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RELATORE:

CH.MO PROF. ALBERTO LUPOI

LAUREANDA: MARTA FACCHIN

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INTRODUCTION

The financial services sector is a cornerstone of modern economies, playing a crucial role in channeling capital, managing risks, and offering indispensable services to both individuals and businesses. Given its central role, it becomes imperative to ensure the sector's stability and integrity. At the heart of this assurance lie two vital components: robust corporate governance and an effective regulatory framework.

Corporate governance is more than just a set of rules; it's a reflection of how a corporation is directed and controlled. Within the financial services sector, where decisions can reverberate throughout the whole economy, the importance of sound corporate governance cannot be overstated. It should guarantee accountability, ensuring that those in charge of decision-making can be held responsible for their choices, thereby promoting transparency and ethical behavior. Moreover, it should act as a barrier against risks, encouraging a corporate culture that is aware of potential consequences and that focus on prudent decision-making. Perhaps most critically, effective corporate governance is the foundation upon which *trust* is built. In a sector where trust is paramount, especially for stakeholders ranging from investors to customers, such governance practices strengthen the credibility of financial institutions.

While corporate governance sets the internal compass for institutions, regulatory frameworks act as the external sentinels, ensuring that financial entities operate within defined parameters and guidelines. These legal frameworks articulate clear standards, guiding financial institutions on aspects like capital adequacy, risk management, and disclosure. More than just rule-setting, regulatory mechanisms are supposed to play a key role in guaranteeing the overall stability of the financial system. Through vigilant oversight, they should constantly monitor the system's health, intervening to mitigate potential threats and support fairness, transparency, and overall the public interest.

In light of the intertwined relationship between corporate governance and regulatory responses, this thesis wants to give an insight into their synergies and tensions within the financial services sector. By examining historical market failures and regulatory reform initiatives, it aims to grasp the evolving dynamics of this critical sector. Through an exploration of case studies, policy analyses, and stakeholder perspectives, my work aspires to offer an understanding of how corporate behaviors and regulatory interventions shape, and are shaped by, the broader financial landscape.

My thesis will be articulated in three main sections: in the first chapter I will briefly discuss the theoretical framework on corporate governance, its key features and models, focusing on the separation of ownership and control and on agency problems. I will delineate the role of the Board of Directors and introduce the most relevant regulatory frameworks that concern corporate governance (focusing on the U.S. and European markets). Then I will briefly present some notable market failures and frauds that involved major corporations; I will focus on the correlation between these market failures and the lack of healthy corporate governance, including failures of appropriate oversight by the Board. I will examine the consequences of these scandals on the firms involved, their stakeholders, the broader financial industry and market integrity, and the impact they had on regulation of corporate governance.

In the second chapter I will present two in-depth case studies of notable market failures in the financial sector: the LIBOR manipulation scandal of 2011 and the Wells Fargo cross-selling scandal of 2016. My study aims to clearly present the factors that allowed misconduct and fraud, highlighting the shortcoming of corporate governance and of the system of check and balances that is supposed to prevent market failures.

In the third and final chapter, I will analyze how legal frameworks have largely been shaped in response to corporate abuses (in particular in the aftermath of the global financial crisis), and dissect the discussion surrounding the regulation of the financial sector, investigating the reforms and policy changes implemented to promote strong corporate governance and prevent future market failures. Finally, I will identify some ongoing challenges faced by regulators and financial firms in improving and maintaining effective corporate governance and discuss emerging trends and the future direction of regulation and corporate governance in the industry.

CHAPTER 1: GOVERNANCE AND REGULATION

1.1 Overview on Corporate Governance

The concept of corporate governance is object of significant attention in both academic circles and the business world. As the intricate framework that governs the relationship between corporate managers and stakeholders, it plays a fundamental role in determining a company's direction, integrity, and performance. This sub-chapter aims to provide a short review of literature on the topic, elucidating on its core principles and in particular focusing on the fundamental question of agency problems that a corporation faces, on the different models that have been developed, and on the multifaceted role of the Board of Directors as the cornerstone of effective governance.

1.1.1 Definition and Principles

Defining the concept of *corporate governance* is not trivial, and different definitions can be provided depending on the relevant disciplinary interest and specific context. A broad definition provided by Shailer (2018) identifies corporate governance as "the processes, structures, and mechanisms that influence the control and direction of corporations". In this context, "control" refers to the way in which stakeholders and other agencies external to a corporation control or influence those responsible for directing and managing the affairs of the corporation, while "direction" refers to the strategic guidance and management of the corporation.

The formulation of international corporate governance principles and best practices has played a crucial role in shaping corporate governance reform globally over the years. The Organization for Economic Co-operation and Development pioneered the development of the initial set of globally recognized standards. The *OECD Principles of Corporate Governance* have served as a foundational reference for corporate governance efforts in nations both within and outside the OECD since their adoption in 1999 and the subsequent 2004 revision. For the purposes of the OECD Principles, corporate governance was defined as, "that structure of relationships and corresponding responsibilities among a core group consisting of shareholders, board members and managers designed to best foster the competitive performance required to achieve the corporation's primary objective"[1].

[1] IMF (2001). Czech Republic: Financial System Stability Assessment (IMF Country Report). International Monetary Fund, Washington, DC.

The OECD principles (Organisation For Economic Co-Operation And Development, 2004) can be synthetized as follows:

A. The design of the corporate governance framework should prioritize its influence on the broader economic health, uphold market fairness, and shape the motivations of market players towards transparency and efficiency.
B. Regulatory mandates impacting corporate governance within a region should uphold the principles of legality, clarity, and enforceability.
C. The allocation of roles among diverse entities within a region must be unambiguously defined, ensuring the overarching public welfare.
D. Entities responsible for oversight, regulation, and enforcement must possess the required authority, credibility, and resources. Additionally, their decisions should be prompt, transparent, and comprehensively elucidated.

As these principles implies, corporate governance at its essence should act as the “compass” that ensures that a company is directed and managed in the best interests of its shareholders and other stakeholders. Central to this definition is the concept of the separation of ownership and control – a foundational element that has profound implications for corporate behavior and decision-making.

1.1.2 Agency Theory

A recurrent theme in corporate governance literature is the agency problem arising from the separation of ownership and control. As managers (agents) make decisions on behalf of the firm’s owners, the shareholders (principals), inherent conflicts of interest can emerge. Issues such as managerial self-interest, risk aversion, and information asymmetry can distort decision-making, potentially compromising shareholder value. Understanding and mitigating these agency problems form a critical aspect of effective corporate governance. Fama and Jensen (1983) argue that the separation of decision and risk-bearing functions survives in many corporations in part because of the benefits of *specialization* of management and risk bearing, but also because is an effective approach to control the agency problems. In particular, they argue that the contract structures of these kind of organizations separate the ratification and monitoring of decisions from the initiation and implementation of decisions.

Fama and Jensen (1983) define an organization as “the nexus of contracts, written and unwritten, among owners of factors of production and customers”. These contracts can be seen as internal “rules of the game” and they specify the rights of each agent in the organization, the standards on

which agents' performances are evaluated, and the payoff functions they face. The form of organization that efficiently meets customer demands, while covering costs, survives. Agency problems arise because those contracts are not costlessly written and enforced. The agency relationship can have a number of disadvantages relating to the opportunism or self-interest of the agent: for example, the agent may not act in the best interests of the principal, or the agent may act only partially in the best interests of the principal. There can be a number of dimensions to this, including, for example, the agent misusing their power for monetary or other advantage, and the agent not taking appropriate risks in pursuance of the principal's interests because he or she views those risks as not being suitable (agent and principal may have different attitudes to risk). There is also the problem of information asymmetry whereby the principal and the agent have access to different levels of information; in practice, this means that the principal is at a disadvantage because the agent will have more information. In the context of corporations and issues of corporate control, agency theory views corporate governance mechanisms, especially the board of directors, as being an essential monitoring device to try to ensure that any problems that may be brought about by the principal-agent relationship are minimized. Hart (1995) goes as far as to argue that corporate governance *would not matter* in the absence of agency problems, because all individuals associated with an organization would simply carry out their instructions, since they would not care per se about the outcome of the organization's activities. Effort and other types of costs could be reimbursed directly and so incentives would not be required to motivate people: no governance structure would be necessary to resolve disagreements, since there would be none.

Jensen and Meckling (1976) in their seminal contribution pointed out how inherent conflict arises because both parties are utility maximizers, leading agents to potentially act against the principal's best interests. To mitigate this, principals may implement incentives and *monitoring mechanisms*, while agents may incur *bonding costs* to ensure trust. However, complete alignment of interests is impossible. The disparity between optimal decisions and actual actions of the agent results in "residual loss", which encompasses monitoring and bonding costs. Jensen and Meckling (1976) underline that the concept of agency extends beyond formal principal-agent relationships. In any cooperative endeavor involving multiple individuals, similar agency costs arise. Notably, the publicly held business corporation exemplifies this dynamic: "it is a remarkable social construct where countless individuals invest substantial wealth, entrusting managers with their resources". Despite the inherent agency costs, the corporate model's widespread adoption and market success suggest its efficacy. The magnitude of agency costs is influenced by legal frameworks and

contractual sophistication. Over time, these have evolved, driven by individuals' incentives to minimize such costs. Even with the availability of alternative organizational structures, the enduring resilience of the corporation shows its adaptability and enduring appeal in navigating the challenges of agency relationships.

1.1.3 Evolution of Governance Theories

We will retrace the main steps of the evolution of corporate governance theories and reforms, in particular focusing on publicly traded companies in the United States, which has historically pioneered this field and influenced the rest of the world.

Adolf Berle and Gardiner Means's 1932 publication, "The Modern Corporation and Private Property," is credited with starting the history of corporate governance reform. It is considered a foundational text in corporate governance and corporate law. Berle and Means (1932) claimed that the structure of corporate law in the United States in the 1930s enforced the separation of ownership and control due to the proliferation of corporations that raise capital from dispersed shareholder. Recognizing the increasing dispersal of ownership from the hands of entrepreneurs/managers into the hands of the investing public, they advocated for all shareholders to have embedded voting rights, as well as for increased transparency and accountability. Some academics have argued that this influential book promoted "managerialism", the philosophy of corporate governance that dominated U.S. business life from the 1930s to the 1970s. Managerialism emphasized that executives should consider the interests of all stakeholders, not just shareholders, when making decisions. Managerialism differed from post-1980 shareholder-value ideology and the pre-New Deal philosophy of corporate governance in the United States, which held that business corporations existed solely to maximize shareholder value. According to scholars such as Roger Martin and Lynn Stout, the rise of managerialism during the New Deal prompted a generation of American managers to share the benefits of rising productivity with workers. The result was marked by a significant period of shared prosperity in the thirty years following 1945 (Smith, Russell and Tennent, 2017).

Academics and others have proposed different solutions to issues raised by the division of ownership and control throughout the history of corporate governance reform. A subset of suggested reforms in the 1970s was referred as the "corporate social responsibility movement". During that time, an increased public sensitivity to environmental and social themes led reformers to advocate for government intervention to broaden corporate responsibility. Beyond shareholders,

they argued that corporate responsibility needed to include "workers, consumers, suppliers, communities in which the corporation had a significant presence, clean air, clean water, and other constituencies". The social responsibility movement demanded government action, but on specific fronts as opposed to all fronts. One academic advocated replacing the common one share, one vote rule in U.S. corporate law with a graduated scale. This way, owners – especially institutional owners, who were thought to be unduly mercenary – would receive progressively less voting power as more shares were acquired. The mandate of "power to the people" would increase the authority of individual proprietors, who typically possessed fewer shares but were perceived to be more socially conscious. There were calls for legislation requiring the appointment of public interest directors to the boards of publicly traded companies, along with suggestions that the directors should be provided with offices and staff at corporate expense. Others suggested imposing obligations on social auditing and making the findings of social audits publicly available. Proposals for expanded public interest proxy and weighted voting schemes never seemed to take off. Though legal scholars claimed to break new ground several decades later by essentially dusting off and advocating the same ideas, the corporate social auditing and disclosure proposal also failed (Branson, 2013).

A significant shift occurred with the transition from the short-lived corporate social responsibility movement to the non-intrusive, minimalist approach of the "law and economics movement" to corporate law and corporate governance. Rarely in the history of jurisprudence has one jurisprudence risen so quickly, while the one it supplanted faded into obscurity. Within the "law and economics movement", some scholars believed that separating ownership and control was not a problem. Instead, it was an efficient use of investor and managerial resources. As a result, law and economics overshadowed the corporate social responsibility movement. Specifically, the law and economics movement proposed the use of microeconomic theory to analyze the law. The field first emerged in the United States in the early 1960s, owing primarily to the work of Chicago School of Economics scholars such as Aaron Director, George Stigler, and Ronald Coase, and became mainstream in the 1980s. The discipline employs economic concepts to explain the effects of laws, to determine which legal rules are economically efficient, and to forecast which legal rules will be promulgated.[2] Corporate law academics who embraced economic analysis rejected the pro-regulation orthodoxy inspired by Berle and Means. According to Jonathan Macey, a prominent law and economics scholar, the law and economics movement challenged the notion that shareholders

[2] Friedman D. (1987) *Law and economics,* The New Palgrave: A Dictionary of Economics, v. 3, p. 144.

were exploited by management. Agency cost theory had a significant impact in this context, with economically inclined corporate law professors drawing inspiration from papers by Jensen and Meckling (1976) and Fama (1980) that provided intellectually elegant accounts of various market-oriented constraints on managerial discretion (Cheffins, 2024). A segment of extreme supporters of law and economics, called "contractarians", vigorously advocated that the only function of corporate law was to offer a pre-made contract that approximated the agreement the parties would have reached independently in the absence of transaction costs. They adopted the belief that contracts could negate any aspect of corporate law, including fiduciary duties. There should have been no requirements in corporate law; corporate participants should be able to contractually choose not to participate in any regulatory provision. The rules governing corporate law only function was to provide "default rules".

The American Law Institute (ALI) Corporate Governance Project challenged the law and economics movement, firmly believing that corporate law plays an important role; this constitutionalist approach radically differs from the contractarian approach. The American Law Institute launched the Corporate Governance Project in 1978, resulting in the *Principles of Corporate Governance: Analysis and Recommendations*, which were approved fourteen years later. The *Principles* aimed to improve management accountability through an innovative fusion of extra-legal governance principles and restatements or revisions to the corporate law provisions that have the most direct bearing on governance. The American Law Institute (ALI) developed a set of recommended guidelines for corporate goals that concerned: structure, such as the composition of the board and committees; duty of "fair dealing" (loyalty); duty of care and the business judgment rule; director and shareholder roles in tender offers and control transactions; and shareholders' remedies, which included appraisal and derivative action remedies. Discrete fair dealing provisions addressed a variety of topics, including the compensation of corporate officials, the competing interests of officers and directors, the transactions of interested directors, and the definition of what constitutes a corporate opportunity. Although those standards were initially considered divisive and drastic, the ALI has proven to be a very successful model for three main reasons. First, all large corporations now adhere to and even surpass the ALI Project's recommendations for board composition and governance through committee structures. Secondly, the ALI Project served as the pioneering comprehensive corporate governance blueprint, serving as an inspiration for numerous subsequent governance blueprints such as the OECD Code and the Cadbury Code. Thirdly, and perhaps most significantly, the ALI Project offered a counterargument

to the then-dominant economics and law movements, arguing that they had little to no bearing on corporate governance law and reform (Bratton, 2022).

The early 1990s were marked by a rise in institutional investments and corresponding decline of the market for corporate control, focusing attention on the role and importance of institutional investors as monitors of corporate governance. The increase in monitoring by traditionally passive institutional investors has been described as "shareholder activism" or "institutional activism". Institutional activism, or "agents watching agents" – bridged the gap left by the separation of ownership and control. Because "product, capital, labor, and corporate market control constraints on managerial discretion are imperfect, corporate managers need to be watched by someone, and the institutions are the only watchers available" (Bratton, 2022). Evidence presented by Smith (1996) indicates that in those yeas shareholder activism was largely successful in impacting the governance structure of target companies and, when successful, resulted in a statistically significant increase in shareholder wealth.

The second half of the 1990s was denoted by an abrupt shift from institutional activism to a call for a global convergence of corporate governance, due to a rapid acceleration of the globalization process. The belief was that a consensus would form regarding what governance procedures were appropriate or optimal through increased international exchanges and global interconnectedness. Legislators and parliaments would face pressure from the business community, bar associations, accounting professionals, and larger corporations to pass laws that would comply with international best practices standards. Thus, the void left by the separation of ownership and control would be filled by the global consensus and the pressure to adhere to or adopt it, at least in its key components. Scholars in the United States argued that the corporate governance model in the United States would be replicated in the global model of good governance (Hansmann and Kraakman, 2000). The convergence advocates emphasized efficiency as the fundamental force, but cultural and political forces differ greatly from region to region and country to country, ultimately preventing a full convergence of governance practices.

