well as social and

28. *Id.* at 499 tbl. IV.

29. See Ronald C. Anderson & David M. Reeb, *Founding-Family Ownership and Firm Performance: Evidence from the S&P 500*, 58 J. FIN. 1301 (2003).

30. Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1651 (2006).

31. Silvia Rigamonti, *Evolution of Ownership and Control in Italian IPO Firms 6–7* (Borsa Italiana BitNotes Series, Paper No. 17, 2007), available at http://www.borsaitaliana.it/borsa_italiana/statistiche/bitnotes/numeripubblicati4839/bitnotes17.en.htm.

32. Enriques & Volpin, *supra* note 3, at 122.

A hypothetical example may help to clarify how tunneling works. In the pyramidal group . . . , imagine what would happen if Marco Tronchetti Provera forced Telecom Italia to buy inputs from Camfin at above market prices. This related-party transaction neither creates nor destroys value, because the loss for Telecom Italia is equal to the gain for Camfin. But Tronchetti Provera would be better off, because he pockets 29.1 percent of Camfin's gain and suffers only 0.7 percent of Telecom Italia's loss.

political prestige.³³ Where a controlling shareholder uses his control position to extract or transfer corporate resources for his own private benefit, value is diminished for minority shareholders. The dominant shareholder may, for example, enter into related party transactions between its various companies on terms advantageous to one company and disadvantageous to the other.³⁴ The difference in value that is transferred from the minority shareholders to the dominant one may be referred to as the private benefits of control.

Some have claimed that, as a result of the risk of expropriation which arises with the existence of controlling shareholders, the attractiveness of the Italian securities markets to investors has been significantly diminished.³⁵ Like that of all other capital markets, the challenge for the Italian securities market has been to attract investors willing to purchase stock in listed companies while also attracting or encouraging companies to list shares. The ability to offer shares that enable a family or other controlling shareholder to retain decision-making control may encourage family-owned or dominant shareholder controlled businesses to consider listing. Attracting new companies to list is a necessary component of any securities market. Yet, the securities being offered must also attract investors to buy.

The current Italian business culture, characterized by small and mid-sized family-owned businesses and pyramidal structures that threaten minority shareholders through expropriation, has been viewed as detrimental to the growth of the Italian securities markets.³⁶ Yet, this cultural environment of dominant shareholders also provides a management

33. See generally Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155, 1161–62 (1985) (discussing amenity potential such as prestige and political connections as an attractive private benefit); Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Tunneling*, 90 AM. ECON. REV. (PAPERS & PROC.) 22 (2000) (discussing the many methods of transferring company resources to a controlling shareholder including one who also acts as top management).

34. See Johnson, La Porta, Lopez-de Silanex, & Shleifer, *supra* note 33.

35. See Macey, *supra* note 1, at 132, 140 (providing anecdotal evidence of the same); Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 742 (1997) (“In many countries today, the law protects investors better than it does in Russia, Korea or Italy.”); Zingales, *Value of the Voting Right*, *supra* note 3 (providing empirical evidence that Italian corporate governance did not sufficiently protect investors from expropriation of minority shareholder value).

36. We know, for example, that countries with weaker investor protections have less developed financial markets. See La Porta et al., *Legal Determinants*, *supra* note 5; accord Rafael La Porta, Florencio Lopez-de Silanes & Andrei Shleifer, *What Works in Securities Laws?*, 61 J. FIN. 1 (2006); cf. Disiano Preite, *Investitori Istituzionali e Riforma Del Diritto Delle Società Per Azioni*, 1993 RIVISTA DELLE SOCIETÀ 476 (supporting the conclusion that Italian companies competing on a global basis for financing were at a disadvantage as a result of poor investor protection mechanisms).

monitoring benefit, the value of which has yet to be fully discussed and evaluated.³⁷

PART II: CORPORATE GOVERNANCE REFORMS IN ITALY: A STATUS UPDATE

Italy has been actively engaged in the process of reforming and regulating its capital markets with the goal of increasing investor confidence by increasing shareholder rights. The intention behind the actual legislated reforms and the changes produced by this reform movement has been to align Italy's capital markets with that of the U.S., by mirroring U.S. corporate governance standards.³⁸ The goal of the reforms has been to decrease the need for state intervention and ownership by producing more vibrant capital markets that can meet the financing needs of Italian companies. These vibrant capital markets would decrease the concentrated ownership characterized by the Italian business environment, increase investor confidence, and foster entrepreneurship.

The first step in this reform period began in the 1990s when the Italian government began privatizing state-controlled companies by making shares in such companies available to investors through private sales, IPOs, and, for already listed companies that were state controlled, through the sale of control blocks in the markets.³⁹ This privatization was the first necessary step in decreasing state intervention in companies and increasing dispersed share ownership in these companies. Between 1991 and 1994, investment services and stock exchange regulations were modernized, insider trading was banned, and a new regulatory framework was created for takeover bids, all laying the groundwork for further capital market development.⁴⁰

37. See Bebchuk, Kraakman & Triantis, *supra* note 25 (emphasizing that although corporate structures used for separating control from cash flow rights create significant limitations on the rights of outside shareholders to influence decision-making and thereby increase agency cost, it is necessary to ascertain whether any benefits inure to the outside shareholders as a result of these structures that warrant the increased agency cost).