The bankruptcies of Enron and of Worldcom in the early 2000s clearly showed the weaknesses of the US model of governance. The emphasis was shifted on the role of the *gatekeepers*, as the subset of monitors of corporate operations and behavior, namely, those monitors who "supply essential verification and certification services to corporations". Audit committees, independent directors, auditors, debt rating agencies, state and federal securities regulators (such as the SEC), and more

specialized state and federal agencies (in insurance, banking, energy production, and so on) are some of the monitors who provide crucial services to every corporation they come into contact with. One of the main themes of the Sarbanes-Oxley Act of 2002, enacted in the wake of the scandals, was bolstering gatekeepers to increase corporate oversight (Branson, 2013).

1.1.4 Corporate Governance Models

Diverse corporate landscapes have given rise to various governance models, each reflecting unique socio-economic contexts and priorities. Corporate governance systems can be broadly categorized into two: the *outsider* and *insider* systems, each shaped by distinct monitoring mechanisms. The outsider system, prevalent in Anglo-Saxon countries, emphasizes a robust financial market and offers strong protection to minority shareholders. However, it poses challenges, like a stark divide between ownership and control, granting managers significant autonomy. Their performance is primarily judged by market reactions, and often their remuneration is tied to company performance in the stock market. Conversely, the insider system, commonly seen in civil law countries, is anchored in close ties between government, industry, and banking. Control isn't dispersed but rests with select entities, making hostile takeovers a rarity. Managers in this system grapple with harmonizing the often-contrasting interests of majority and notably underrepresented minority shareholders (Mastrodascio, 2021). The insider system, prevalent in Continental Europe, is characterized by concentrated ownership, intricate crossholdings, and stable ownership structures. Here, insiders with privileged information dominate governance, often including founding families on boards. Unlike the outsider model, the insider system prioritizes a broader range of stakeholders, granting entities like employees a voice in corporate decisions (Baker and Anderson, 2010).

Another categorization of corporate governance models regards management and control functions, which can be led by one or two bodies, defining the one-tier system or two-tier system, respectively.

In the *one-tier* system, also known as the *monistic system*, there is only one board that consists of both the management and the supervisors, designate by the shareholders' meeting (*Figure 1*). In particular, the shareholders' meeting selects the administrative body known as the board of directors, which is composed of two categories of directors: *executive* directors, who manage the organization (among them it can be appointed the Chief Executive Officer, or CEO) and *non-executive* directors, who actively engage in the management of the organizations without having direct contact with the shareholders. The latter are also known as *outsider* directors. Since they do

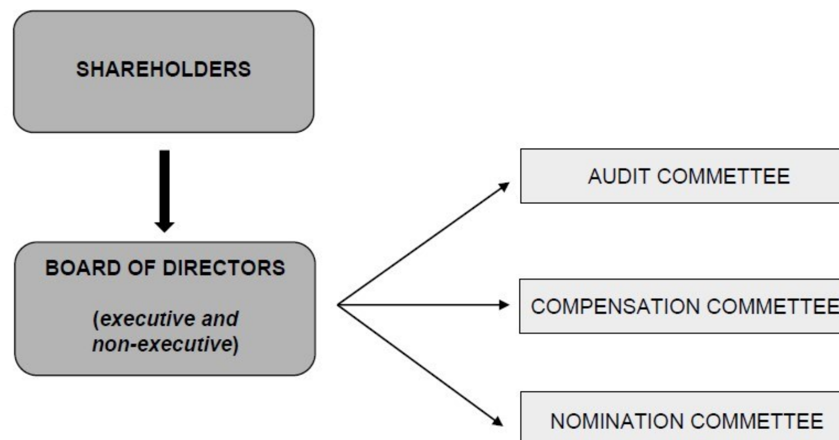
not own company shares like the executive directors, they are supposedly able to ensure independent and fair judgement based on reason, rather than the pursuit of self-serving interests.

This corporate governance system's characteristic is that control and monitoring functions can only be performed internally by non-executive directors – that have therefore a crucial role – through three committees:

- The audit committee, that oversees and regulates the actions of the executive directors;
- The nomination committee, that suggests possible directors to the shareholders' meeting;
- The compensation committee, that determines managers' and directors' salaries.

The one-tier system, which relies on trust between shareholders and the board of directors, is widely utilized in US and UK public companies. However, it has received significant criticism. Non-executive directors' role as controllers has been criticized for lack of impartiality, as they are still members of the board of directors. This means that controllers and subjects under their control are on the same board. Non-executive directors have been criticized for having limited access to high-quality information, while executive directors have access to more timely and reliable information. Finally, since they both serve on the same board, non-executive directors may have a limited propensity to question executive directors' decisions.

Figure 1. The one-tier corporate governance system (Mastrodascio, 2021)



The *two-tier* system, also known as the *dualistic* system, has two separate bodies responsible for administration and control: the management board, which holds executive responsibilities, and the supervisory board, which is appointed by shareholders' meetings and approves financial statements and has the authority to appoint, control, and remove managers. Dualistic corporate governance

systems fall into two categories: vertical and horizontal. The two systems differ in terms of who can appoint members of the management and supervisory boards.

The *vertical* dualistic system (*Figure 2*) involves the general shareholders' meeting appointing supervisory board members, who then appoint the management board. The vertical system was developed in Germany as a control body to oversee company management while also meeting stakeholder needs (in particular creditors and employees).

In the *horizontal* dualistic system (*Figure 3*), management and supervisory board members are appointed by the general shareholders' meeting. This corporate governance model, developed in Italy and a few other countries, has a fundamental rule that no one can be a member of both the supervisory and management boards (in Italian *Collegio sindacale* and *Consiglio di amministrazione*, respectively).

In all dualistic models, the management board primarily focuses on developing and implementing strategic plans. The Supervisory Board oversees operational programs and evaluates the quality of information and internal control systems. In the absence of a general shareholders' meeting, the supervisory board can make decisions related to specific skills, such as accounting knowledge for financial statement approval. The two-tier system is often used during generational transitions, allowing founding members to join the Supervisory Board and oversee the company's management. The criticism of the two-tier system stems from the fact that the supervisory board is required to frequently approve specific decisions made by the management board, which restrains the smooth execution of activities.

Figure 2. The two-tier vertical corporate governance system (Mastrodascio, 2021)

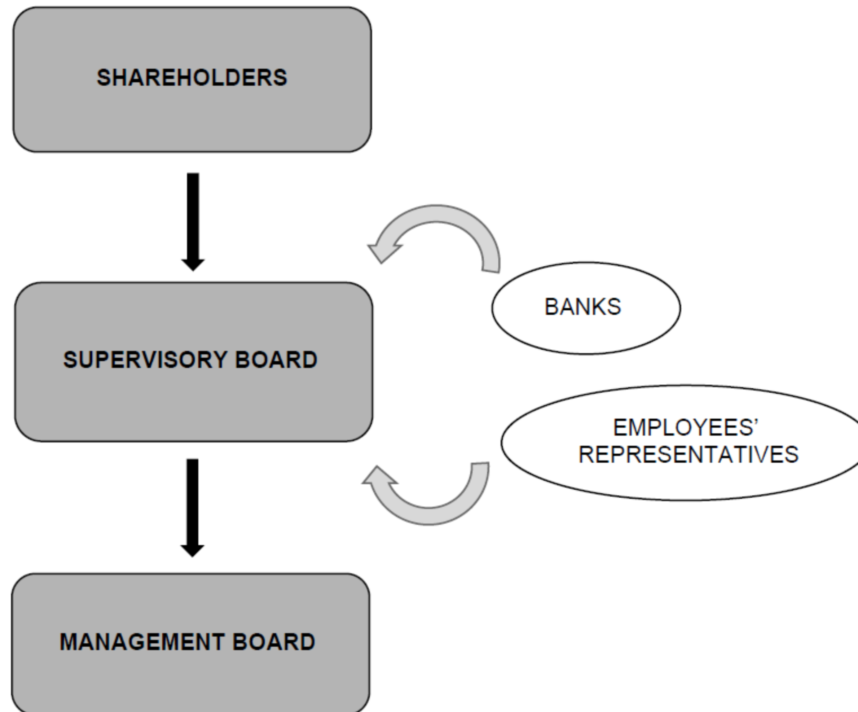
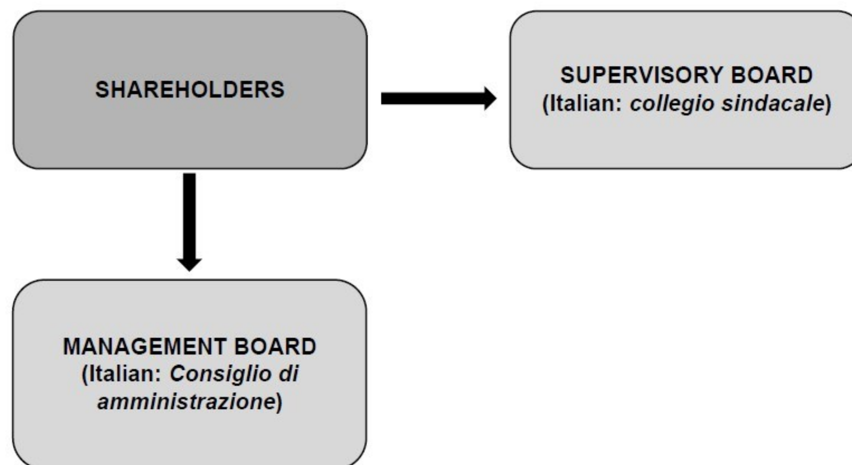


Figure 3. The two-tier horizontal corporate governance system (Mastrodascio, 2021)



A peculiar case of corporate governance model can be found in Japan, where most corporations adopt a *hybrid* approach called Japanese model. It is characterized by the development of a unique corporate structure called *Keiretsu*, a corporate group where each member operates in a different sector but linked to one another through crossholdings, without the control of a holding company. The group's bank serves as both a creditor and shareholder, with a representative on the board of directors (financing is largely bank-based). The board of directors is typically comprised of

insiders, including firm executives. If profits begin to decline, Keiretsu may remove directors from the board. Corporate transparency is less likely in this model due to the concentration of power and the emphasis on the interests of those in positions of power.

The debate on the international convergence towards a specific system of corporate governance is still ongoing due to the fact that, despite the push given by the increasing globalization of financial markets and the tendency to homogenization of national cultures and regulations, the differences among the various models still remain evident. Therefore, it emerges that there is no absolute superior system, as each is specific to each national context (Mastrodascio, 2021).

1.1.5 The Board of Directors

Central to the corporate governance framework is the Board of Directors – a collective body vested with the responsibility of overseeing the company's affairs and safeguarding stakeholder interests. Beyond its regulatory and oversight functions, the Board plays a pivotal role in shaping the company's strategic direction, monitoring management, and upholding principles of accountability, fairness, and transparency. The Board's influence extends far beyond mere governance; it embodies the company's ethos, values, and vision. It represents the link between managers and investors and is essential to good corporate governance and investor relations. As such, its composition, dynamics, and practices are subjects of rigorous scrutiny and debate in corporate governance literature.

The Board holds significant authority in making economic decisions that impact the interests of investors, employees, communities, and executives. Its role and power are often overlooked: managers, the government, and special interest groups may influence the corporation, but it is the board of directors that possesses ultimate internal authority. Acting as trustees for shareholders, the board selects the management structure of the firm and delegates administrative matters chosen by the board itself. The extent of delegation varies among boards, with many opting to delegate a substantial portion of decision-making authority (Molz, 1985).

In the Anglo-Saxon model of corporate governance, the two key figures within the board are the CEO and the Chair. While the Chief Executive Officer (CEO) is responsible for leading the company's business, the Chair leads the board. Combining the two roles is discouraged, as it would provide too much authority to a single individual (Mallin, 2019).

- The CEO is the highest-ranking executive in a corporation; their principal duties include taking major corporate decisions, directing a company's personnel and resources toward strategic

objectives, and serving as the primary intermediary between the board of directors and corporate operations.

- The Chair is in charge of the board's leadership, and of making sure that the board meets regularly, that directors have access to all the information they require to participate fully in board discussions, and that each director has the chance to speak at meetings.

The board may appoint multiple subcommittees, which must report to the board on a regular basis. Although the board delegate certain activities to these subcommittees, the board as a whole is still accountable for the areas covered by the subcommittees.

- The *audit committee* is arguably the most important of the board subcommittees. The audit committee reviews the scope and outcome of the audit and ensures the auditors' objectivity. This typically includes reviewing audit fees and non-audit activity, as well as ensuring auditor independence. The audit committee serves as a mediator between internal and external auditors and the board, ensuring the board is properly informed about audit-related issues.
- The *remuneration committee*, composed by independent non-executive directors, advises the board on the company's executive remuneration framework and costs. It also determines specific salary packages for each executive director, including pension rights and compensation payments, within agreed-upon criteria. The establishment of a remuneration committee is meant to restrict executive directors from determining their own pay levels.
- The *nominating committee*, responsible for identifying candidates for positions on the board, should assess the board's current balance of abilities, expertise, and experience when creating a candidate profile for future appointments. In a quickly changing business environment, the nominating committee should be active in succession planning. This includes identifying potential difficulties and shortages in skills and experience that may require new appointments.
- The *risk committee* is particularly important in the context of financial firms. Its purpose is to support the board in overseeing the management's implementation of an efficient global risk management framework that is properly structured to identify, evaluate, and manage the market, operational, credit, investment, and strategic risks of the company. The Risk Committee's duties encompass approving relevant primary risk policies and examining specific related frameworks, analyses, and reports that have been set up by management.

Other board committees can be established according to the relevant regulatory framework and specific necessities of the company (Mallin, 2019).

According to the *OECD Principles of Corporate Governance*[3], the Responsibilities of the Board of Directors are as follows:

A. Board members must act in the company's and shareholders' best interests, with informed decision-making, good faith, and diligence.
B. Decisions affecting shareholders should be made fairly for all.
C. The board must uphold high ethical standards, considering stakeholder interests.
D. Key board functions include:
    - Guiding corporate strategy and overseeing major actions;
    - Ensuring effective governance practices;
    - Managing executive selection, compensation, and succession;
    - Aligning remuneration with company interests;
    - Ensuring transparent board elections;
    - Managing conflicts of interest and related party transactions;
    - Ensuring integrity in accounting, audits, and controls;
    - Overseeing disclosure and communication processes.
E. The board should exercise independent judgment, potentially appointing non-executive members for certain tasks, defining committee roles, and ensuring member commitment.
F. Board members need access to accurate and timely information to fulfill their duties.

The board is not only accountable to the company and its shareholders but also has a *duty* to act in their best interests. Furthermore, boards are obliged to consider and treat other stakeholders, such as employees, creditors, customers, suppliers, and local communities, fairly and with due consideration. Adhering to environmental and social standards is also crucial within this framework.

According to Baker and Anderson (2010), modern boards have evolved beyond just offering advice to playing an active fiduciary role, underscoring the vital importance of directors' independent judgment. While regulatory guidelines outline what constitutes independence, the genuine essence of this – being free from undue influence of management – requires a nuanced, qualitative assessment tailored to each director during both elections and annual board reviews. While it's crucial to thoroughly examine a nominee's professional background, affiliations, and personal

[3] Organisation For Economic Co-Operation and Development (2004). *OECD principles of corporate governance.* Paris: OECD.

connections, the primary emphasis should be on their capacity to remain unbiased against managerial pressures. Recent instances of corporate misconduct highlighted that simply ticking off formal requirements doesn't guarantee board autonomy. Directors need not only the readiness to collaborate with top executives but also the assertiveness and knowledge to ask tough questions, ensuring effective oversight.

The *Italian Corporate Governance Code*[4], lastly updated in January 2020, outlines principles and recommendations for good corporate governance practices in Italy, focusing on the role of the board of directors. The Code applies to all companies with shares listed on the Italian main market (known as "Mercato Telematico Azionario" or MTA) managed by Borsa Italiana SpA. Adoption of the Code is voluntary and is disclosed in the company's corporate governance report. Each article of the Code consists of principles, which define the objectives of good governance, ensuring alignment with international best practices. The Code remains neutral regarding the specific governance model adopted by the company (one-tier, or two-tier model).

Regarding the role of the board, the Code outlines the following principles:

I. *The board of directors leads the company by pursuing its sustainable success.*
II. *The board of directors defines the strategies of the company and the group it heads in accordance with principle I and monitors its implementation.*
III. *The board of directors defines the corporate governance system that is most functional for carrying out the company's business and pursuing its strategies, taking into account the flexibility offered by the legal framework. If necessary, the board of directors evaluates and promotes the appropriate changes and submit them to the shareholders' meeting when such changes are necessarily subject to the shareholders' vote.*
IV. *The board of directors promotes dialogue with shareholders and other stakeholders which are relevant for the company, in the most appropriate way.*

For companies adopting the two-tier model, the Code requires that the supervisory board be assigned the task of deliberating on the company's strategic guidelines and transactions of strategic importance (referred to as "high-level" management powers).

[4] Borsa Italiana (2020). *CORPORATE GOVERNANCE CODE*. Available at: https://www.borsaitaliana.it/comitato-corporate-governance/codice/2020eng.en.pdf.

1.2 Governance in the Financial Sector

Corporate governance in the financial industry refers to the set of principles, processes, and structures that guide and oversee the activities of financial institutions and markets. It encompasses the mechanisms through which these entities make decisions, manage risks, and ensure transparency and accountability to stakeholders. Effective financial sector governance is crucial for maintaining stability, protecting investors, and guaranteeing trust in the integrity of financial systems. Key components include regulatory frameworks, risk management practices, ethical standards, and the role of governing bodies in shaping policies that contribute to the sound functioning of the financial sector. As global economies become increasingly interconnected, the importance of robust governance in the financial sector is paramount in sustaining economic growth and safeguarding against systemic risks.

1.2.1 Specificities of the Industry

The financial sector stands distinct from other industries in several significant ways, shaped by its role, structure, and impact within the broader economy. Banks in particular possess a distinctive characteristic, wherein their operation broadly rely on *deposits*, essentially employing the funds of the public. Given the fiduciary responsibility of managing deposited funds, there exists a heightened risk and potential impact on individuals, businesses, and the whole economy.

It is important to underline the systemic importance of the financial sector, that serves as the backbone of modern economies, facilitating the flow of capital, allocating resources, and providing essential services such as lending, investing, and risk management. Its interconnected nature means that disruptions or failures within the financial sector can have cascading effects, impacting other sectors and the overall economy. This systemic importance places a heightened emphasis on stability, resilience, and effective governance within the financial industry. The financial sector by nature operates in a globalized environment, with interconnected markets and cross-border transactions becoming increasingly prevalent. Globalization introduces additional layers of complexity related to regulatory harmonization, cross-border supervision, and managing global risks, distinguishing the financial sector's dynamics from more localized industries.

Moreover, the financial sector is characterized by its complexity, driven by intricate financial products like exotic derivatives, sophisticated market structures, and rapid technological advancements and innovations. This complexity also introduces challenges related to risk management, governance, and regulatory compliance, distinguishing the financial sector from

other industries. Many governments recognize the particular need to protect customers that interact with complex financial products and services.

Another key aspect of the financial sector is the need for *trust* among the participating agents. Institutions and markets rely heavily on the integrity of information. The presence of information asymmetry – where one party has more or better information than the other – poses unique challenges. Ensuring transparency, ethical conduct, and accountability is essential to maintain trust and confidence in financial markets, setting the financial industry apart from other sectors where information symmetry may not be as pronounced. The financial sector faces specific challenges related to ethical conduct and behavior. Issues such as conflicts of interest, market manipulation, and misconduct can have significant repercussions, given the sector's systemic importance and impact. Addressing these ethical and conduct risks requires robust governance frameworks, regulatory oversight, and a culture of integrity within financial institutions.

Given the specificities mentioned above, the financial sector is subject to extensive regulatory oversight, which is particular stringent comparing to other industries. Regulatory frameworks are designed to ensure transparency, protect consumers, maintain market integrity, and mitigate systemic risks. The regulatory landscape in the financial sector is often more complex and rigorous compared to other industries, reflecting the unique risks and challenges inherent to financial services.

1.2.2 Risk Management

A fundamental general principle in finance is that there is a trade-off between risk and return. Shareholders are primarily concerned with systematic (non-diversifiable) risk, as they can diversify away unsystematic risk. However, companies, driven by concerns such as bankruptcy costs, consider both systematic and unsystematic risks in risk management. Financial institutions, particularly banks and insurance companies, face additional regulatory pressures that focus on minimizing the probability of failure. The two broad risk management strategies that can be implemented are either to identify risks one by one and handle each one separately, called risk decomposition, or to reduce risks by being well diversified, called risk aggregation. Both these approaches are adopted by financial institutions to manage market and credit risks. Credit risks have traditionally been managed using risk aggregation, but with the introduction of credit derivatives the risk decomposition approach has become more relevant (Hull, 2018).

Stulz (2016) underlines how the success of banks is closely tied to how effectively they manage risks. Proper risk management is seen as a key factor in creating value for shareholders. There is no one-size-fits-all approach to risk management, each bank may require a unique strategy based on its specific circumstances, indicating the complexity of implementing effective risk management practices. The optimal risk management structure for one bank may not be suitable for another. This implies that banks need to customize their risk management approaches based on their individual characteristics, business models, and risk profiles. Success in risk management involves not only having the right risk management processes but also the right governance structure, incentives, and organizational culture. These elements collectively contribute to a bank's ability to manage risks effectively.

The success of risk management is contingent on the corporate environment in which it operates, this suggests that risk management should be adaptable and capable of influencing or being influenced by the broader organizational context. While better risk management is expected to result in improved risk-taking decisions, having good risk management doesn't necessarily mean low risk: banks with effective risk management can still engage in risk-taking activities, but with a more informed and controlled approach. The organizational culture is a critical factor in the success of risk management. The culture of a bank can impact how risk management practices are implemented and integrated into the overall operations. In summary, the multifaceted nature of risk management in banking determines the need for a tailored and comprehensive approach that encompasses governance, incentives, and culture to create value for shareholders and contribute to the overall success of the financial system.

A crucial factor contributing to inadequate risk management at the board level highlighted by Pirson and Turnbull (2011) is the limited access to important risk-related information. An emblematic example reported in their study concerns Lehman Brothers: according to the Lehman Brothers bankruptcy report, essential pieces of information necessary for effective risk assessment were not properly communicated to the board. In this case, the management of Lehman Brothers in 2007 reportedly did not disclose to the board a three-month period characterized by heightened risk-taking. This lack of transparency and communication from management to the board is a contributing factor to insufficient risk management practices. When key information is not effectively communicated to the board, it hampers the board's ability to assess and manage risks adequately; a more open and transparent communication process, especially regarding crucial risk-related information, is essential for effective risk management at the board level. This issue is

particularly relevant in the context of corporate governance, where the balance of power and information flow between executives and the board plays a crucial role in decision-making and risk oversight.

1.2.3 Governance of Banks

The peculiarities of the banking sector like the presence of deposit insurance, the high level of leverage, and the banking regulation framework, have important repercussion on corporate governance. As underlined by John et al. (2016), the governance implications of high leverage are significant, especially in the context of banks where the conflict of interest between shareholders and debtholders is pronounced. Unlike manufacturing firms, banks are more susceptible to moral hazard issues due to their unique attributes. In banks, debtholders (depositors) have conflicting interests with shareholders, as the former seek fixed payoffs while the latter aim to maximize wealth. Managers in highly leveraged banks may have a risk-shifting incentive, favoring high-risk investments that benefit shareholders but pose a threat to debtholders. If projects fail, debtholders suffer as the value of collateral decreases, while shareholders, protected by limited liability, can walk away. The alignment of top management with equity interests can exacerbate this conflict, leading to potentially value-detrimental high-risk investments. Strong equity governance, intended to align managerial and shareholder interests, might intensify shareholder-debtholder conflicts in highly leveraged firms. Paradoxically, robust equity governance could increase the agency cost of debt, potentially reducing overall firm value. Regulatory measures may be needed to mitigate these risks, as extreme forms of equity governance might amplify the agency costs of debt in banks, ultimately compromising firm value. Therefore, a careful balance between equity governance and regulation is essential for maintaining the stability and value of highly leveraged financial institutions.

Anginer et al. (2018) confirmed with their study that a corporate governance approach favoring shareholders is linked to increased stand-alone and systemic risk within the banking sector. Shareholder-friendly governance is associated with heightened risk, particularly for larger banks and those situated in countries with robust financial safety nets, as banks aim to transfer risk onto taxpayers. The researchers arrived at these conclusions by comparing banks to nonfinancial firms and analyzing fluctuations in bank risk surrounding a regulatory shift in governance. These findings underscore the significance of the financial safety net and considerations related to "too-big-to-fail" assurances when contemplating corporate governance reforms within the banking industry.

The BCBS[5] *Corporate governance principles for banks* offer guidelines for banks and supervisors to operate within, ensuring robust and transparent risk management and decision-making. This, in turn, should foster public confidence and upholds the safety and soundness of the banking system. The Basel Committee's updated set of principles was published in 2015, in the aftermath of the global financial crisis, highlighting the critical role of corporate governance in ensuring the safe and sound operation of banks. It underscores the significance of risk governance within a bank's overall corporate governance structure and advocates for strong boards, board committees, and effective control functions. Specifically, the revised principles recommendations can be summarized in the following key points[6]:

- Expand guidance on the board of directors' role in overseeing the implementation of effective risk management systems.
- Emphasize the collective competence of the board and the individual obligation of board members to dedicate sufficient time to their roles and stay informed about banking developments.
- Strengthen guidance on risk governance, including the roles of business units, risk management teams, and internal audit and control functions (the *three lines of defense*). It underscores the importance of a sound risk culture in driving risk management within a bank.
- Provide guidance for bank supervisors in evaluating banks' processes for selecting board members and senior management.
- Acknowledge that compensation systems are a key component of governance and incentive structures, enabling the board and senior management to convey acceptable risk-taking behavior and reinforce the bank's operating and risk culture.

In the context of the European Union, the European Banking Authority (EBA)[7] in 2021 issued updated guidelines on internal governance to ensure robust and effective management within financial institutions. These guidelines aim to harmonize internal governance arrangements, processes, and mechanisms across the EU, in line with the new requirements introduced in the fifth

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[5] The Basel Committee on Banking Supervision (BCBS) is the primary global standard-setter for bank prudential regulation and serves as a venue for ongoing cooperation on banking supervisory issues. Its 45 members include central banks and bank supervisors from 28 countries.

[6] Bank for International Settlements (2015). *Corporate governance principles for banks.* Bis.org. Available at: https://www.bis.org/bcbs/publ/d328.htm.

[7] The EBA is an independent EU Authority tasked with safeguarding the integrity and robustness of the EU banking sector to support financial stability in the European Union.

Capital Requirements Directive (CRD V)[8] and the Investment Firms Directive (IFD)[9], and with the proportionality principle.

The *EBA Guidelines on internal governance* are articulated in seven titles:

I. Proportionality
II. Role and composition of the management body and committees
III. Governance framework
IV. Risk culture and business conduct
V. Internal control framework and mechanisms
VI. Business continuity management
VII. Transparency

The Guidelines consolidate and update previous Internal Governance guidelines, and include new chapters on corporate structure transparency, the role, functions, and responsibilities of the supervisory function, as well as IT systems and business continuity management. Their goal is to strengthen and solidify supervisory expectations, thereby improving the effective implementation of internal governance measures.

Fighting money laundering and terrorist funding is critical to protecting the financial system's stability and integrity. As a result, revealing any involvement of credit institutions and investment corporations in money laundering and terrorist funding can jeopardize the financial system's sustainability and credibility. In this context, these Guidelines emphasize that recognizing, monitoring, and reducing money laundering and terrorism financing risk is an essential component of strong internal governance arrangements and credit institution risk management frameworks.

The framework pertaining to loans to members of the management body and their affiliated parties is further clarified and strengthened in the updated Guidelines. Due to the possibility that those loans could represent a particular source of actual or potential conflicts of interest, the Directive CRD has specifically included certain provisions. Similarly, other transactions involving members of the management body and their affiliated entities may give rise to conflicts of interest; for this

[8] Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures.
[9] Directive (EU) 2019/2034 of the European Parliament and of the Council of 27 November 2019 on the prudential supervision of investment firms and amending Directives 2002/87/EC, 2009/65/EC, 2011/61/EU, 2013/36/EU, 2014/59/EU and 2014/65/EU.

reason, the EBA is offering guidelines on how these transactions should be handled. Finally, the amended Guidelines include new guidelines on the code of conduct to ensure that credit institutions take all necessary steps to avoid any type of discrimination and guarantee equal opportunities to staff members of all genders, in line with the requirement to implement a gender-neutral remuneration strategy.[10]

[10] European Banking Authority (2021). *EBA publishes its final Guidelines on internal governance.* Available at: https://www.eba.europa.eu/publications-and-media/press-releases/eba-publishes-its-final-guidelines-internal-governance.

1.3 Relevant Regulatory Frameworks

The landscape of corporate governance is not solely defined by internal mechanisms and stakeholder dynamics; it is also significantly influenced by external regulatory frameworks. These regulations support and guide corporate behavior, ensuring transparency, accountability, and fairness. In the interconnected world of global finance, it is not trivial to delineate which pieces of legislation regulate a pervasive and important topic such as corporate governance. This sub-chapter introduce some of the most salient regulatory frameworks that concern corporate governance at present time, to help delineate the complex legal environments in which companies operate. We will focus on some fundamental legislation pieces that regulate firms and markets in the United States, United Kingdom and European Union, since this research will mainly focus on these markets, with a hint on the global perspective.

1.3.1 United States

Some key sources of corporate governance law and regulation in the United States include state corporate law, stock exchange listing rules (predominantly the New York Stock Exchange and the NASDAQ), federal securities law, including the US Securities Act of 1933 and the US Securities Exchange Act of 1934, and federal and state laws regarding particular areas of corporate practice.

State corporate law governs companies based on the state of incorporation. Over half of all US publicly traded corporations are incorporated in the state of Delaware due to its well-established corporate code (the Delaware General Corporation Law or DGCL). The DGCL, found in Title 8, Chapter 1 of the Delaware Code, is a comprehensive statute that governs corporate law within the state of Delaware. It is essentially a “specialized contract law governing the respective roles, duties, and relationships of those who manage corporations and those who invest in them”. While the DGCL covers corporate governance comprehensively, it does not address other aspects of business law, such as competition, labor, or securities. The courts that interpret that state law in this case are the Delaware Court of Chancery and the Delaware Supreme Court.[11] Over the years, Delaware has established a body of corporate case law that has become the standard in the corporate landscape of America. The Delaware approach is often characterized as favorable to companies, and a majority of U.S. companies listed on the NYSE choose to register in Delaware to leverage its more flexible and less prescriptive regulatory framework. The focus is on granting boards of directors

[11] State of Delaware. (2017). *About Delaware’s General Corporation Law.* Available at: https://corplaw.delaware.gov/delawares-general-corporation-law/.

the authority to pursue corporate strategies and objectives, all while adhering to the concept of fiduciary duty, typically involving acting in the best interests of shareholders who ultimately benefit from the company's performance. Although there are statutory requirements to safeguard minority interests, Delaware's legal framework is generally less procedural compared to other state laws in the US, making it an appealing choice for company registration.[12]

The two largest US stock exchanges, the NYSE and the NASDAQ, each have their own set of rules that firms must follow in order to be listed on their respective exchanges. These listing standards include all areas of corporate governance, such as director independence, the composition of board committees, obligations to put certain things to a vote of shareholders, rules on dual-class stock structures and other special voting rights, the publication of and themes covered by corporate governance guidelines, and even requirements for the corporation's public website. These restrictions are enforced through the threat of public reprimand from the exchanges, temporary suspension of trade for repeat offenses, and permanent delisting for persistently or egregiously non-compliant corporations.[13]

Within the framework of the United States legal system, the Sarbanes-Oxley Act (also known with the acronym SOX) is probably the most significant piece of federal legislation that addresses corporate governance, financial disclosure, and the responsibilities of public companies and their auditors. This federal law was passed by the U.S. Congress and signed into law by President George W. Bush in 2002. It was a bipartisan bill named after its sponsors in Congress: U.S. Senator Paul Sarbanes and U.S. Representative Michael G. Oxley.

The primary goal of the Sarbanes-Oxley Act was to fix auditing of U.S. public companies, consistent with its full, official name: the *Public Company Accounting Reform and Investor Protection Act of 2002*. Enacted in the wake of high-profile corporate scandals of American firms like Enron and WorldCom, the Sarbanes-Oxley Act represents the reaction of the U.S. federal government and its willingness to reinforce corporate accountability. At its core, SOX seeks to enhance the accuracy and reliability of corporate disclosures. It introduces stringent requirements concerning internal controls, auditor independence, and the disclosure of off-balance-sheet

[12] Mallin, C.A. (2019). *Corporate Governance. 6th ed.* Oxford: Oxford University Press.
[13] ECGI (2019). *Corporate Governance in the United States*. Available at: https://www.ecgi.global/content/corporate-governance-united-states.

transactions. By imposing rigorous standards, SOX aimed to rebuild investor confidence and instill a culture of transparency and integrity within corporate America.