38. See generally Enriques & Volpin, *supra* note 3.

39. Decreto Legge [D.L.] 31 maggio 1994, n. 332, in Gazz. Uff. 1 giugno 1994, n. 474 (It.), available at <http://www.consob.it/main/documenti/Regolamentazione/normativa/leg474.htm?hkeywords=&docid=2&page=0&hits=16>; Legge [L.] 30 luglio 1994, n. 474, in Gazz. Uff. 30 luglio, n. 177 (It.), available at <http://guide.supereva.it/diritto/interventi/2001/06/51599.shtml>. See also Marcello Bianchi & Luca Enriques, *Corporate Governance in Italy after the 1998 Reform: What Role for Institutional Investors?* (CONSOB Quaderni Di Finanza: Studi e Ricerche, Paper No. 43, 2001) (discussing the legislative reform movement in Italy), available at <http://www.consob.it/mainen/consob/publications/papers/papers.html?symbblink=/mainen/consob/publications/papers/index.html> (follow the "Corporate Governance in Italy after the 1998 reform: what role for institutional investors?" hyperlink) (last visited Feb. 11, 2011). See generally Enriques, *supra* note 1 (summarizing the laws and regulations relating to the reform of the Italian capital markets and Italian corporate governance).

40. Leggi [L.] 17 maggio 1991, n. 157, in Gazz. Uff. 20 maggio 1991, n. 116 (It.), available at <http://guide.supereva.it/diritto/interventi/2001/05/45043.shtml> (banning the use of confidential information for trading by insiders); Leggi [L.] 18 febbraio 1992, n. 149 in Suppl. Ordinario Alla Gazz. Uff. 21 febbraio 1992, n. 43 (It.), available at <http://guide.supereva.it/diritto/interventi/>

Additionally, as an initial move to attract purchasers to these newly privatized companies, 1994 decrees mandated the representation of minority shareholders on the boards of directors of the privatized companies by requiring that one-fifth of the board of director seats, as well as one seat on internal auditor boards—the internal corporate body of Italian corporations responsible for overseeing audit functions—be allocated to these shareholders.⁴¹ The early 1990s, therefore, reflected a growing recognition of the need to decrease state involvement by increasing the attraction of the markets both to those already listed and now privatized companies and to outside investors.

The main legislative reform in Italy began in 1998 with the passage of corporate governance legislation in the form of the Draghi Law.⁴² The Draghi Law was meant not only to apply—as the prior reforms predominantly did—to those companies that were being privatized through the disposition of state holdings to outside investors, but also to any listed or newly listed company. New rights were granted to minority shareholders in these companies and the exercise of existing rights was expanded. Protections were fortified by the requirement that, at extraordinary shareholder meetings, a vote of two-thirds of the capital represented at the meeting was necessary for the approval of amendments to the corporate charter, new issuances of shares, and mergers.⁴³ Shareholders holding at least 5% of the company's capital were now further empowered to sue directors derivatively (later amended in 2005 to holders of 2.5%);⁴⁴ shareholders holding 5% or more of the company's shares could now request that a shareholder meeting be convened;⁴⁵ and shareholders with 10% or more of the company's shares may file a complaint with the court asking for the appointment of an inspector to review the business of the corporation.⁴⁶

The Draghi Law also revised the role, composition, and powers of the board of internal auditors. As in the case of the minority shareholders of privatized companies, minority shareholders of listed companies are now

2001/05/43415.shtml (regulating the process for public offerings, subscriptions, purchases and exchanges of securities and authorizing CONSOB to develop and implement regulations relating to takeover bidding).

41. D.L. n. 332/1994 (It.), arts. 4, 5; L. n. 474/1994 (It.).

42. Decreto Legislativo [D.Lgs.] 24 febbraio 1998, n. 58 (It.), *available at* <http://www.consob.it/main/regolamentazione/tuf/tuf.html?queryid=main.regolamentazione.tuf&resultmethod=tuf&search=1&symblink=/main/regolamentazione/tuf/index.html>; Codice Civile [C.c.] arts. 2368, 2369, *available at* <http://www.altalex.com/index.php?idnot=37056>.

43. D.Lgs. n. 58/1998 (It.), art. 126(4); C.c. arts. 2368, 2369 (It.).

44. D.Lgs. n. 58/1998, art. 129; Codice Civile [C.c.] art. 2393-bis (It.). *See* Legge [L.] 28 dicembre 2005, n. 262, in Suppl. *Organario Gazz. Uff.* 28 dicembre 2005, n. 208 (It.) (reducing the percentage required for derivative suits to 2.5%).

45. D.Lgs. n. 58/1998 (It.), art. 125; Codice Civile [C.c.] art. 2367 (It.).

46. D.Lgs. n. 58/1998 (It.), art. 128; Codice Civile [C.c.] art. 2409 (It.).

also entitled to representation on the company's internal auditor board.⁴⁷ The responsibility of the internal auditors board to focus on controls was also clarified.⁴⁸ By strengthening minority shareholder rights,⁴⁹ these reforms also began limiting the ability of controlling shareholders to extract private benefits.⁵⁰

In conjunction with shareholder reforms, the Draghi Law also sought to increase transparency by overhauling issuer disclosure obligations relating to IPOs and material extraordinary transactions such as mergers, new issuances, acquisitions and dispositions so as to align them more closely with U.S. and U.K. disclosure requirements.⁵¹ For example, required disclosure of ownership structure was expanded to include disclosure of all existing shareholder agreements,⁵² a legal structure often used by Italian companies to cement cross-shareholding relationships⁵³ and thereby increase dominant shareholder control. Disclosure of these agreements began to provide markets with important information regarding the level of entrenched control in a listed company.