The Sarbanes-Oxley Act, enacted in response to financial scandals, encompassed six major themes targeting the root causes of the crises[14], that can be summarized as follows:

- Created the Public Company Accounting Oversight Board (PCAOB) to independently oversee public accounting, register accounting firms, and establish standards for auditing, quality control, and ethics.
- Introduced standards to preserve auditor independence, prohibiting auditors from performing certain non-audit services concurrently with an audit. Included provisions on audit partner rotation, auditor approval, and reporting requirements.
- Mandated that public company audit committees consist of independent board members, with at least one financial expert. Committees were required to establish procedures for addressing complaints on accounting issues and have the authority to engage independent advisors.
- Implemented rules for senior executives to certify financial statements, prohibited executive interference in audits, and outlined the forfeiture of executive compensation in specific circumstances following an accounting restatement.
- Introduced new requirements for enhanced financial disclosures related to SEC-filed transactions and established internal control mechanisms for financial reporting.
- Expanded criminal laws related to financial records, reporting, and disclosure. Introduced federal criminal penalties for manipulating financial records to obstruct investigations, retaliating against whistleblowers, and enhanced penalties for certain white-collar crimes, making the failure to certify financial reports a felony.

The Sarbanes-Oxley Act, while facing criticism during its development and enactment, has largely withstood challenges to its legitimacy. While concerns about its scope, jurisdiction, and impact on the IPO market were raised, they have not significantly undermined the law’s credibility over time. However, two aspects of Sarbanes have faced sustained criticism. Firstly, there’s apprehension that the law relies on procedural solutions, leading to a superficial “tick the box” approach that prioritizes form over substance. The concern is that important principles may be lost in bureaucratic

[14] Elson, C., Peregrine, M. (2022). *The Important Legacy of the Sarbanes Oxley Act.* The Harvard Law School Forum on Corporate Governance. Available at: https://corpgov.law.harvard.edu/2022/08/30/the-important-legacy-of-the-sarbanes-oxley-act/.

procedures. The second and more controversial provision is Section 404, requiring an annual internal controls certification. While well-intentioned, it has been criticized for subjecting internal controls to extensive bureaucratic review by individuals lacking top-level experience in evaluating systemic risk. This has resulted in increased costs for companies without necessarily providing a meaningful risk analysis. During the 2008 financial crisis, the failure of such controls to identify serious risks in financial instruments raised doubts about the competence of the evaluators. The reliance on Section 404 reviews for assessing financial health was questioned, with some arguing that it may have contributed to disastrous consequences. Despite the importance of internal controls, Section 404 remains a contentious aspect of Sarbanes, casting a controversial shadow over the legislation for some observers. Coates (2007) argued that the Sarbanes-Oxley led to increased spending on internal controls by firms and higher audit costs. The legislation promised long-term benefits, such as reduced risk of fraud, reliable financial reporting, transparency, and accountability. It was expected to lower the cost of capital for public companies and contribute to a better allocation of resources and faster economic growth. However, the full costs and benefits are challenging to quantify. The paper argues that Sarbanes-Oxley should bring net long-term benefits, improving auditing and preventing a return to the problems of scandals like Enron and Worldcom. Despite being a work in progress, the legislation requires ongoing scrutiny, particularly in terms of governance and accountability enforced by the Public Company Accounting Oversight Board.

1.3.2 United Kingdom

The United Kingdom is widely recognized as a global frontrunner in the reform of corporate governance. This position emerged due to an increasing focus on corporate governance matters, and it was partly spurred by notable scandals, including the Maxwell scandal of 1991 (a major case of fraud), and partly a consequence of boards and shareholders reflecting on their practices following the economic downturn in the early 1990s. The release of the Cadbury Report in 1992 marked the initial effort to codify best practices in corporate governance in a formal document, elucidating the previously implicit corporate governance frameworks within many UK firms. This influential report has since paved the way for corporate governance reforms in the UK, inspiring a multitude of policy papers, principles, guidelines, and codes of conduct both in the UK and internationally (Solomon and Solomon, 2004). Over the years, subsequent reports and codes, such as the Greenbury Report (1995), Hampel Report (1998), Turnbull Guidance (1999), Higgs Review (2003), and Walker Review (2009), have built upon the principles established by the Cadbury

Report, addressing various aspects of corporate governance, including executive remuneration, risk management, board effectiveness, and shareholder engagement.

The UK Corporate Governance Code, formerly known as the Combined Code, was first introduced in 1998 and has been periodically updated to reflect changing governance practices and regulatory requirements. It sets out principles of good governance for listed companies in the United Kingdom, covering areas such as board composition, directors' duties, board evaluation, remuneration, and shareholder relations. The Code functions under a principle of "Comply or Explain", understanding that a single method may not be appropriate for all firms. It acknowledges that certain situations might warrant an alternative to adhering to a specific Provision, considering variables such as a company's size, intricacy, location, and ownership model. This "Comply or Explain" system provides adaptability, urging companies to select governance frameworks tailored to their unique needs, both immediate and long-term. If companies opt not to follow the Code, they are expected to clarify why their chosen approach better serves the purpose of maintaining robust governance standards.[15] Thoughtfully crafted corporate governance strategies coupled with transparent operations can foster greater trust. Such practices enable investors and stakeholders to evaluate a company's governance and reporting with a more informed perspective.

Roberts et al. (2020) argue that while visible compliance with a Code of conduct may not directly indicate board effectiveness, it plays a crucial role in establishing and reinforcing norms that shape board behavior. The "Comply or Explain" approach enhanced transparency regarding board structure and operations, potentially making boards more accountable to shareholders. However, the main focus of the Code was on directors; it emphasized that directors should ensure their actions align with the principles of the Code. The Cadbury report highlighted the inherent "freedom" of directors and suggested that along with this freedom, directors should also bear accountability. To address this, the Code mandated companies to either adhere to its guidelines or provide explanations if they chose to deviate. The Code is seeking to influence "how directors act upon themselves and each other". It seems likely that the Cadbury Committee in 1992 utilized agency theory to emphasize the importance of the independent non-executive director's "control function" and to establish "best practice" rather than solely focusing on having independent non-executive directors oversee potentially self-serving executives.

[15] Financial Reporting Council (2023). *UK Corporate Governance Code.* FRC. Available at: https://www.frc.org.uk/library/standards-codes-policy/corporate-governance/uk-corporate-governance-code/.

1.3.3 European Union

The corporate governance framework for listed companies in the European Union is a combination of legislation and "soft law", and, as in the United Kingdom, it is largely based on a comply-or-explain principle. While legislation define clear lines to distinguish legal from illegal activity, soft law is typically composed of corporate governance codes that contain "recommendations" for healthy and responsible governance. In this section we will retrace the main steps of the evolution of corporate governance regulation in the European Union in the latest decades.

In late 2001, the EU Commission formed the EU High-Level Group of Company Law Experts, to offer impartial guidance on updating company law in Europe. The group was led by Jaap Winter, which is why the report they produced is sometimes called "the Winter Report" (2002). Regarding matters of corporate governance, the committee recommended the following actions for publicly traded companies:

- Mandating companies to publish an annual corporate governance statement, expressing compliance with national codes on a "comply or explain" basis;
- Entrusting nomination, remuneration, and audit decisions to non-executive or supervisory directors, with a majority being independent;
- Requiring companies to disclose details about independent directors, including reasons for independence, qualifications, and remuneration;
- Prescribing detailed disclosure of individual directors' remuneration and prior shareholder approval for stock option schemes;
- Requiring mandatory publication of relevant material for annual general meetings on company websites, with provisions for electronic voting.

In 2007, the Directive on the exercise of shareholder rights (Directive 2007/36/EC) was issued, recommending timely access to information and the ability to vote remotely for shareholders. The directive abolished share-blocking practices, allowing shares to be traded freely during annual general meetings. These changes aimed to enhance shareholders' voting capabilities and facilitate cross-border voting. In 2010, following the global financial crisis, the European Systemic Risk Council (ESRC) was created to oversee the macro-prudential aspects of the financial system and to prevent and mitigate systemic risks to financial stability in the EU. A public consultation on potential future improvements to the current corporate governance mechanisms was initiated by the EU in 2011 with the release of the "Green Paper on the EU Corporate Governance Framework". The Green Paper was divided into three chapters: shareholders, boards, and the "comply or explain"

rule. The aim of the Green Paper was to initiate a comprehensive discussion on the matters presented.[16] The main piece of legislation in the European Union that concerns corporate governance at the present date is the Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017. Commonly known as *EU Shareholder Rights Directive II* or with the acronym *EU SRD II*, it amends and supplements Directive 2007/36/CE and entered into force on 9 June 2017. It represented a pivotal step towards harmonizing corporate governance standards across the European Union. By addressing shareholders' rights to vote and engage in decision-making, the Directive seeks to rebalance the relationship between companies and their investors. Furthermore, by enhancing transparency in related-party transactions and encouraging active shareholder engagement, EU SRD II aims to foster a more accountable and responsive corporate environment.

The original Directive of 2007 established "rules promoting the exercise of shareholder rights at general meetings of companies with registered offices in the EU and the shares of which are admitted to trading on a regulated market in the EU".[17] The 2017 revision aimed to "encourage long-term shareholder engagement to ensure that decisions are made for the long-term stability of a company and take into account environmental and social issues". The revised Directive is aimed to facilitate the identification of shareholders and improve the flow of information between the shareholders and the company; and to improve the oversight of directors' compensation; moreover it regulates related party transactions (transactions that take place between two parties who hold a pre-existing connection prior to the transaction); and introduces greater transparency.

The amended Directive has introduced significant changes to enhance shareholder rights and transparency in companies, in particular:

- Companies are now required to provide shareholders with 21 days' notice for general meetings, and meeting details, including date, location, agenda, voting procedures, and participation guidelines, must be available on the company's website.
- Shareholders with a 5% holding can propose agenda items and resolutions for general meetings. They also have the right to ask questions related to agenda items, with the company obligated to respond. Shareholders can participate and vote without limitations, subject to a qualifying date set by the company.

[16] Mallin, C.A. (2019). *Corporate Governance. 6th ed.* Oxford: Oxford University Press.
[17] European Union (2017). *Legal content summary. Shareholder Rights Directive.* EUR-Lex. Available at: https://eur-lex.europa.eu/EN/legal-content/summary/shareholder-rights-directive.html

- EU countries are urged to eliminate restrictions on shareholders participating in meetings through electronic means and accepting proxy appointments electronically. Companies are required to accurately count votes for each resolution and publish results within a specified timeframe.
- The directive introduces additional rights, including allowing shareholders to vote on director remuneration policy every four years. The policy should align with company strategy and disclose fixed and variable components of directors' pay. Shareholders can also vote on annual remuneration reports, with both the policy and reports being publicly disclosed.
- Companies now have the right to identify shareholders and obtain information on shareholder identity from intermediaries. Some countries may implement a minimum holding threshold before companies can request shareholder identification.
- The directive aims to facilitate shareholder rights, making it easier for shareholders in other EU countries to participate in general meetings. Intermediaries are tasked with providing shareholders with necessary information for exercising their rights and transmitting shareholder information to the company.
- For material transactions between listed companies and related parties, public announcements are required, and depending on the country, an independent report and shareholder approval may be necessary.
- Institutional investors and asset managers must publish a policy on shareholder engagement, disclosing their voting practices annually. Asset managers need to explain how their investment strategy contributes to medium to long-term performance.
- Proxy advisors, providing research and recommendations on voting, are subject to transparency requirements, reporting on the application of their code of conduct or providing reasons for not applying it.
- Implementing Regulation (EU) 2018/1212 establishes minimum requirements for identifying shareholders, transmitting information, and facilitating the exercise of shareholders' rights.

1.3.4 Global Perspective

Baker and Anderson (2010) argue that the persistence of differences in global financial systems necessitates a move toward convergence in corporate governance rules and guidelines. The emerging global corporate governance rules are shaping capital market structure worldwide as well

as informing competitiveness and the level of protection provided to investors. The globalization of capital markets and the demand for investor protection in response to financial scandals also require consistency and uniformity in corporate governance rules and guidelines. Standard-setting bodies in global finance typically operate with a core-periphery approach, separating standard-setters from standard-takers and emphasizing financial stability. This approach is problematic in today's interconnected financial world, especially for developing countries outside these bodies. Using the Basel banking standards as an example, it's evident that such a two-tier decision-making structure can disadvantage peripheral countries. Additionally, when regulating non-bank credit intermediation, an exclusive focus on financial stability can undermine other essential goals like financial inclusion. To enhance international standards, the following recommendations are proposed:

- Enhance the applicability of standards across diverse jurisdictions.
- Broaden the scope of standard-setting to consider more than just financial stability.
- Establish a new standard-setting body for fintech regulation that adopts a more inclusive and comprehensive perspective.

As Solomon and Solomon (2004) underline, the issue of corporate governance internationally revolves around the potential harmonization of standards. While some believe that countries are moving towards a unified global approach, particularly with initiatives like the OECD Principles, the actual trajectory remains uncertain. Rapid reforms, often in response to crises like the 1997 Asian Crisis or the Enron collapse, may not be thorough or sustainable. There's a risk that countries might hastily adopt the Anglo-Saxon model of corporate governance without considering its fit within their unique legal, economic, and cultural contexts. The demand for worldwide alignment in corporate governance arises from the presence of factors driving international harmonization in financial markets. This trend is fueled by the growth in global investment, foreign subsidiaries, and the integration of international capital markets. Companies are increasingly seeking capital from foreign investors rather than relying solely on domestic sources. Standardizing corporate governance practices is viewed as a means to instill confidence in a nation's financial markets and attract investors to commit their funds. A key recommendation though is for policymakers globally to carefully evaluate and choose a sustainable governance model suited to their specific circumstances rather than hastily embracing potentially unsuitable systems.

Regulatory frameworks play a pivotal role in shaping the contours of corporate governance. Whether through fostering transparency, enhancing shareholder rights, or safeguarding market

integrity, these regulations serve as catalysts for change, driving companies towards greater accountability and responsibility. The development of corporate governance regulation has largely stem by the need for more transparency and accountability to help restore the economic agents' confidence in the world's markets, firms and institutions after the damage caused by financial scandals and corporate collapses, that are often the result of unhealthy corporate governance and reckless risk management or by the lack of appropriate oversight by the companies' boards.

1.4 Cases of Corporate Failures

Numerous high-profile corporate collapses and scandals in recent times have shown how corporate actions can have huge negative consequences on global markets and on all the economic agents. These incidents have urged regulators to reconsider their regulatory approaches and enforcement strategies, while also pushing companies to reassess their organizational designs and emphasize the need for ethical business practices. The repercussions of corporate failures extend to various stakeholders, including employees, business partners, investors, creditors, auditors, regulators, capital markets, and society as a whole. The gravity of these consequences becomes more pronounced when such events coincide with economic turmoil, like during financial crises, or when they involve an entire industry, as seen for example in the diesel emission scandal. In such instances, the fallout can trigger widespread adverse effects within a country, and potentially result in contagion effects spreading across borders and industries (Cole, Johan and Schweizer, 2021). In this section I will discuss two significant cases of corporate fraud: the infamous scandal that involved the American energy giant Enron and the bankruptcy of the Italian company Parmalat. These market failures that took place in the early 2000s had major impact on regulation and the issues they raised regarding corporate governance are still relevant.

1.4.1 Enron (2001)

The Enron case clearly shows the dangers of weak corporate governance and ineffective checks and balances; with its failings it underlines some crucial challenges that emerge in the direction and control of a company. Despite the superficial appearance of robust corporate governance and a company's seeming financial health, unscrupulous conduct at the top can lead to an inevitable downfall, emphasizing that ethical integrity at all levels is fundamental for sustainable success.

On 2 December 2001 Enron Corporation, one of the ten largest companies in the USA, filed for Chapter 11 bankruptcy (a type of court protection giving the company management time to make arrangements with their creditors), becoming the largest bankruptcy in American history at the time.[18] In the following months, more and more evidence emerged of corporate governance weaknesses and fraudulent activity. Enron was a Houston-based energy company founded in 1985 by Kenneth Lay, by merging two American gas pipeline companies, Houston Natural Gas and InterNorth. In a period of 16 years the company transformed itself from a relatively small

[18] Bratton, W. (2002). *Does Corporate Law Protect the Interests of Shareholders and Other Stakeholders?: Enron and the Dark Side of Shareholder Value.* Tulane Law Review. New Orleans: Tulane University Law School (1275).

enterprise, involved in pipelines, oil and gas trading, to the world's largest energy trading company. In the mid-1990s, Enron embarked on an expansion of its gas trading strategy into diverse markets characterized by certain features. These markets were marked by fragmentation, intricate distribution systems, fungible commodities, and opaque pricing structures. Enron expanded its investments by introducing more adaptable pricing frameworks through the use of financial derivatives to manage risks. The company confidently claimed that the expertise and systems acquired in gas trading could be successfully applied to these other markets, allowing it to transition from an energy-centric entity to a diversified financial services company, poised for substantial growth. As it approached its final stages, Enron had metamorphosed from an energy company into a predominantly financial and energy trading entity, engaging in the trading of financial derivatives alongside energy contracts.