Italy continued to revise its corporate law from 2001 through 2005 through the Vietti Reforms. These reforms required that shareholders of listed companies be notified of their right to exercise shareholder voting rights and the amount of shareholdings prior to shareholder meetings.⁵⁴ Corporate charters may require that such communication (usually electronic) be sent at most two days in advance of the meeting. Prior to this reform, shareholders were required to deposit shares for five days before shareholder meetings in order to be able to vote those shares. The reform no longer requires such shareholder blocking, unless the charter expressly forbids trading after the communication is sent. In this instance, trading may be restricted for a maximum of the two day period between notification and the shareholder meeting. If shares are sold prior to the meeting, voting rights are reduced proportionately.⁵⁵ As a result, participation by

47. D.Lgs. n. 58/1998 (It.), art. 148.

48. *See id.* art. 150, 151.

49. *See, e.g.,* Guido Ferrarini, *Corporate Governance Changes in the 20th Century: A View from Italy* 22–24 (Eur. Corporate Governance Inst., Law Working Paper No. 29, 2005), available at <http://ssrn.com/abstract=695762> (discussing how the impact of the Draghi Laws on Italian corporate governance was an improvement on Italian shareholder protection, as calculated by the La Porta corporate governance score, from 1 to 5). *Accord* Aganin & Volpin, *supra* note 17.

50. *See* Dyck & Zingales, *supra* note 3, at 570 (empirically finding that before the passage of the Draghi Law the average value of extracted private benefits in Italy was 47% and after the reform the average had been reduced to 6%).

51. *See generally* Enriques, *supra* note 1; Enriques & Volpin, *supra* note 3.

52. D.Lgs. n. 58/1998 (It.), art. 122(1).

53. Enriques, *supra* note 1, at 10.

54. Codice Civile [C.c.] arts. 2366, 2370.

55. *Id.* art. 2370. For public companies, the share deposit requirement can no longer be imposed for longer than two days in advance of the meeting. In addition, when shares are in electronic form as in the case of listed companies, the deposit requirement is replaced by a

institutional shareholders in shareholder meetings was made significantly more attractive.⁵⁶

Reforms inspired by the U.S. Sarbanes-Oxley Act were introduced from 2005 to 2008. The European Union's Market Abuse Directive strengthened sanctions for insider trading and securities fraud and granted stronger investigative powers to public prosecutors and CONSOB.⁵⁷ In addition, during this time period: (1) minority shareholders were empowered to add items on the shareholder meeting agenda as a result of a reduction in the shareholding requirement from 5% to 2.5% of the capital stock of the corporation;⁵⁸ (2) shareholders holding a minimum of 2.5% of the capital stock of the company could now initiate derivative actions against the directors of the company;⁵⁹ and (3) board representation for minority shareholders was significantly improved by the requirement that at least one director of the governing board in one-tier companies or one supervisory board member in companies with two-tier boards must be elected from a slate presented by the minority shareholders.⁶⁰ Italy has also imposed stricter disclosure obligations for listed companies relating to the compensation of officers and directors based on the granting of stock or securities.⁶¹ CONSOB has been afforded broader powers to ensure that Italian listed companies comply with required disclosure obligations.⁶² Lastly, at the end of 2004, CONSOB was finally empowered to regulate related third party transactions.

In April 2008, CONSOB proposed regulation to revise disclosure obligations applying to related party transactions. On March 12, 2010, Resolution No. 17221 passed new rules governing related party transactions entered into by listed issuers.⁶³ The regulation empowers independent directors, organized in committees and possibly assisted by advisors, to

certification issued by the relevant intermediary attesting to the shareholder's right to vote the shares. *See* Enriques, *supra* note 1, at 28 n.80.

56. Enriques, *supra* note 1, at 28.

57. Council Directive 2003/6, 2003 (L 96/16) (EC); Commission Directive 2004/72, 2004 O.J. (L 162/70) (EC).

58. Legge [L.] 28 dicembre 2005, n. 262, art. 5, in Suppl. Ordinario Gazz. Uff. 28 dicembre 2005, n. 208 (It.).

59. *Id.* art 3; Decreto Legislativo [D.Lgs.] 24 febbraio 1998, n. 58, art. 129 (It.), available at <http://www.consob.it/main/regolamentazione/tuf/tuf.html?queryid=main.regolamentazione.tuf&resultmethod=tuf&search=1&symlink=/main/regolamentazione/tuf/index.html>; C.c. art. 2393-bis.

60. L. n. 262/2005, art. 1.

61. *Id.* art. 16. *See also* CONSOB Resolution 14 maggio 1999, n. 11971, art. 78, 84 (It.) (as amended by CONSOB Resolution 3 maggio 2007, n. 15915 (It.); CONSOB Resolution 1 aprile 2009, n. 16859 (It.), available in English at http://www.consob.it/mainen/documenti/english/laws/reg11971e.htm?mode=gfx#Article_78.

62. Decreto Legislativo [D.Lgs.] 24 febbraio 1998, n. 58, arts. 91, 113–15 (It.), translated at <http://www.consob.it/main/regolamentazione/tuf/tuf.html?queryid=main.regolamentazione.tuf&resultmethod=tuf&search=1&symlink=/main/regolamentazione/tuf/index.html>.