The first relevant worries about the solidity of the firm emerged in the late '90s and regarded Enron's ability to effectively handle its growing number of smaller customers. Criticisms were also directed at the management team, accused of being arrogant, overly ambitious, and possibly sycophantic, with allegations that Kenneth Lay operated like a cult leader, fostering an unhealthy business environment. Such ethical lapses were deemed indicative of poor corporate governance, serving as warning signs for potential issues within the company (Solomon and Solomon, 2004). Enron faced significant skepticism and criticism over confusing financial disclosures for the year 2000, raising doubts about the quality of earnings and the purpose of transactions. More and more analysts started to question the lack of transparency. The CFO, Jeffrey Skilling, replied with dismissive and arrogant comments. In February 2001 Kenneth Lay retired, and named Skilling CEO, while boasting about the stock's value. In March Enron's video-on-demand deal with Blockbuster was canceled, and the stock fell. During the spring and the summer, risky deals unraveled, causing a huge cash shortfall and the stock price decline. Skilling resigned in August, and internal warnings emerged about undisclosed related party transactions used to hide the total amount of debt. Enron's first quarterly loss was announced in October, followed by SEC scrutiny. The company restated financials, revealing enormous losses and liabilities. An announced merger with the competitor Dynegy failed, and Enron filed for bankruptcy on December 2, 2001 (Thomas, 2002).

The ethical breakdown in the Enron case extends beyond questionable business transactions. When a strong and decisive leadership was crucial, Enron's leader chose to step down. In August 2001, Jeffery Skilling resigned from his position as President and CEO of Enron, simultaneously selling

$66 million worth of his company stock. Merely two months later, Enron revised its earnings, leading to a plummet in stock prices. In an effort to stabilize the company, Enron froze shares, leaving employees, who had been encouraged to heavily invest in the company, unable to salvage their investments. The corporate culture, emphasizing individualism and innovation ultimately lacked compassionate and responsible leadership. Inadequate leadership by Lay and Skilling significantly contributed to shaping the company's culture, ultimately leading to its downfall. the repercussions of unethical or illegal actions often unfold long after the deeds are committed. Enron's collapse can be attributed to a web of interconnected decision-making processes. The gradual erosion of Enron's culture occurred through the continuous violation of ethical boundaries, allowing increasingly questionable behavior to go unchecked. While this decline did not escape everyone's notice, individual employees at Enron, auditors at Anderson, and even some market analysts identified irregularities in the Enron situation well before the public became aware of the company's transgressions (Sims and Brinkmann, 2003). As Giroux (2008) underlined, Enron's scandal is emblematic, featuring massive executive compensation packages, a management fixated on consistently meeting quarterly earnings forecasts to sustain lucrative compensation – often achieved through accounting manipulations. The board of directors merely served as a rubber stamp, and the CFO personally benefited from related-party partnerships and undisclosed side agreements. The auditing firm, Arthur Andersen, and legal counsel, Vinson and Elkins, played accommodating roles. Enlisting investment bankers willing to structure financial deals globally for substantial fees, their financial analysts consistently rated Enron as a strong buy, irrespective of economic realities. The political system, influenced by significant campaign contributions and extensive lobbying, frequently tilted in favor of Enron. Those who dared to voice concerns, both within and outside the company, often faced termination. Overall, ethical standards were conspicuously absent among nearly everyone involved.

The collapse of Enron's stock value had a devastating impact on its employees, that lost their jobs and a significant portion of their retirement savings. Former employees testified before Congress that they had retired with substantial amounts in Enron stock, but due to the stock's decline, they were left with virtually nothing except for their social security funds. The paper by Sridharan et al. (2002) highlighted the disparity between the treatment of regular employees and senior officers regarding the ability to sell Enron stock. While many employees were restricted from selling their stock, even as its value decreased, senior officers were able to sell their shares without similar restrictions. Enron's shareholders experienced a staggering loss of $74 billion in the four years

leading up to the company's bankruptcy, with an estimated $40 to $45 billion directly attributed to fraud, and the company's auditor, Arthur Andersen, ceased doing business after losing many of its clients. Thousands of Andersen employees lost their job, despite many of them being unrelated to the Enron audit. [19]

Jeffrey Skilling, Enron's former CEO, and Kenneth Lay, the company's founder and former chairman were both convicted in 2006 on charges of conspiracy and fraud related to the company's downfall. Skilling received a lengthy initial sentence of more than 24 years, but it was later reduced to around 14 years. He ultimately served about 12 years in prison and was released in 2019. Kenneth Lay, however, died of a heart attack in July 2006, just a few months after the verdict and before he could be sentenced.[20]

The response of American lawmakers to the company's collapse was swift and far-reaching. The aforementioned Sarbanes-Oxley Act, adopted by the US Congress in 2002, is the most significant piece of federal corporate law since the New Deal of the 1930s. The Sarbanes-Oxley is a "mirror image of Enron: the company's perceived corporate governance failings are matched virtually point for point in the principal provisions of the Act" (Deakin and Konzelmann, 2003). The underlying premise of the new legislation is that Enron's collapse was primarily caused by conflicts of interest among its senior managers and a deficiency in oversight from its board and advisers. Consequently, the Act introduces regulations designed to bolster the autonomy of directors and auditors, seeking to better align managerial conduct with the concerns of shareholders.

1.4.2 Parmalat (2003)

Parmalat Finanziaria S.p.A. filed for bankruptcy protection in December 2003, marking the largest financial collapse in European corporate history, earning it the moniker "Europe's Enron". According to Buchanan and Yang (2005), the Parmalat debacle offers a valuable lens through which to analyze the Italian corporate governance system and it highlights a specific agency problem: the conflicts of interest between a controlling shareholder and minority shareholders.

In the case of Parmalat, the controlling shareholder, Calisto Tanzi, also served as the founder, Chairman, and CEO of the company. Tanzi founded the company in the 1960s as a modest diary company, setting the stage for a trajectory of rapid growth. Upon its listing on the Milan stock

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[19] Constable, S. (2021). *How the Enron Scandal Changed American Business Forever.* Time magazine. Available at: https://time.com/6125253/enron-scandal-changed-american-business-forever/.

[20] Bondarenko, P. (2016). *Enron Scandal - Downfall and Bankruptcy.* Encyclopedia Britannica. Available at: https://www.britannica.com/event/Enron-scandal/Downfall-and-bankruptcy.

exchange in 1989, Parmalat Finanziaria emerged as the holding company for a group encompassing 58 entities, 33 of which were situated outside Italy, boasting combined sales of $720 million. The Tanzi family held control through an unlisted company. Throughout the 1990s, the company's expansion gathered momentum, with sales escalating to $3.6 billion in 1996 and nearly $10 billion in 2002. The majority of the group's growth centered on milk and dairy products, particularly in South America. However, the Tanzis also pursued diversification beyond the food industry, venturing into soccer and tourism. The majority of Parmalat's acquisitions were funded through debt. An unusual feature of Parmalat's financial structure was the simultaneous presence of substantial debt and cash. In 2002, the annual report disclosed $4.3 billion in cash and equivalents alongside $9.3 billion in debt. However, a significant portion of the reported cash on the balance sheet had in reality already been depleted (Buchanan and Yang, 2005). As per a report commissioned by prosecutors in Milan and conducted by an independent auditor, Parmalat experienced only one profitable year between 1990 and 2002. This comprehensive report sheds light on Parmalat's financial situation, revealing a decade-long deception by the company. Despite Parmalat's claims of profitability each year since 1990, the auditor suggests that the fabrication of earnings statements likely began even earlier. The report outlines numerous instances where Deloitte's Italian office, in particular, allegedly neglected to apply fundamental accounting principles and verify questionable entries. Deloitte Italy, responsible for coordinating the global audit of Parmalat, is accused of consistently overlooking and suppressing evidence of accounting irregularities (Roberts, Swanson and Dinneen, 2004).

The collapse of Parmalat empire occurred in December 2003. Despite numerous unsuccessful attempts to secure debt refinancing, Parmalat publicly acknowledged on December 8 that it could not meet its maturing bond obligations. This led to a downgrade of the bonds to junk status, precipitating a sharp decline in the company's share price. Simultaneously, Consob, the Italian securities and exchange commission, sought verification of the existence of a Bank of America account where the purported $4.3 billion cash of Parmalat was held (through a Cayman Islands entity named *Bonlat*). Bank of America promptly responded that no such account existed. Consequently, Parmalat Finanziaria was declared insolvent, and Calisto Tanzi was incarcerated (Enriques and Volpin, 2007).

Parmalat case clearly illustrates the vulnerability to fraud when a dominant group of managers and shareholders operates without a robust system of internal controls. As underlined by Dibra (2016), the effectiveness of the system of checks and balances supporting corporate governance is crucial.

Both the Enron and Parmalat cases underscore the vital roles played by non-executive directors, audit and disclosure processes, and the ethical conduct of management. While corporate governance mechanisms may not entirely prevent unethical behavior by top management, they serve as a means of detecting such activity before it becomes irreparable.

According to Sorensen and Miller (2017), several key issues contributed to this scandal. Firstly, the Tanzi family had complete control over Parmalat's board of directors, violating the principles outlined in the Codice Preda. The lack of independence in the board allowed the Tanzi family to manipulate decision-making processes to their advantage. Moreover, Parmalat's governance structures were not well-designed (in contrast to Enron, that appeared to have a model corporate governance structure on paper). The concentration of power, the absence of independent board members, and the lack of checks and balances contributed to the failure of Parmalat's governance. The external auditor, Deloitte & Touche, also played a role in the scandal. While Italian law mandated the rotation of external auditors every three years, Parmalat found a way around this by keeping Grant Thornton involved as a subcontractor, and this lack of auditor independence allowed Parmalat's managers to conceal losses and debts. Parmalat's legal counsel, the New York-based Italian law firm Zini, also participated in fraudulent activities: the sale and repurchase of Parmalat-owned companies in sham transactions, designed to create the appearance of liquidity, were facilitated with the help of Zini. The company's true financial condition was obscured by complex corporate structures and opaque financial reporting, and this lack of transparency made it difficult for investors and regulators to assess its actual financial health.

The regulatory response of the Italian government to the Parmalat scandal was embodied in the Law on Savings No. 262, also known as the *Investor Protection Act of 2005*. This law introduced a set of key provisions aimed at enhancing corporate governance, financial reporting accuracy, and investor protection. The most notable provisions can be summarized as follow[21]:

- Listed companies were mandated to adopt cumulative voting systems for the election of directors. This measure aimed to address the issue of non-independent, family-controlled boards of directors.

[21] Reform of Italian Corporate and Securities Laws: The Investor Protection Act. (2006). Available at: https://www.clearygottlieb.com/-/media/organize-archive/cgsh/files/publication-pdfs/reform-of-italian-corporate-and-securities-laws--the-investor-protection-act.pdf.

- The Chief Financial Officer was required to certify the accuracy of financial information in any public document or statement of the company. This provision aimed at ensuring accountability and accuracy in financial reporting.
- The CFO was tasked with setting up adequate controls over financial reporting, emphasizing the importance of internal controls to prevent financial misconduct.
- Both the CFO and the CEO were required to certify that internal controls over financial reporting were adequate, duly followed, and that the information in financial statements matched the company's books and records. This provision aligned with the focus on internal controls introduced by the Sarbanes-Oxley Act (SOX).
- Shareholders were given the responsibility to appoint external auditors for a term of six years. This measure aimed to enhance auditor independence and oversight by shareholders.
- Audit firms were prohibited from providing non-audit services to their audit clients, reinforcing the separation of audit and non-audit functions.
- Directors, officers, and employees of audit firms were restricted from being employed by their audit clients for a minimum of three years, preventing conflicts of interest.
- The lead auditor firm was made responsible for the audit of the client's consolidated financial statements, addressing concerns about subcontracting audit work on a global entity.
- The Italian Securities and Exchange Commission (Consob) was mandated to adopt rules defining circumstances where an Italian listed company may own subsidiaries in jurisdictions whose laws are deemed to be seriously inadequate in terms of financial reporting and transparency.
- Crimes related to financial reporting and corporate governance were introduced, accompanied by increased penalties.

The provisions of Italian Law No. 262 bear a resemblance to the Sarbanes-Oxley Act (SOX), which was enacted in the United States in response to the Enron scandal. While many provisions are similar, specific elements in the Italian law were tailored to address issues highlighted by the Parmalat scandal, such as the problems associated with non-independent board structures and lead auditors subcontracting audit work on a global scale. This regulatory response aimed to strengthen corporate governance, improve financial reporting practices, and rebuild investor confidence in Italian financial markets.

The response to corporate scandals, including the Parmalat scandal, led to a cooperative effort between the European Union and the United States in the realm of financial regulation. The European Commission and European auditing groups sought exemptions from the provisions that would subject European accounting firms to the oversight of the Public Company Accounting Oversight Board (PCAOB), created by SOX. However, after transatlantic negotiations, the EU recognized the need for regulatory reforms and agreed to replicate several provisions of SOX in its own regulations. To facilitate cooperation, the EU established the Committee of European Securities Regulators (CESR) as a forum for coordinating efforts among national regulators in the EU. This allowed the EU to present a unified voice in regulatory discussions with the U.S. Securities and Exchange Commission (SEC).

In May 2003, in response to the Parmalat scandal and other accounting irregularities, the EC published a communication titled "Reinforcing the Statutory Audit in the EU". This communication called for regulation of the accounting profession in a manner similar to the provisions of SOX. Subsequently, the EC proposed a new directive, the "Directive on Statutory Audit of Annual Accounts and Consolidated Accounts", which introduced several key requirements[22]:

- All audit firms were required to register with member states.
- Listed companies were mandated to establish an audit committee to oversee internal controls, financial reporting processes, and the independence of auditors. The committee would also monitor the annual statutory audit.
- Companies within a consolidated entity undergoing audits by multiple firms were required to establish a clear chain of responsibility.

This directive, designated 2006/43/EC, was approved by the European Parliament on May 17, 2006. It marked the end of self-regulation for the accounting profession in the EU, similar to the regulatory changes brought about by SOX in the United States.

In summary, the Parmalat scandal and subsequent accounting irregularities prompted collaborative efforts between the EU and the U.S. to strengthen financial regulations. The EU, recognizing the need for reforms, adopted measures similar to those in SOX to enhance the oversight and accountability of audit firms and listed companies.

[22] Gornik-Tomaszewski, S. and McCarthy, I. (2005), *Response to corporate fraud in the United States and Europe: towards a consistent approach to regulation*, Review of Business, Vol. 26 No. 2, pp. 15-23.

1.4.3 Some Considerations

The likelihood of engaging in corporate misconduct largely depends on the anticipated gains from such actions and the chances of being caught, along with the subsequent penalties. The promptness with which misconduct is detected and addressed plays a crucial role in maintaining an effective governance system. Additionally, internal and external governance mechanisms within companies, along with individual factors, can greatly impact the likelihood and magnitude of such misconduct (Cole, Johan and Schweizer, 2021). The speed of detecting and addressing misconduct is vital for effective governance, spanning country or state levels. Internal governance factors like strong boards, managerial ownership motives, board diversity, and audit committee compositions can reduce misconduct risks. Conversely, factors like CEO pay gaps, corrupt cultures, and political ties may increase risks. Externally, financial analysts, auditors, institutional investors, and the media play roles in monitoring and revealing misconduct. Concentrated ownership fosters better monitoring, while shareholders may value control for reasons beyond firm fundamentals, like social prestige. Media exposure also uncovers and publicizes corporate wrongdoings.

Soltani (2014) identified in his research several areas that can be considered as possible causes of corporate financial scandal. The first dimension to consider is the *corporate ethical climate* of the company and the potential for management misconduct. The climate of an organization is intended as "perceptions of organizational practices and procedures that are shared among members" and ethical climate can be seen as "the normative systems that guide organizational decision-making and the systematic responses to ethical dilemmas". Another critical aspect is the so-called "tone at the top" and executive leadership, which concerns the influence and behavior of top executives in shaping the corporate culture and how their attitudes and actions can impact the ethical standards and financial practices of the organization. The third category concerns environmental factors, including elements such as the bubble economy and market pressure: economic and market conditions might contribute to corporate financial scandals. Factors like economic bubbles can influence decision-making within corporations, that are pressured to meet the unrealistic expectations of analysts and investors. Accountability, control mechanisms, auditing, and corporate governance form another integral dimension. As we have mentioned, the role of auditing and corporate governance in preventing financial misconduct is a crucial aspect. They are supposed to ensure accountability, control, and transparency within an organization; for example, independent auditors can reduce the information asymmetry between the owners and the managers. The fifth area of focus centers on executive personal interest, compensation packages, and bonuses.

Personal interests and remuneration structures of senior executives may impact their decision-making, and, in turn, executive incentives may be linked to potential unethical financial practices. For example, the goal of reaching earning targets at all costs can result in unscrupulous behavior. Lastly, the exploration extends to fraud, fraudulent financial reporting, and earnings management. Specific financial activities and reporting practices could be indicative of fraud or manipulation. The so-called fraud triangle framework suggests that the three elements present in cases of fraud are "an incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act". Soltani (2014) acknowledges the intricate interrelationships between these core areas. These interconnections should be highlighted and discussed to reach a holistic understanding of the multifaceted dynamics contributing to corporate financial scandals.