63. CONSOB Resolution 12 marzo 2010, n. 17221, in Gazz. Uff. 25 marzo 2010, n. 70 (It.), available in English at <http://www.consob.it/mainen/documenti/english/laws/reg17221e.htm>.

provide opinions on related party transactions *ex ante*. There are procedural differences for material transactions⁶⁴ and non-material transactions. In connection with material transactions, independent directors are to be specifically involved in the negotiation and preparation of the documentation relating to the third party transaction. The opinion of the independent director committee and any opinions of outside independent advisers must be presented to the corporation's administrative body as a whole. The administrative body shall then take action to either approve or disapprove the resolution authorizing the transaction. In addition, the corporation's administrative body may approve the material transaction regardless of negative opinions of the independent board committee and/or outside advisers if the transaction is approved by a favorable majority vote of the unrelated shareholders (whitewash mechanism).⁶⁵

The regulation further fosters transparency by enhancing existing disclosure requirements. Issuers must publish a disclosure document within seven days of the company's approval of a material related party transaction. The disclosure document must describe the transaction, the economic rationale for the transaction that led the issuer to enter into the transaction, and the method for determining the consideration paid for the transaction. The requirement to disclose is also triggered if, during one fiscal year, the issuer enters into multiple related party transactions with the same related party that, when taken together, would amount to a material transaction. In addition, the annual management report and the interim management report must contain information on the specific material transaction, on other related party transactions (including non-material ones) entered into during the relevant time period and which significantly affect the issuer's assets or earnings, and any change or development in related party transactions described in a previous annual financial report that has a significant effect on the issuer's assets or earnings.⁶⁶

These reforms have translated into important developments for corporate governance in Italy. First, the independence of boards of listed companies has improved as a result of increased minority shareholder representation on boards, the increased role of the audit board, and strengthened procedures and board disclosure relating to self-dealing third party transactions. Second, the power of minority shareholders has increased through easier exercise of voting rights, the availability of derivative suits for holders of at least 2.5% of total shares, and the lowering of thresholds for the exercise of voting rights. Third, greater disclosure has been mandated. Since at least 1998, therefore, Italy has reformed its capital

64. *Id.* at Annex 4. Material transactions are those where certain quantitative parameters identified by the regulation, such as net assets, market capitalization, or total assets and liabilities, exceeds a 5% threshold. *Id.* at Annex 3.

65. *Id.* art. 11, Annex 2.

66. *Id.*

markets regulations so as to increase: (1) transparency with respect to information available on listed companies; and (2) shareholder rights with respect to corporate decision-making with the resulting expectation of increased shareholder protection against the decisions and excesses of both management and—with the passage of CONSOB’s 2010 regulation—controlling or dominant shareholders. These important steps taken to improve investor protection have increased the attractiveness of the Italian capital markets to investors, including institutional investors.⁶⁷ The recent reforms directed at containing the possibility of dominant shareholder expropriation should further positively impact the markets.⁶⁸

PART III: THE 2008 U.S. FINANCIAL CRISIS: THERE IS NO PERFECT SYSTEM

Since the Great Depression, America has not experienced a financial crisis of such magnitude as that produced by the financial meltdown of 2008. In a single year, stock prices had plummeted further than at any other time since the 1930s.⁶⁹ This meltdown occurred despite the significant improvements in U.S. corporate governance made over the past few decades.

In contrast to the Italian capital markets improvements, which have been focused on increasing the attraction of the market to investors, the U.S. improvements have focused on defining the role of the corporation, particularly as a body whose primary goal is to increase shareholder value. In an environment where institutional share ownership increased, the U.S. investor base changed from one comprised of passive individual shareholders to one consisting of investors more engaged in corporate affairs, more watchful of shareholder interests, and more focused on the goal of increasing the value of their share of the company. Since the late

67. Enriques, *supra* note 1, at 35–36.

There is no doubt that the landscape is much friendlier to minority shareholders of listed companies today than ten years ago Although it is of course impossible to measure such improvements, one can go back to La Porta et al.’s indexes to see whether Italy’s updated scores reflect a better corporate governance framework. Starting from the original anti-director index, we can see how Italy’s score has steadily gone up, and is now close to the highest possible.

Id.

68. See Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430, 453–54 (2008) (describing the variables considered in determining the anti self-dealing index score); see also Enriques, *supra* note 1, at 39 (concluding that although the Draghi Law had a modest positive impact on the index which measures a country’s risk of shareholder expropriation of private benefits, the passage and implementation of CONSOB Resolution 17221 will greatly improve this anti self-dealing score).

69. Brian R. Cheffins, *Did Corporate Governance “Fail” During the 2008 Stock Market Meltdown? The Case of the S&P 500* 1–4 (Eur. Corp. Governance Inst., Law Working Paper No. 124/2009, 2009), available at <http://ssrn.com/abstract=1396126>.

1970s, therefore, corporate governance has been the subject of significant debate resulting from the incentive and agency problems associated with management action in the corporation. With the separation of ownership and management, shareholders—whose primary goal is the maximization of the firm's value—are forced to delegate the implementation of this goal to effort- and risk-averse rational agents (managers) who are not necessarily incentivized to take potentially growth producing risks on behalf of the shareholders.⁷⁰ In response to this agency problem, a number of best practices were established in an attempt to align the interests of shareholders with risk-averse management. These best practices include board independence, separation of Chairman and CEO positions, and the use of outcome-based compensation.

Unfortunately, with the revelation of such corporate scandals as Enron, Worldcom, Tyco, Adelphia, and Global Crossing, the 2000s brought increased attention to the need for management accountability. Prompt legislative response arrived in the form of the Sarbanes-Oxley Act of 2002, which sought to restore investor confidence in the marketplace by strengthening the existing corporate governance model with—once again—heightened regulation. With the increase in share prices during the mid- to late-2000s, it appeared that all was well again with the markets and corporate governance.⁷¹ The meltdown of 2008 followed.

Many of the recently failed companies followed all the then-best corporate governance practices. For instance, Lehman Brothers adopted almost all of the suggested governance practices and even reserved a special place on their website to explain that it had sound governance structures in place, including compensation guidelines and a Code of Ethics. Why then the financial crisis? Many causes have been suggested, including an uncontrolled real estate market, the large amount of subprime lending in the U.S., deregulation—in particular, deregulated derivatives—and old-fashioned greed. But underlying all these very specific reasons is a more pervasive one—excessive and uncontrolled risk-taking.

Prior to the 2008 crisis, in most financial institutions, the majority of executive compensation packages consisted of variable, performance-based annual incentives delivered in both cash and equity.⁷² The use of these

70. Jensen & Meckling, *supra* note 6; *cf.* Kathleen M. Eisenhardt, *Agency Theory: An Assessment and Review*, 14 *ACAD. MGMT. REV.* 57, 58 (1989) (discussing how agency theory is concerned with two problems, one of which is the problem of risk-sharing that arises when principals and agents have different attitudes toward risk).

71. See Cheffins, *supra* note 69, at 1. On October 9, 2007, the Dow Jones Industrial Average closed at the record level of 14,164.53. Dow Jones Industrial Average (DJIA) History, N.Y. STOCK & COMMODITY EXCHANGES, <http://www.nyse.tv/dow-jones-industrial-average-history-djia.htm> (last visited Feb. 8, 2011).

72. See Felix Suntheim, *Managerial Compensation in the Financial Service Industry* 8–9 (Sept. 29, 2010) (unpublished manuscript), *available at* <http://ssrn.com/abstract=1592163> (discussing the structure of CEO remuneration where based on an analysis of the CEO compensation packages of

outcomes-based incentives—such as stock options and annual bonuses—as a method of incentivizing management to perform in accordance with shareholder desires, was believed to align the interests of managers with shareholders by allowing managers to profit when shareholders profit. But instead, the use of these compensation systems—in particular stock option grants—as mechanisms for addressing the agency problem has encouraged excessive risk-taking⁷³ on the part of senior executives who, while maximizing their personal payouts from option exercises, contributed to the system-wide failure to manage and control risk that resulted in the 2008 financial crisis.⁷⁴

A problem associated with stock options and other similar methods of compensation is that, with these benefits, management is rewarded when the stock price increases, but management's real wealth is not penalized if the stock price declines. Similarly, the use of annual bonus plans as a management incentive causes executives to focus on single-year performance and to incur risks that foster short-term benefits at the expense of long-term planning.⁷⁵ As a result, management compensation packages have an aggressively risky impact on policy decision-making by executives. By allowing management to recognize the value of equity-based and bonus compensation before the long-term consequences of their decision-making

77 out of 100 of the largest international banks in 1997 finds that CEO pay in the banking industry consists of four different components: base salary, short-term bonuses, stock options, and stock ownership resulting from either the exercise of options and share plans, mandatory minimum requirements on CEOs to own shares, or voluntary purchases made by the CEO).

73. See U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 29 (2009), available at http://www.financialstability.gov/docs/regs/Final_Report_web.pdf (acknowledging that compensation packages were a leading cause of the financial crisis, particularly noting that “incentives for short-term gains overwhelmed the checks and balances meant to mitigate against the risk of excess leverage”); see also Jeffrey L. Coles, Naveen D. Daniel & Lalitha Naveen, *Managerial Incentives and Risk-Taking*, 79 J. FIN. ECON. 431 (2006) (studying the impact of executive compensation packages on risk and policy choices of U.S. banks and finding that CEO incentives do have an impact on risk-taking); Robert DeYoung, Emma Y. Peng & Meng Yan, *Executive Compensation and Business Policy Choices at U.S. Commercial Banks* (Fed. Reserve Bank of Kansas City Econ. Research Dep't., Working Paper No. 10-02, 2010), available at <http://www.kansascityfed.org/PUBLICAT/RESWK/PAP/PDF/rwp10-02.pdf> (reporting specifically that banks with a higher risk inducing compensation structure engage in riskier policies).

74. See Suntheim, *supra* note 72, at 3–5 (empirically analyzing CEO compensation of major international banks (including those of the U.K. and Italy) from 1997 to 2008 and concluding that there is a “strong link between CEO incentives and bank risk taking,” that “banks from countries with strong regulators rely more on equity based compensation than those from countries with weaker shareholder protection” and that banks relying on CEO option based compensation and short-term bonuses performed worse during the 2008 financial crisis than banks whose CEOs were incentivized by holding a large share in stocks); cf. Cheffins, *supra* note 69, at 32 (“Hence, while in a majority of companies removed from the S&P 500 in 2008 executive pay was uncontroversial and the controversies that arose occurred in the ‘right’ companies, executive pay likely deserves at least some of the blame for the 2008 stock market meltdown.”).