In closing this chapter, it becomes evident the importance of healthy governance in preventing corporate misconduct and the far-reaching consequences of major corporate failures. The analysis of notable scandals like Enron and Parmalat has shed some light on the vulnerabilities within governance structures and regulatory frameworks. It is imperative to keep these lessons in mind and recognize the importance of continuous improvement in governance models and regulatory mechanisms to ensure the stability and integrity of financial markets.

CHAPTER 2. MARKET FAILURES

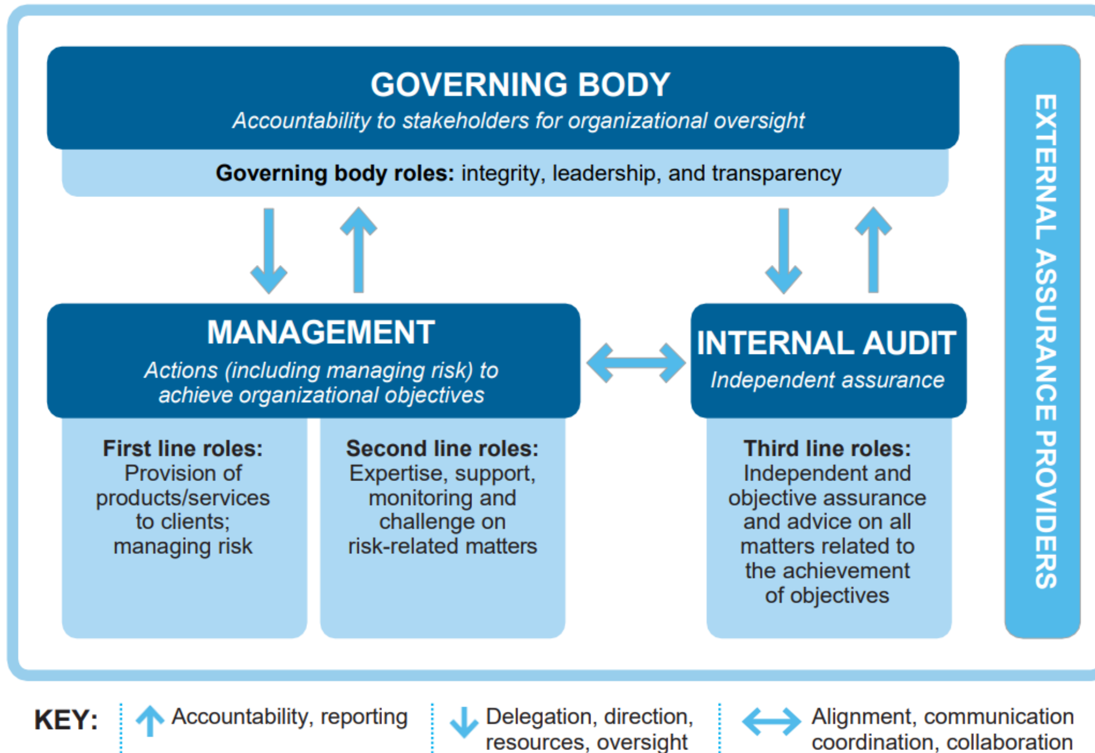
2.1 Failures of Governance in the Financial Sector

Despite the presence of internal control systems, governance processes, audit mechanisms, and regulatory structures, corporate governance failures still occur and cannot be entirely prevented, even with established control mechanisms. The emergence of governance failures adds pressure to supervisory mechanisms: a single failure tends to overshadow previous instances of effectiveness in public perception. Governance failures often result from attempts to circumvent regulations rather than a lack of regulations; strengthening the governance framework should encourage good corporate behavior. There may not be a one-size-fits-all approach to ensure good governance, regulatory efforts should focus on creating fail-safe systems and processes to the best extent possible. There is a need to understand the precise reasons for governance failure in financial institutions, this involves assessing not only regulatory aspects but also various behavioral issues contributing to the failures (Srivastava, 2023).

2.1.1 The Four Lines of Defense Model

There exists wide consensus on the fact that the Global Financial Crisis can be attributed to an important extent to failures and weaknesses in corporate governance. It becomes therefore clear why it is imperative to assure that processes are robust and effective in mitigating risks. At an international level, a lot of debate has taken place on how the corporate governance processes of financial institutions might enhance risk management (Arndorfer and Minto, 2015). In 2013, the *Institute of Internal Auditors* (an international professional association) developed the so-called "three lines of defense model", that has since then been widely adopted as a benchmark for managing risk and exercising control within organizations. The model is designed to clarify and strengthen the principles of risk management, broadening its scope, and explaining how key organizational roles work together to facilitate strong governance and risk management. However, the model was initially developed with a general applicability in mind and did not fully account for the specificities of certain sectors, such as regulated financial institutions. This has led to challenges in its implementation, with issues such as duplication of processes and lack of understanding of roles and responsibilities across organizations.

Figure 4. The IIA Three Lines Model (Institute of Internal Auditors, 2013)



As we can observe in *Figure 4*, the first line of defense involves revenue-generating units, assigning control and risk management to staff in these units. Controls in this line are very granular but allows to take action early on and to immediately notify the appropriate management levels. The second line of defense, activated if the first line fails, includes risk management and compliance functions, evolving in response to regulatory requirements; it defines preventive and detective controls, ensuring independence from the first line. The third line represents internal audit, providing independent assurance on various objectives, relying on high independence and periodic risk-based assessments. External controls involve external auditors and regulatory bodies, setting standards and assessing compliance. Cooperation and communication among these lines are crucial for effective governance and control structures (Institute of Internal Auditors, 2013).

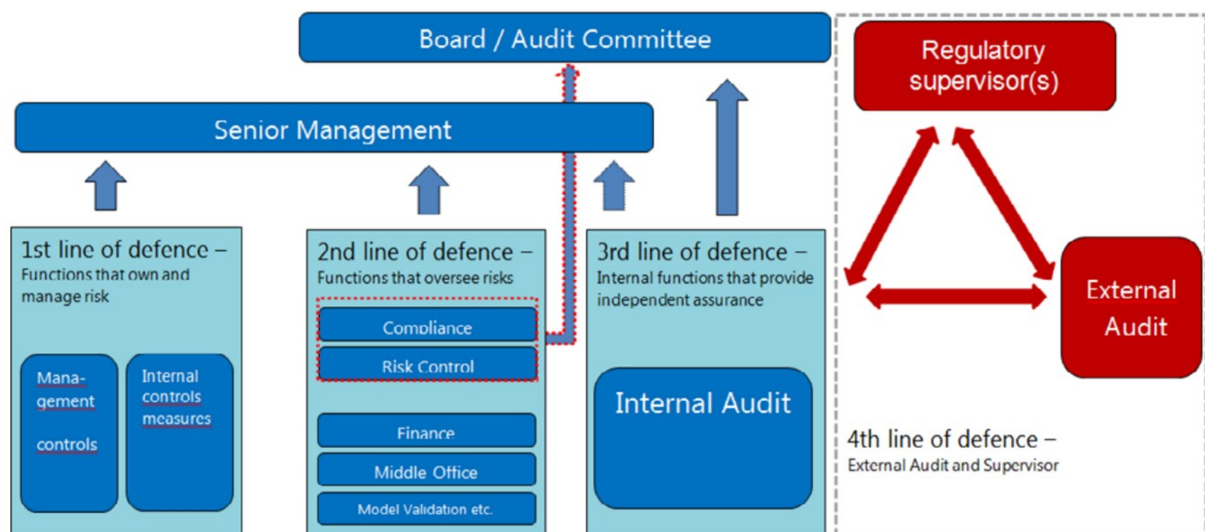
Arndorfer and Minto (2015) discuss the issues and weaknesses in the traditional three lines of defense model and propose some solutions. Let's break down the main shortcomings of the model:

- Misaligned incentives in the first line of defense. The primary responsibility of the first line of defense is generating revenue, which conflicts with control objectives. The proposed solution is to introduce a compensation system that includes a low proportion of a flexible bonus element, tied to the achievement of mandatory control objectives before any bonus payout.

- Lack of organizational independence in the second line of defense. The lack of independence in control functions, with reporting lines often going to senior management instead of the board. To address this problem, it would be useful to establish organizational independence for control functions and address remuneration challenges to ensure that control units are adequately compensated for risk awareness while allowing the organization to generate profits.
- Lack of skills and expertise in the second line functions. Second-line functions may lack the skills and expertise to effectively challenge practices in the first line. To mitigate this issue, highly qualified staff should be attracted to second-line functions by addressing remuneration disparities and offering incentives for experienced professionals to work in control roles.
- Inadequate and subjective risk assessment by internal audit. The effectiveness of internal audit work depends on a well-established, comprehensive, and objective risk assessment. It's important to enhance internal auditors' knowledge, skills, and experience, and mitigate delays in finalizing audit reports to avoid focusing on the wrong risk areas.

In response to these challenges, some have proposed adaptations to the model. With regard to the financial sector, the most notable revision is the so-called "four lines of defense model", which takes into account the specific governance features of regulated financial institutions. This model aims to enhance the existing three lines of defense model by giving it a specific focus on the regulation of banks and insurance companies. The fourth line of defense endows supervisors and external auditors, who are formally outside the organization, with a specific role in the organizational structure of the internal control system.

Figure 5. The Four Lines of Defense Model (Arndorfer and Minto, 2015)



The four lines of defense model, as we can notice in *Figure 5*, improves coordination between internal auditors and external parties, thereby reducing asymmetric information among the involved parties. Historically, international standard setters did not mandate a close relationship between supervisors and internal organs and functions. However, in the wake of the Global Financial Crisis there has been a call for increased interaction, especially in terms of strengthening dialogue with the board and senior management regarding risk governance. The four lines of defense model is designed to enhance communication between supervisors and internal audit functions by assigning a precise role to some external entities – namely external auditors and banking regulators – concerning the design of the internal control system. It recognizes that, even though these external entities are outside the organization's boundaries, they play a crucial role in assurance and governance systems.

External auditors should be an integral component of the internal control and risk monitoring systems and offer an independent evaluation of the first three lines, particularly in connection to auditing the organization's financial reporting and ensuring compliance with regulatory standards. In doing so, external auditors contribute significant assurance to shareholders and senior management; their role is pivotal in the governance and control structure of an organization, providing additional oversight alongside regulators and other external entities. Banking supervisors also bear essential responsibilities such as authorizing banks, conducting continuous supervision, ensuring compliance with laws, and taking prompt corrective actions to address safety and soundness concerns, particularly those with potential risks to financial stability. Operational independence of supervisors, coupled with a robust governance framework within the supervisory authority, stands as a cornerstone for effective supervision. In response to regulatory changes and lessons learned from the Global Financial Crisis, supervisory activities have expanded to encompass additional tasks. These include reviewing the operational risk management framework, assessing internal control frameworks, and evaluating the sufficiency of internal and external audits (Arndorfer and Minto, 2015).

2.1.2 Reasons for Governance Failures

Srivastava (2023) illustrates some major factors that have historically led to market failures, particularly in the financial sector. One of them concerns the first line of defense, that as we have seen is formed by field executives, tasked with mitigating unwarranted risk and preventing transactions that pose ethical, legal, or proprietary issues, but also expected to generate adequate, and sometimes targeted, revenue for the enterprise. This pressure can compel the front-line staff to

resort to unethical practices such as mis-selling, engaging in dubious conduct, or hiding unfavorable deals. This aspect is clearly present in the Wells Fargo scandal that we will analyze in detail, as underlined by Tayan (2019). The second and third lines of defense, comprising compliance, risk, and internal audit functions, are intended to oversee, monitor, and report on risk and misconduct at the front line. In reality, however, it is challenging for these functions to fully detach from business processes, often aligning with business decisions instead of maintaining an independent stance. The difficulty lies in the behavioral aspect of being part of the enterprise and developing an independent perspective. Additionally, management tends to place talented executives in revenue-generating roles, leading to a potential mismatch in expertise between functional teams and risk/compliance/audit teams.

Another crucial aspect to consider is the danger of personality cults inside an organization, as we have clearly seen in the Enron case. Individuals who amass power due to long tenures, expertise, charisma, or strong networks may become too influential to be governed by established systems and procedures. This issue is particularly challenging when powerful individuals, such as heads of business verticals or CEOs, make unscrupulous decisions. Financial institutions need to guard against the development of personality cults within senior management or the board, ensuring that individuals do not overshadow the importance of established systems.

One of the most complicated aspects to address is the (unfortunately not infrequent) instance of corruption at the highest levels of ownership or management. Financial institutions entrust boards and senior management with the responsibility of upholding governance standards, but there's a potential risk of their involvement in misconduct for personal gain. This poses a challenge for the first, second, and third lines of defense. In such cases, the fourth line, represented by external audit and supervisory action, becomes crucial. Effectiveness in this area requires coordination and information sharing between external auditors and supervisors. Despite their shared objective of ensuring strong financial institutions, their mandates and scopes differ. Aligning these differences through mutual respect and a well-structured mechanism is essential for swift detection and prevention of malfeasance, ensuring that any wrongdoing does not persist undetected for an extended period.

External oversight provided by "gatekeepers" such as auditors, rating agencies, and credit analysts serves as a valuable fourth line of defense for financial institutions. However, there are challenges, as gatekeepers may lack incentives to thoroughly investigate and may face limitations in accessing

accurate and transparent information, especially in cases of top-level corruption or managerial misconduct. Gatekeepers may resort to releasing evasive qualified audit reports as a way to protect themselves; their failure to report unscrupulous transactions results in poor market discipline due to a lack of credible information for stakeholders. Designing the proper balance of incentives and disincentives, strengthening regulatory frameworks, and supporting whistle-blower policies can all help to promote good corporate governance in financial institutions.

2.1.3 The Case of Elon Musk and Tesla

Regarding the excess of influence of key figures in a company, and the risks that this brings for the governance of an organization, it is interesting to mention a recent court case (Tonetta v. Musk, et al.)[23] that involved Elon Musk. Musk is the founder, CEO and former Chair of *Tesla*, the famous automotive company specialized in electric cars. The Delaware Court of Chancery – arguably the most important court for corporate governance litigation in the United States – with a verdict issued on January 30, 2024, nullified Musk's ambitious multi-year remuneration plan, called "Grant 2018", despite it had received the approval of the board. This of verdict is worthy of note, as Courts typically evaluate officer compensation with extreme deference to the board of directors (Ellis, 2022).

To give a bit of context, "Grant 2018" had a maximum value of $55.8 billion and a grant date fair value of $2.6 billion, making it the greatest pay package ever seen in public markets by many orders of magnitude: 250 times greater than the contemporaneous median peer compensation plan and more than 33 times larger than the plan's closest counterpart, the former remuneration plan of 2012 of Musk himself. The stock options would vest contingent upon "market capitalization and operational milestones." Tesla's board of directors presented the Grant to shareholders, and a majority of disinterested shareholders approved it. After the board disclosed the Grant's approval, the plaintiff, a minority shareholder, filed a lawsuit to challenge it.

To justify its verdict, the Court called into question the supposed independence of the board members that approved the remuneration plan. The Delaware Court of Chancery (McCormick, 2024) described Musk's as a "Superstar CEO", stating that he has "enormous influence" on the company and that he made Tesla "highly dependent on him". The Court acknowledged that 22.1%

[23] Delaware Court of Chancery (2024), *Tornetta v. Musk, et al*., C.A.; Jan. 30, No. 2018-0408-KSJM, 2024 WL 343699

voting power was "relatively low" in the controlling shareholder context, but even so, found that Musk was a controlling shareholder.

The Court stated that the vote approving Musk's Grant was not fully informed because the proxy statement inaccurately described key directors as independent. In virtue of his position, Musk had extensive personal and professional ties with the members of the board, including the supposedly independent directors of the remuneration board, that therefore could not be considered independent and could not prove that the compensation plan was entirely fair. The fact that Musk and the other directors merely accompanied the process rather than engaging in any meaningful negotiation serves as further evidence of this lack of independence. The Court stated: "In the final analysis, Musk launched a self-driving process, recalibrating the speed and direction along the way as he saw fit. The process arrived at an unfair price".

In fact, beside the flawed process to approve the Grant, the Court considered its extraordinary amount. The Court determined that the plan was not necessary for Tesla to keep Muska and neither to meet the company's objectives for three primary reasons:

- Musk's ownership stake of 21.9% in Tesla provided motivation to increase the company's market capitalization without additional compensation.
- There was no risk that Musk would leave Tesla without receiving the Grant, and the Board did not condition the package on Musk devoting any set amount of time to Tesla.
- The Grant's performance conditions were not ambitious or difficult to meet.