75. GERRY HANSELL ET AL., BOSTON CONSULTING GRP., FIXING WHAT'S WRONG WITH EXECUTIVE COMPENSATION 3–4 (2009), available at <http://www.bcg.com/documents/file20211.pdf>.

become apparent, management is incentivized to focus on short-term results and inadequately factor in the long-term risks associated with these decisions.⁷⁶ This form of managerial expropriation may be a reason why companies like Lehman Brothers, Bear Stearns, Fannie Mae, and Freddie Mac got involved in risky ventures, such as mortgage securities, without adequate concern for the long-term overall corporate risk.

The 2008 financial crisis provides important lessons regarding incentives in the U.S. corporate system. First, the need for corporate risk-taking associated with the motive of corporate gain must be balanced with corporate risk-taking that is blind to long-term effects. Since both excessive risk-taking and no risk-taking can have harmful corporate results, risk management tools are needed to approximate optimal risk-taking behavior on the part of management.⁷⁷ Second, pay practices have outraged the public as current systems do not appear to incentivize managers to perform in the shareholders' best interest. Setting pay strategies that incentivize corporate risk-taking driven by short-term management gains without consideration of long-term effects has had disastrous consequences.⁷⁸ It is evident that managerial expropriation has become a significant threat to the well-being of individual corporations, to the U.S. and to the global financial system as a whole.

This managerial expropriation is a significant problem for U.S. and U.K. listed companies that are said to operate within an "outsider" system of corporate governance⁷⁹ in which the most important characteristic is

76. See Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71, 82, 87, 89 (2003); Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. CORP. L. 647, 664–67, 669–670 (2005). Cf. Sunstein, *supra* note 72.

77. See generally Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247 (2010) (discussing how bank executive pay has produced incentives for excessive risk-taking and such pay should be reformed to achieve appropriate levels of corporate risk).

78. Though not the subject of this article, Congress has recently addressed the issue of systemic risk-taking on a macro level by passing comprehensive regulations on July 15, 2010, which, among other things, increased the tools available to financial regulators to identify and curb reckless risk-taking. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). The goal of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 is to prevent future crises through the collection and analysis of data concerning risk in the financial system by creating a Financial Stability Oversight Council charged with looking beyond the safety of individual firms to the health and stability of the entire system. See Press Release, U.S. Dep't of the Treasury, Treasury Secretary Timothy Geithner Remarks on Passage of the "Wall Street Reform and Consumer Protection Act" (July 15, 2010), <http://www.treasury.gov/press-center/press-releases/Pages/tg777.aspx>; Wall Street Reform, FINANCIALSTABILITY.GOV, <http://www.treasury.gov/initiatives/wsr/Pages/wall-street-reform.aspx> (last visited Feb. 10, 2011).

79. Erik Berglöf, *A Note on the Typology of Financial Systems*, in COMPARATIVE CORPORATE GOVERNANCE: ESSAYS AND MATERIALS 159 (Klaus J. Hopt & E. Wymeersch eds., 1997); William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and Barriers to Global Cross Reference*, in CORPORATE GOVERNANCE REGIMES: CONVERGENCE AND DIVERSITY 26 (Joseph A. McCahery, Piet Moerland, Theo Raaijmakers & Luc Ronneborg eds., 2002).

widely-held share ownership. The principal challenge in such a system is ensuring that management is accountable to—and its interests aligned with—the interests of dispersed shareholders.⁸⁰ Although dispersed shareholder interests in the U.S. have been equated with higher stock prices,⁸¹ the risk is that when charged with implementing corporate policy, management will prefer its own short-term interests to the detriment of the outside shareholders.

The main characteristic of Italian listed companies and the corresponding corporate governance system, on the other hand, is that the ownership of shares in these companies is predominantly concentrated in the hands of dominant or controlling shareholders and shares are thus not widely held. In this “insider” model, managers are accountable to the controlling shareholders, as controlling shareholders are incentivized to closely follow and monitor the actions of management.⁸²

In contrast to managerial expropriation, the risk associated with insider systems is that controlling shareholders will expropriate corporate assets to their benefit and to the detriment of the minority shareholders (controlling shareholder expropriation). As a result, the types of fraud that occur in outsider versus insider systems are different. As evidenced by Enron and Worldcom, the risk in the outside system is that management will focus on short-term gains to obtain private benefits from executive compensation and then hide poor corporate performance. On the other hand, as evidenced by Parmalat, the risk in the inside system is that controlling shareholders expropriate corporate funds or opportunities for their private benefit.⁸³

Over the last several decades, regulatory reforms relating to the Italian capital markets have focused on modeling U.S. and U.K. protections in an attempt to move the “insider” model—a product of Italian business culture—closer to the “outsider” model which exists in the U.S. and U.K. The goal has been predominantly focused on more disperse share ownership in conjunction with increasing protections for outside investors. What the 2008 financial crisis has continued to demonstrate is that managerial expropriation is at least as significant a problem for capital markets as controlling shareholder expropriation. As a result, we should not assume that there is one perfect capital markets system or that one risk

80. See John Armour & Joseph A. McCahery, *After Enron: Improving Corporate Law and Modernizing Securities Regulation in Europe and the US* 8 (Amsterdam Ctr. for Law & Econ., Working Paper No. 2006-07, 2006), available at <http://ssrn.com/abstract=910205> (discussing the differences between outsider and insider systems); Bratton & McCahery, *supra* note 79, at 26 (discussing outsider systems).

81. Armour & McCahery, *supra* note 80, at 8.

82. *Id.*

83. John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the U.S. and Europe Differ*, 21 OXFORD REV. ECON. POLICY 198 (2005) (discussing the differences between the Parmalat fraud and the Enron fraud, and suggesting that the differences in these corporate scandals can be explained by differences in the structure of share ownership).

factor (managerial expropriation) is more or less manageable than another (controlling shareholder expropriation). We should also not assume that the legal reforms addressing the management risk in outsider systems are appropriate—or required, or even sufficient—to address the expropriation risk associated with insider systems.⁸⁴ Recognizing that the outsider and insider models create different risks for minority shareholders, certain academics have even begun to advocate the development of separate corporate governance indices for common law and civil law countries.⁸⁵ These separate indices would address the different governance risks associated with each of the “outsider” and “insider” systems separately and identify different factors that make for good governance in each. Bebchuk and Hamdani, for example, posit that rules facilitating voting by majority shareholders by allowing for vote by mail or proxy or vote without the deposit of shares are not critical in controlling shareholder companies, while rules on disclosure and fiduciary duties governing self-dealing and freezeouts matter more.⁸⁶ Such distinctions will increase the usefulness of indexes which attempt to assess corporate governance risk. This attempt to develop a more comprehensive methodology for assessing shareholder protections provided by countries with “outsider” and “insider” systems implies an increasing awareness that the straightforward adoption of common law protections by civil law countries such as Italy may not be the solution, and indicates a growing recognition of the potential value in the controlling shareholder model.

PART IV: ITALIAN CAPITAL MARKETS ADVANTAGE

The business culture of Italy which permeates its capital markets—characterized mostly by controlling shareholder or family-owned companies—suggests a different environment for the growth of these markets. Empirical studies on the role of large shareholders have demonstrated that family firms have lower agency costs and that these lower costs are due to the fact that family members have positional advantages in monitoring management and strong cash flow incentives to

84. *Id.*; see N. Balasubramanian, Bernard S. Black & Vikramaditya Khanna, *Firm-Level Corporate Governance in Emerging Markets: A Case Study of India* 3 (Euro. Corp. Governance Inst., Law Working Paper No. 119/2009, 2009), available at <http://ssrn.com/abstract=992529> (“[T]he benefits of particular corporate governance practices will vary depending on firm and country characteristics.”); Sanjai Bhagat, Brian Bolton & Roberta Romano, *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803, 1808 (2008) (“The most effective governance institution depends on context and on firms’ specific circumstances.”).

85. Bebchuk & Hamdani, *supra* note 4, at 1268.

86. See Vikramaditya Khanna, *Response, Corporate Governance Ratings: One Score, Two Scores, or More?*, 158 U. PA. L. REV. PENNUMBRA 39, 43–44 (2009), available at <http://www.pennumbra.com/responses/10-2009/Khanna.pdf> (explaining summarily Bebchuk and Hamdani’s list of which governance practices matter most in outsider companies and which matter most in insider companies).

monitor firms closely.⁸⁷ Family members have greater access to operational and other firm information than other shareholders.⁸⁸ The improved monitoring of top management arises from the existence of the dominant shareholder, a benefit that then accrues to all other shareholders.⁸⁹ Research has shown that the presence of a controlling shareholder may result in improved corporate policing of management in public corporations and that this policing function is more effective than the wide variety of market techniques utilized when shareholdings are widely dispersed.⁹⁰ The fact that: (1) poorly performing managers are more likely to be eliminated in Japanese firms with large shareholders as opposed to those without them;⁹¹ and (2) in Belgian firms, top management turnover increases with the presence of dominant and family shareholders,⁹² indicates that there is a direct connection between the replacement of management and the existence of a dominant or controlling shareholder. These large shareholders, therefore, can play an important role in monitoring management and can directly benefit the outside minority shareholders by the exercise of control over management.

Since the 1990s, the Italian capital markets have focused on the adoption of reforms that better align Italy's corporate governance with those

87. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, in MICHAEL C. JENSEN, FOUNDATIONS OF ORGANIZATIONAL STRATEGY 175 (2nd prtg, 2001). See generally Meckling & Jensen, *supra* note 6.

88. Benjamin Maury, *Essays on the Costs and Benefits of Large Shareholders in Corporate Governance* 8 (Publ'n of the Swedish Sch. of Econ. & Bus. Admin., No. 127, 2004), available at <http://dhanen.shh.fi/dspace/bitstream/10227/99/2/127-951-555-830-1.pdf>.

89. See Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 463 (1986) (analyzing the ways in which large shareholders increase corporate value by bringing changes in corporate policy and stating that all shareholders benefit from these changes since they too enjoy gains on the value of their shares).

90. Gilson, *supra* note 30; Maury, *supra* note 88, at 10.

91. See Jun-Koo Kang & Anil Shivdasani, *Firm Performance, Corporate Governance and Top Executive Turnover in Japan*, 38 J. FIN. ECON. 29 (1995). In this article, Kang and Shivdasani examine the relationship between the non-routine replacement of top executives and firm performance by analyzing information on 270 Japanese firms compiled from 1985 to 1990 in order to assess the effects of main banks, block holders, kieretsu groups, and outside directors on such relationship. *Id.* Main banks and other large shareholders were identified as having a major role in the decision-making process regarding the appointment of new top executives from outside the firm. *Id.* Their conclusion is that concentrated equity ownership has a significant effect on Japanese corporate governance. *Id.*; cf. Steven N. Kaplan & Bernadette A. Minton, *Appointments of Outsiders to Japanese Boards, Determinants and Implications for Managers*, 36 J. FIN. ECON. 225 (1994) (finding that the turnover of incumbent top executives increases substantially in Japan in the years when outside bank and corporate directors are appointed to Boards and further concluding that banks and corporate shareholders play an important monitoring and disciplinary role in Japan); Maury, *supra* note 88, at 10.