The Court stated: "Faith in a superstar CEO changes the dynamics of corporate decision-making". That is true for all corporate decisions, but the risk is magnified in cases where the Superstar CEO's interests are directly affected. That is especially true when it comes to the compensation of the Superstar CEO. In the face of a Superstar CEO, it is more important than ever for a company to implement strong minority stockholder protections, such as staunchly independent directors. In this case, Tesla's fiduciaries were not strictly independent – quite the contrary. The Court concluded that the influence of Musk on the company is so pervasive that exceptional limits must be installed to prevent the approval of an abnormally high remuneration plan that could bring the entire company on an excessive level of risk/return.

Larger-than-life business executives who can disrupt established players are frequently seen as possessing the vision, excellent leadership, or other special traits that make them extremely valuable to their company. Elon Musk is perhaps the most famous present-day example. Other

well-known figures include Jeff Bezos (Amazon), Jamie Dimon (J.P. Morgan), and Reed Hastings (Netflix). However, these “Superstar CEOs” present problems for the doctrine of corporate law. Hamdani and Kastiel (2023) demonstrated that superstar CEOs still have a great deal of influence over boards of directors, even in this day and age of ever-more-powerful shareholders. Superstar CEOs’ influence does not stem from their official control over director nomination or other sources of directors’ agency costs. Instead, it is predicated on the widely held notion that a CEO – and this particular CEO alone – possesses the necessary skills to generate superior returns for investors. As a result, it is worth noting that the influence of superstar CEOs is limited in both time and extent: it will probably disappear when investors lose faith in their star power, and it cannot be abused if the CEO’s negative effects on the business outweigh the value of their distinctive contribution.

One of the main issues for good corporate governance presented by Superstar CEOs is that directors may be reluctant to oppose them, because they worry about the impact losing one would have on the business, especially if their misbehavior is uncovered. Think about a CEO who participates in illegal activities that could be detrimental to the business, like unfair hiring practices. The board may be reluctant to fire the CEO if he or she is widely seen as essential to the company’s success or, more likely, may decide that it is better to keep the CEO’s wrongdoings a secret. The CEO may also receive more weight from the board when it comes to legal risks and compliance plans. Shareholders may benefit from the continued leadership of a powerful CEO and are more likely to tolerate wrongdoings despite its consequences for third parties (as long as it does not significantly reduce company value). It is therefore clear that too-powerful CEOs or other key figures can pose relevant risks to the check-and-balances system that corporate governance is supposed to uphold, as multiple scandals and corporate failures have shown.

2.1.4 The Role of Regulators

Hopt (2021) presents the main regulatory core issues for the corporate governance of banks and financial institutions. One suggested intervention is to target the composition of bank boards in favor of creditors, either by directly including creditors on the board or by entrusting someone else to represent their interests. The rationale is that creditors, being less risk-tolerant than shareholders, could help moderate a bank’s risk-taking. However, concerns are raised about the potential fragmentation of the board if creditors are given seats, which may disadvantage shareholders. The passage also mentions historical considerations of having a public interest representative on the board, but this idea was not adopted due to the challenges of defining public interest and potential political influence. Alternatively, labor representatives or supervisors could be entrusted with

safeguarding creditors' interests. However, the effectiveness of labor representatives in representing creditors is questioned. The idea of giving bank supervisors a regular seat on the board is considered, but arguments against it include existing rights for supervisors to participate in board sessions, implications for supervisors' liability and potential conflicts of interest, since they would have to "oversee as supervisors what they co-decided as board members". Another suggested approach involves increasing the role of independent directors, with a focus on their qualifications and expertise. The lack of independence has been cited as one of the elements that led to Enron's failure (Gillan and Martin, 2007): several board members and the external auditor faced conflicts of interest that weakened their role as monitors. However, empirical research indicates that, for banks, *expertise* may be even more critical than independence in overseeing executive directors (except in audit and risk committees).

Supervisory practices, in particular in Europe, emphasize risk management, compliance, and organizational issues for bank boards. The duties imposed on banks, particularly after the financial crisis, are more stringent and detailed compared to general corporate regulations. Recent attention has been given to the compensation of bank directors to avoid misplaced incentives, as underlined also by Triplett (2018), in connection to the Wells Fargo scandal. The unique dangers of banking groups, such as interconnectedness and loss of confidence, lead to more demanding regulations than those for corporate groups. While proposals for stricter personal director liability may not be convincing, a promising idea is the introduction of a "compliance clawback" system, holding directors liable for compliance failures with limited recourse to a proportionate clawback of stock-based pay. In contrast to general corporations, where the focus is on the board, the financial industry requires a more comprehensive approach. The financial crisis revealed that abuses often occurred below the board level, necessitating direct addressing of bank managers and personnel undertaking risky business. The conflict between bank governance rules and labor law regarding personal liability for employees needs resolution, with a preference for bank governance rules prevailing or finding a legal solution.

In discussions about corporate governance enforcement, there is a growing focus on procedural and insolvency law, particularly in banking law, shifting from banking contract law to bank supervisory law and regulation. Despite this shift, there is limited evidence of increased enforcement by shareholders, including large shareholders, institutional investors, and hedge funds. Imposing legal obligations on creditors instead of investors is seen as inadequate, as it would merely transfer the issue from one group to another. Small and bond creditors have rational

disinterest, while large investors like banks may not have strong incentives to intervene. Bank and insurance supervisory control, acting as trustees for debtholders and depositors, should ensure effective enforcement of corporate governance rules, possess necessary competence, and have the ability to impose sanctions. However, supervisory regulations should not stifle the board but allow for discretion under co-regulation. Additionally, there is a potential role for banks' own codes of conduct, endorsed by institutions like the Basel Committee, EBA, and FSB. Ultimately, ethical standards set by companies and business leaders, especially in the banking sector, play a crucial role in shaping corporate governance.

In the following pages we will analyze two major scandals that shook the financial industry in the previous decade: the infamous LIBOR manipulation scandal and the case of misconduct that involved the American bank Wells Fargo. I believe these examples are useful to grasp the consequences of lack of healthy corporate governance and how dire can be the impact on the stakeholders.

2.2 The LIBOR Manipulation Scandal

In the intricate world of global finance, where trust is at the foundation of the entire system, the London Interbank Offered Rate (LIBOR) used to stand as a symbol of stability. This index played a decisive role in determining interest rates for trillions of dollars in loans, mortgages, and financial derivatives. The LIBOR manipulation scandal, which came to light in the years following the Global Financial Crisis, shook the foundations of the financial industry: the very benchmark that financial institutions and markets relied upon for transparency and accuracy was being systematically manipulated by some of the world's largest banks. This egregious betrayal of trust not only undermined the credibility of the financial system, but also exposed the vulnerabilities and ethical shortcomings intrinsic in the mechanisms that govern global finance. This analysis aims to expose the motives, methods, and repercussions that defined one of the most infamous episodes in modern financial history. From the origins of LIBOR to the mechanisms of its manipulation, we will explore the ripple effects that reached far beyond Wall Street and the City of London, and we will examine the regulatory oversights, institutional failings, and the profound impact on market participants and the broader economy. The LIBOR manipulation scandal serves as a reminder that even the most trusted pillars of the financial world can fall under the weight of malpractice, raising critical questions about the resilience and ethical foundations of the global financial system.

2.2.1 Origin and Evolution of LIBOR

The importance and impact that the London Interbank Overnight Rate had on the global financial markets cannot be overstated: through the years it has been referred as *"the world's most important number"* (Wiggs, 2022). Minos Zombanakis, a Greek banker, is credited with the origination of LIBOR. In 1969, he arranged an $80 million syndicated loan from the bank *Manufacturer's Hanover* (now part of JP Morgan) to the Shah of Iran. This transaction was based on the reported funding costs of a set of reference banks. Zombanakis recalled: "We had to fix a rate, so I called up all the banks and asked them to send to me by 11 a.m. their cost of money. We got the rates, I made an average of them all and I named it the London interbank offer rate."[24] The rate was set in this way for more of 15 years, founding its reliability on a sense of responsibility and trust among large banks.

[24] Thomas, L. (2012). *Trade Group for Bankers Regulates a Key Rate.* The New York Times. 5 Jul. Available at: https://www.nytimes.com/2012/07/06/business/global/the-gentlemens-club-that-sets-libor-is-called-into-question.html.

Establishing LIBOR introduced a standardized interest rate that exhibited lower volatility compared to the highly fluctuating rates of government debt, which was the sole reputable alternative during that period. By the mid-1980s, banks whose submissions determined the LIBOR fixing began to heavily borrow using LIBOR-based contracts. In response to this, the British Bankers' Association (BBA) took control of the LIBOR rate in 1986 to formalize the data collection and governance process. In 1986, LIBOR fixings were calculated for the U.S. dollar, the British pound, and the Japanese yen. Over time, additional currencies were included, and existing ones were integrated into the euro. In 2012, the BBA had oversight of fixings for over ten currencies, with fifteen maturity terms (called *tenors*) reported for each currency, ranging from overnight to a 1-year term (Hou and Skeie, 2014). The U.S. dollar LIBOR rates were considered particularly important, given the global significance of the U.S. dollar. The rates were reported daily by panels of banks for various currencies, including Australian dollars, British pounds sterling, Canadian dollars, Danish kroner, euros, Japanese yen, New Zealand dollars, Swedish kronor, and Swiss francs.

Table 1 presents a snapshot of the contributor banks to each panel on January 1, 2013, indicating whether each bank was considered a Globally Systemically Important Bank (GSIB), with a systemic significance "bucket number", which measures the systemic significance of a bank from 1 (lowest) to 5 (highest). Notably, the majority of contributor banks were GSIBs, and even those that weren't were likely considered local-SIBs, emphasizing the systemic significance of LIBOR contributors, many of whom fell into the "too big to fail" category. The table also reveals the banks that were included in the so-called *Group of Fourteen* (G14), comprising the most active derivative traders globally. These fourteen banks collectively represented a substantial share, approximately 70%, by value of basic interest rate swaps (IRSs) and over 80% of the total outstanding interest rate derivatives (McConnell, 2013).

Table 1. LIBOR panels on January 2013 (McConnell, 2013)

Contributor bank	GSIB	G14	USD	EUR	GBP	JPY	CHF	CAD	AUD	NZD	DKK	SEK
Abbey National	—	—	—	Yes	Yes	—	—	—	—	—	—	—
Bank of America	2	Yes	Yes	—	—	—	—	—	—	—	—	—
Bank of Nova Scotia	—	—	—	—	—	—	—	Yes	—	—	—	—
Bank of Tokyo-Mitsubishi UFJ	2	—	Yes	Yes	Yes	Yes	Yes	—	—	—	—	—
Barclays Bank	3	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
BNP Paribas	3	Yes	Yes	—	Yes	—	—	—	—	—	—	—
CIBC	—	—	—	—	—	—	—	Yes	—	—	—	—
Citibank NA	4	Yes	Yes	Yes	Yes	—	Yes	—	—	—	—	—
Commonwealth	—	—	—	—	—	—	—	—	Yes	Yes	—	—
Credit Agricole	1	—	Yes	—	Yes	Yes	—	—	—	—	—	—
Credit Suisse	2	Yes	Yes	Yes	—	—	Yes	—	—	—	—	—
Deutsche Bank	4	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
HSBC	4	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
JP Morgan Chase	4	Yes	Yes	Yes	Yes	Yes	Yes	—	Yes	Yes	Yes	Yes
Lloyds Banking Group	—	—	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Mizuho Bank	1	—	—	Yes	Yes	Yes	—	—	—	—	—	—
Rabobank	—	—	Yes	Yes	Yes	—	—	—	—	—	—	—
Royal Bank of Canada	—	—	Yes	Yes	Yes	—	—	Yes	—	—	—	—
Société Générale	1	Yes	Yes	Yes	Yes	Yes	Yes	Yes	—	—	—	—
Sumitomo Mitsui Banking Corporation	1	—	Yes	—	—	Yes	—	—	—	—	—	—
Norinchukin Bank	—	—	Yes	—	—	Yes	—	—	—	—	—	—
Royal Bank of Scotland	2	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
UBS	2	Yes	Yes	Yes	Yes	Yes	Yes	—	—	—	—	—
Panel Size	—	11	18	15	16	13	11	9	7	7	6	6

Standardized inter-bank rates, such as LIBOR, served as attractive benchmarks for investors and borrowers because they enabled lending banks to adjust loan terms based on changes in the funding costs of an average bank during the loan's duration. The development of LIBOR was influenced by the need for a standardized interest rate benchmark that provided consistency in assessing and pricing various financial products, driven by the growth in financial instruments like forward rate agreements. The construction of LIBOR provides the justification for its widespread use in contracts. LIBOR acts as the lower bound for the borrowing rate of other less creditworthy institutions and individuals, ceteris paribus, since it represents the terms at which the biggest and most financially stable institutions in the world are able to obtain funding on a short-term basis. Rates are commonly expressed as "*LIBOR + x*", where *x* is the premium, expressed in basis points, that is added to the LIBOR rate of the corresponding maturity term for each individual borrower. Hou and Skeie (2014) break down the theoretical component of LIBOR:

LIBOR = overnight risk-free rate over the term + term premium + bank term credit risk + term liquidity risk + term risk premium

- Overnight risk-free rate over the term: This is the hypothetical overnight interest rate at which a riskless institution could borrow over the LIBOR loan period. It serves as a baseline for the cost of funds without considering any other risk factors.

- Term premium: Represents the intertemporal rate of substitution for the term of the loan. It accounts for the fact that lenders may prefer shorter-term loans over longer-term ones or vice versa. The term premium compensates for the time value of money.
- Bank term credit risk: LIBOR banks are not considered risk-free borrowers. This component adds the borrower's counterparty credit risk, which is commensurate with the loan maturity. It reflects the risk that the borrowing institution may default on its obligations over the term of the loan.
- Term liquidity risk: Compensates for the maturity risk incurred by the lender. It reflects the potential market illiquidity for interbank funds, which may increase the lender's rollover refinancing costs. This factor acknowledges that tying up funds for a longer period of time exposes the lender to liquidity risks.
- Term risk premium: Accounts for the risk that any of the aforementioned components (overnight risk-free rate, term premium, bank term credit risk, term liquidity risk) may have realizations that differ from their expected amounts. It provides compensation for uncertainty and potential fluctuations in these factors.

Together, these components should make up the LIBOR rate, supposedly reflecting the true cost of funds for banks in the interbank lending market. Understanding these theoretical elements is crucial for assessing how LIBOR is supposed to behave in different market conditions, especially during times of crisis when various risks may become more pronounced or interconnected, and over different maturities and time periods.

The process to establish the LIBOR rates involved – for each panel – for the contributing banks to respond to the following question: *"At what rate could you borrow funds, were you to do so by asking for and then accepting interbank offers in a reasonable market size just prior to 11 a.m.?"*. The international media and information firm Thomson Reuters, which was responsible for calculating LIBOR, then trimmed the rates by removing the top and bottom 25 percent and averaged the remaining rates to create the final LIBOR rates. These rates were published and made available around midday London time; all individual bank submissions were made public at the same time. This mechanism had several shortcomings: the process was hypothetical, subjective, and open to abuse. The hypothetical nature of the rate submission means that it was based on *estimates* rather than actual transactions. The subjectivity arose from the fact that the rate was based on what the contributing banks believed they could borrow at, rather than actual market transactions. This subjectivity opened the process to manipulation, in particular unethical

individuals within contributing banks could submit rates that did not accurately reflect market conditions. The trimming of the rates by removing the top and bottom 25 percent was intended to mitigate extreme values, but it did not entirely prevent manipulation: a bank could still submit inaccurate rates that fell within the trimmed range, leading to inaccurate LIBOR rates. In fact, even if the untruthful contribution were discarded it caused a shift in the calculation window for the trimmed mean, for example moving towards the inclusion of a panel bank with a higher rate and the exclusion of one with a lower rate or vice versa. This lack of effectiveness in preventing manipulation became a significant issue, and in the aftermath of the LIBOR scandal, efforts were made to transition away from LIBOR to alternative benchmark rates with more robust methodologies (Huan, Previts and Parbonetti, 2022).

As underlined by Kiff (2012), the significance of LIBOR did not mainly derive by the fact that banks directly transact business with each other at the announced rate, but due to its widespread use as a benchmark for various interest rates in financial contracts globally. LIBOR was crucial because it has been used as a benchmark for a wide range of interest rates in financial contracts. According to a U.K. Treasury report (HM Treasury, 2012), an estimated $300 trillion in financial contracts were tied to LIBOR. This massive figure underscores the pervasive influence of LIBOR on the global financial system. In *Table 2* we can observe the break-down of the estimated notional value LIBOR-related financial contracts. Furthermore, the $300 trillion figure does not include rates tied to adjustable-rate home mortgages and other consumer loans and, according to the report, various estimates suggest the total notional value of financial products tied to LIBOR could have reached a sum between $300 and $800 trillion.