92. Isabelle Dherment-Ferere, Jens F. Köke, & Luc Renneboog, *Corporate Monitoring by Blockholders in Europe: Empirical Evidence of Managerial Disciplining in Belgium, France, Germany and the UK* (Ctr. for Euro. Econ. Research, Discussion Paper No. 01-24, 2001), available at <http://ssrn.com/abstract=358286> (discussing how there is some evidence in Belgium and Germany of an increase in executive turnover when individuals or families (not related to a director) holding companies or industrial firms are blockholders).

of the U.S. and the U.K. Although these reforms almost uniformly reflect the better governance practices relevant to “outsider” systems, these developments, even if not perfectly responsive to the “inside” system concerns evident in Italy’s business culture, have been a tremendous improvement for the Italian capital markets. With its 2010 CONSOB resolution, Italy has made positive strides in regulating the disclosure of controlling shareholder related transactions and increasing the corporate approval process with respect to these transactions. But more work still needs to be done in order to maximize the monitoring role of these shareholders, increase the transparency with respect to the inner workings of controlling/dominant shareholders, and control the potential for private benefit extraction.

Research has shown that management turnover in response to poor performance decreases when the top management of Italian public companies is not independent from the controlling family or shareholder. There is a low sensitivity of turnover to performance when: (1) top executive positions are held by the controlling shareholder; (2) control is completely in the hands of one shareholder and no other dominant or large shareholders are present; and (3) the controlling shareholder’s cash flow rights are less than 50% of the firm’s total outstanding cash flow rights.⁹³ This research suggests that, to realize the monitoring benefits of the controlling shareholder and to strengthen the controlling shareholder’s oversight role in connection with the problems of unrestrained management risk-taking, we should consider reforms that encourage: (1) independence between management and the controlling shareholder; (2) increased or minimum cash flow ownership levels to be held by the controlling or dominant shareholder; and (3) the development of the presence of other shareholders with significant voting and cash flow rights in the company. In addition, further research is necessary in order to understand how controlling shareholders exert control over management and whether more formal legal mechanisms to regulate such control are needed. Although there is room for the continued improvement of its corporate governance, the time has come for Italy to focus its reforms so as to capitalize on both the unique advantages offered by the controlling or dominant shareholder system and the improvements already made in protecting the investing minority.

In striking the regulatory balance between, on the one hand, the need for transparency, disclosure, and shareholder rights and, on the other, the need to retain and capitalize on the monitoring benefit of the controlling shareholder structure, the Italian capital markets may succeed in encouraging the new listing of companies while increasing investor

93. Paolo F. Volpin, *Governance with Poor Investor Protection: Evidence from Top Executive Turnover in Italy*, 64 J. FIN. ECON. 61 (2002).

confidence in the capital markets system. Although further reforms may be required, it is time for Italy to stress that the differences of the Italian business culture may also have value. Pricing-wise, a premium is paid for voting versus non-voting shares. In countries, such as Italy, characterized by companies with controlling shareholders, the price differential between the voting and non-voting shares has been found to be one of the highest in the world.⁹⁴ In a controlling shareholder company, this price discrepancy may reflect both the decreased power to control corporate decision-making and the increased risk of expropriation of benefits by the controlling shareholders. Purchasers of these non-voting shares can expect to pay proportionately less for these limited voting rights shares. As regulatory improvements are made to address the issue of controlling shareholder expropriation, however, the pricing of these shares should improve; and, in contrast to the high-flying risk-taking actions of U.S. management (especially those of financial services industry leaders) in recent years, the existence of an engaged, active controlling shareholder comes with the benefit of closer monitoring of management decisions. The Italian capital markets, therefore, may be offering investors a different investment choice: securities with significant minority shareholder protections in companies where the actions of management are closely scrutinized by another interested party (the dominant shareholder), coupled with the opportunity for financial gain but free of the responsibility of monitoring. This too has value that should be reflected both in the price of the shares being purchased and the reputation of the Italian securities market.

The Italian business culture may, in fact, present two opportunities. The first is an alternative corporate governance approach that differentiates the Italian capital markets from those of the U.S. The second is an opportunity for those investors who recognize that: (1) managerial expropriation is as much a risk to the value of minority shareholders as controlling shareholder expropriation; (2) Italy has made great strides in affording minority shareholders protections similar to those available in the U.S. and, with the passage of the March 2010 CONSOB resolution, has made progress toward regulating controlling shareholder expropriation; and (3) the existence of a dominant shareholder can actually benefit the minority shareholder.

Although in Italy—as in the U.S. and elsewhere—the work of improving capital markets must continue, it is important to recognize that much progress has been made with respect to increasing the attractiveness of Italian capital markets to investors. At this point, given the reforms over the past twenty years and the increased recognition of the imperfections of U.S. corporate governance, it is time to increase awareness in the

94. *E.g.*, Dyck & Zingales, *supra* note 3, at 538; Nenova, *supra* note 3, at 327–28, 331–36, 340–41; Zingales, *Value of the Voting Right*, *supra* note 3, at 125–26.

marketplace of the potential unique benefits arising from investing in companies characterized by controlling shareholders.