Table 2. Use of LIBOR in Financial Contracts (HM Treasury, 2012)

Instrument/Application	Estimated value of contracts with LIBOR as benchmark
Syndicated Loans	~$10tn[(a)]
Floating Rate Notes	~$3tn[(b)]
Interest Rate Swaps	$165[(c)] – $230tn[(d)]
Exchange-traded Interest Rate Futures and Options	$30tn[(d)]
Forward Rate Agreements	$25[(d)] – $30tn[(e)]
Total	**~$300tn**

Note: Assumptions are that 50% of contracts reference LIBOR and that this list is not exhaustive.
Sources: (a) Oliver Wyman; (b) Dealogic; (c) DTCC; (d) Bank for International Settlements; (e) Trioptima

These numbers illustrate very clearly the extent of the influence LIBOR rates had on the global financial market, and the massive consequences of manipulation of LIBOR rates at the hands of submitters as we will explore on the following pages.

2.2.2 The Rate-Fixing Scandal

Early reports on LIBOR manipulation emerged in April 2008, in the midst of the Global Financial Crisis, when the *Wall Street Journal* released an article claiming that some major banks might have underreported their borrowing costs in relation to LIBOR, misleading other economic agents about their financial positions during the 2008 credit crunch.[25] This report, alongside other articles released by financial newspapers, was initially rejected by reputable international financial organizations like the International Monetary Fund[26], who stated that although there were a few unusual quotes, the evidence did not support a material manipulation of the LIBOR rates and that banks were not manipulating the rates to increase profits. Generally, it was asserted that banks weren't manipulating LIBOR rates to increase profits, but rather that these rates represented trustworthy indicators of the typical marginal cost of unsecured funding for creditworthy banks. Academic research published in the following years gave support to the initial claim made by the financial mass media that several panel banks had understated their LIBOR submissions to increase profits. Regulatory agencies in both the United Kingdom and the United States at that point

[25] Mollenkamp, C. (2008). *Bankers Cast Doubt On Key Rate Amid Crisis.* Wall Street Journal. 16 Apr. Available at: https://www.wsj.com/articles/SB120831164167818299.

[26] International Monetary Fund (2008), G*lobal Financial Stability Report: Financial Stability and Deleveraging: Macrofinancial Implications and Policy*, IMF, Washington, DC.

appeared to be aware of the irregularities surrounding the setting of LIBOR rates but did not react firmly because the LIBOR system was then a private sector arrangement, not directly subject to financial regulation (Yeoh, 2016).

The magnitude of the scandal became apparent and became a global mediatic case in mid-2012, when Barclays Bank, headquartered in the UK, was fined by two US government agencies – the Commodity Futures Trading Commission (CFTC) and the Department of Justice (DOJ) – as well as the UK's Financial Services Authority (FSA). Barclays agreed to settle at an early stage of parallel investigations by these three regulatory bodies. Since the initial revelations, more banks became implicated in the scandal, including Deutsche Bank, UBS and the Royal Bank of Scotland (Ashton and Christophers, 2015). Since then, regulators in the United States, the UK, and the European Union have imposed fines exceeding $9 billion on banks for their involvement in rigging Libor. Additionally, since 2015, authorities in both the UK and the United States have pursued criminal charges against individual traders and brokers for their complicity in manipulating interest rates (McBride, 2016).

We will focus primarily on the case against Barclays, since it can serve as a broad illustration of the scandal on a larger scale, as the main types of attempted manipulation being investigated at the overall market level closely parallel those for which Barclays, in particular, faced fines. In June 2012, Barclays Bank Plc faced a £59.5 million fine from the UK's Financial Services Authority (FSA) due to misconduct concerning the London Interbank Offered Rate (LIBOR) and the Euro Interbank Offered Rate (EURIBOR). Notably, this marked the highest fine ever imposed by the FSA.[27] The investigation revealed that Barclays began manipulating Libor in the years 2005–2007 to benefit its traders' profits on derivatives linked to the base rate. During this period, traders at Barclays reportedly influenced the submitted rates to favor their positions, and there was coordination with other banks to alter rates. As the global financial crisis unfolded in 2007–2008, Barclays was accused of manipulating Libor downward by providing false information to make it appear less risky and protect itself. This manipulation occurred during a tumultuous time, providing the bank with a semblance of stability. In 2012, Barclays admitted to misconduct in the manipulation of rates as part of a settlement with U.S. and UK authorities. Barclays agreed to pay

[27] Financial Conduct Authority (2012). *Barclays fined £59.5 million for significant failings in relation to LIBOR and EURIBOR*. FCA. Available at: https://www.fca.org.uk/news/press-releases/barclays-fined-%C2%A3595-million-significant-failings-relation-libor-and-euribor.

a $160 million penalty as part of an agreement with the U.S. Department of Justice[28] (McBride, 2016).

Ashton and Christophers (2015) illustrate how the LIBOR manipulation operated by Barclays took two forms, both of which revolved around the bank making improper rate submissions. The term "inappropriate" is used to convey that the submitted numbers did not faithfully and exclusively represent the best estimates of borrowing rates in the interbank market, as they should have. The first type involves traders at Barclays applying pressure on submitters to make rate submissions that would positively impact the traders' open positions in interest rate derivative products, specifically swaps and futures. The traders entered into contracts with counterparties that depended on interest rates pegged to LIBOR. By influencing the submitted rates, the traders could potentially gain from the impact on published LIBOR and, consequently, the quantum of interest due on these contracts. This manipulation was not an isolated incident but had become commonplace. Hundreds of requests were made by Barclays traders, often on a daily basis. The submitters at Barclays actively took these requests into account, as evidenced by both correspondence and the quantitative consistency between the submitted rates and the requests in the majority of cases. Additionally, Barclays was involved in a wider network of manipulation, including attempts to influence the rate submissions of other banks and requests from traders at other banks, including ex-Barclays employees.

The second form of manipulation involved managers exerting pressure on submitters to make submissions aimed at mitigating negative media commentary regarding Barclays' liquidity status. During the early stages of the credit crunch, a LIBOR submission was perceived as indicative of a panel bank's "goodwill" – its ability to secure uncollateralized borrowing in the interbank market, influencing creditors' assessments of the bank's future prospects. In late 2007, Barclays grew concerned that media observers had singled out its LIBOR submissions as being on the higher end of the range, leading to the interpretation of potential liquidity challenges. Instructions were provided to Barclays' submitters to decrease their submissions, and they complied accordingly. As a result, Barclays' submissions no longer appeared disproportionately higher than those of the other banks in the panels.

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[28] U.S. Department of Justice (2012). Barclays Bank PLC Admits Misconduct Related to Submissions for the London Interbank Offered Rate and the Euro Interbank Offered Rate and Agrees to Pay $160 Million Penalty. Available at: https://www.justice.gov/opa/pr/barclays-bank-plc-admits-misconduct-related-submissions-london-interbank-offered-rate-and.

The investigation into Swiss bank UBS focused on British trader Thomas Hayes, a former yen derivatives dealer and the first person convicted of rigging LIBOR. Prosecutors argued that this manipulation led to significant profits for UBS over three years. After Hayes's arrest in December 2012, UBS executives faced criticism for negligence, as they initially denied knowledge of the traders' schemes, attributing it to the complexity of the bank's operations. The fraudulent collusion, primarily involving Hayes and traders at the Royal Bank of Scotland (RBS), impacted submissions across multiple institutions, with RBS being majority-owned by UK taxpayers (McBride, 2016). Hayes was convicted of eight counts of conspiracy to defraud for his role as the ringleader in a conspiracy to manipulate the Libor rate between 2006 and 2010. He received a 14-year prison sentence, becoming the first individual convicted by a jury for rigging Libor. Hayes set up a network of brokers and traders across powerful global banking institutions to influence LIBOR for enhanced earnings. Despite defending his actions as transparent and industry-wide practice, the court deemed them unacceptable. Hayes had earlier cooperated with the UK Serious Fraud Office (SFO) as part of a plea bargain but received no reduction in his sentence and the SFO confiscated the proceeds of his crime. This and other criminal convictions that followed highlight the SFO's commitment to policing banking fraud and white-collar crimes in the UK (Yeoh, 2016).

2.2.3 Aftermath and Reform Initiatives

As we have discussed, the consequences of false reporting for many major financial institutions and individuals were severe, but the impact of the manipulation of these key rates extended to the whole financial market.

On January 31, 2014, the responsibility for administration of LIBOR was transferred from the British Banker's Association to the Intercontinental Exchange Benchmark Administration Ltd (ICE). Authorities such as the Financial Stability Oversight Council (FSOC) in the United States, the Financial Stability Board (FSB) globally, and regulatory bodies in the UK and other jurisdictions began efforts to reform the benchmark rate-setting process. The goal was to enhance transparency, eliminate conflicts of interest, and ensure the accuracy of benchmark rates. Due to the inherent vulnerabilities of LIBOR, global financial authorities advocated for the transition to alternative reference rates that were more reliable and less susceptible to manipulation.

On July 27, 2017, the Financial Conduct Authority announced that that the LIBOR rates would be gradually phased out and that the publication of LIBOR would not be guaranteed beyond 2021.[29] The Bank of England and the FCA deemed that LIBOR as unsustainable and inappropriate for the extensive reliance that has been placed on it due to the absence of an active underlying market. To protect financial stability and market integrity, both collaborated extensively with global regulatory bodies and market players to guarantee the availability of strong LIBOR alternatives and the ability to convert existing contracts to them. Additionally, new rules were introduced to make manipulation of benchmark rates a criminal offense.[30]

The publication for one-week and two-month US dollar LIBOR ceased at the end of 2021. The remaining tenors of US dollar LIBOR ceased publication on June 30, 2023. To address the necessity for a substitute benchmark due to LIBOR's termination, the US Congress passed the *Adjustable Interest Rate (LIBOR) Act* in March 2022 In contracts with terms that do not allow for a clear transition, this Act offers a procedure and protections for switching to an alternative rate. The Secured Overnight Financing Rate (SOFR) was the basis for the benchmarks that the Federal Reserve Board established in December 2022 as the replacement rates for the LIBOR Act. SOFR is based on observable transactions in the repurchase market and is collateralized by U.S. Treasury securities. [31]

The evidence presented in the paper by Batten et al. (2021) suggests that the manipulation of LIBOR by major international banks had consequences that extended far beyond the notional values of financial contracts (as we said the LIBOR rate, which was manipulated, was used to price a substantial amount of financial instruments, totaling a notional value that exceeded $300 trillion). While the immediate impact was on the pricing of those financial contracts – impacting in different ways millions of economic agents – there were broader effects. The rigging resulted in reputational damage to the implicated institutions; the trust and confidence in these banks, which are crucial for the proper functioning of financial markets, were compromised. The LIBOR rigging influenced not only the pricing of floating rate bank loans and securities, but also derivative contracts issued in international debt markets. The consequences of market manipulation led to a shift away from

[29] Financial Conduct Authority (2017). The future of LIBOR. Available at: https://www.fca.org.uk/news/speeches/the-future-of-libor.

[30] Bank of England (2024). Announcements on the end of LIBOR. [Press Release]. Available at: https://www.bankofengland.co.uk/news/2021/march/announcements-on-the-end-of-libor.

[31] Securities and Exchange Commission (2023). *What You Need to Know About the End of LIBOR – Investor Bulletin*. SEC. Available at: https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-end-libor-investor-bulletin.

pricing contracts based on LIBOR to fixed-rate borrowing facilities. Shifting from floating rate to fixed-rate borrowing incurred additional costs on corporations, as well as eventually on individuals and households. The manipulation appears to have triggered a shift in market preferences from LIBOR-based floating rate contracts to fixed-rate borrowing facilities. This shift happened despite the usual trend where floating rates are typically lower than fixed rates. The transition to fixed-rate liabilities raised risk management concerns due to the potential mismatch of maturities between assets and liabilities. The abrupt shift from floating to fixed rates introduced the possibility of vulnerability to interest rate shocks. In summary, the rigging of LIBOR by major banks had wide-ranging consequences, impacting not only the pricing of financial contracts but also causing reputational damage, shifts in market preferences, and risk management challenges.

The LIBOR case underscore the importance of ethical conduct of individuals working in financial institutions. Some legal proceedings express the view that financial markets abuse can be victimless, but even though the counterparties to manipulated LIBOR transactions were often unknown to the manipulators, the trades affected financial contracts worth trillions of dollars. Many LIBOR-linked contracts have the form of zero-sum games, for example in futures contracts, where the net gain to one party is matched by a loss to the other. Since the manipulators were always the winners in LIBOR-related trades, the financial consequences to the counterparties would have been considerable, even if they were able to offset their transactions with others.

The corporate social responsibility and stakeholder theory provide a framework to understand the process to improve ethical conduct. Epstein (1987) describes a corporate social policy process that involves individual moral reflection and choice within the corporation to facilitate corporate longevity in a changing social environment. This article is important because it makes the connection between the concepts of ethics, corporate social responsibility (CSR), and corporate responsiveness. Subsequent literature has shown that corporate responsibility generates additional economic value as well as favorable attributions from stakeholders. There is ample documentation regarding price manipulation in financial markets, such as stock markets where regulatory supervision may be compromised. But even when regulatory oversight is strong, there is no certainty of integrity, as was clearly demonstrated in the Enron, Parmalat and other cases of corporate failures. The intricacy of modern financial markets has led regulators to increasingly rely on market participants for monitoring of market behavior, including relying on individual and institutional whistleblowing. This is especially needed in over-the-counter (OCT) markets where technology-based surveillance is ineffective, and it was key in the breaking of the LIBOR scandal.

The case of LIBOR manipulation underscores the shortcomings of industry-driven market surveillance and underscores the influence of individual incentives on unethical conduct. It also emphasizes the significant role organizational culture plays in shaping individual behavior. These incidents reveal the inadequacies of top-down regulatory frameworks in deterring unethical actions and the limitations of regulatory surveillance systems in detecting illicit activities. Moreover, the dependence on whistleblowers (often granted immunity) further complicates the challenges associated with the current regulatory structure (Batten, Lončarski and Szilagyi, 2021).

2.3 The Wells Fargo Cross-Selling Scandal

This case entails the significant controversy that implicated one of the largest financial institutions in the United States, Wells Fargo. The scandal came to light in 2016 and involved widespread fraudulent activities committed by the bank's employees, leading to severe consequences for both the institution and its customers. This misconduct primarily revolved around the creation of unauthorized accounts by Wells Fargo employees in an attempt to meet aggressive sales targets and quotas. The scandal exposed a deeply rooted corporate culture that prioritized sales goals over ethical practices, ultimately resulting in the unauthorized opening of millions of deposits and credit card accounts without customers' knowledge or consent. The revelation shocked the public and prompted investigations by regulatory authorities and congressional committees. The fallout from the Wells Fargo scandal included financial penalties, executive resignations, and a tarnished reputation for the bank. It also sparked discussions about the need for stronger regulations and oversight within the banking industry to prevent similar unethical practices in the future. The Wells Fargo scandal serves as a cautionary tale about the importance of a healthy corporate governance in financial institutions and the potential consequences of prioritizing short-term financial gains over ethical decision-making.

2.3.1 Background

In 2015, Wells Fargo, headquartered in San Francisco, claimed the title of the world's largest bank by market capitalization. During the Global Financial Crisis, unlike its major competitors the bank navigated successfully by steering clear of risky lending and avoiding numerous exotic mortgage products, focusing its core business on consumer lending and traditional banking services. Despite experiencing a decline in market share over several years, the bank remained largely unscathed when the mortgage crisis unfolded. In *Table 3* we can observe some key financial data from 2010 to 2015 that testify to the bank's overall financial health. Notably, in 2015 Wells Fargo earned recognition as one of Fortune's most admired companies (Veetikazhi and Krishnan, 2018).

Table 3 Six Year Summary of Select Financial Data (Veetikazhi and Krishnan, 2018)

(in millions, except per share amounts)		2015	2014	2013	2012	2011	2010	% Change 2015/ 2014	Five-year compound growth rate
Income statement									
Net interest income	$	**45,301**	43,527	42,800	43,230	42,763	44,757	**4%**	**–**
Noninterest income		**40,756**	40,820	40,980	42,856	38,185	40,453	**–**	**–**
Revenue		**86,057**	84,347	83,780	86,086	80,948	85,210	**2**	**–**
Provision for credit losses		**2,442**	1,395	2,309	7,217	7,899	15,753	**75**	**(31)**
Noninterest expense		**49,974**	49,037	48,842	50,398	49,393	50,456	**2**	**–**
Net income before noncontrolling interests		**23,276**	23,608	22,224	19,368	16,211	12,663	**(1)**	**13**
Less: Net income from noncontrolling interests		**382**	551	346	471	342	301	**(31)**	**5**
Wells Fargo net income		**22,894**	23,057	21,878	18,897	15,869	12,362	**(1)**	**13**
Earnings per common share		**4.18**	4.17	3.95	3.4	2.85	2.23	**–**	**13**
Diluted earnings per common share		**4.12**	4.10	3.89	3.36	2.82	2.21	**–**	**13**
Dividend declared per common share		**1.475**	1.350	1.150	0.880	0.480	0.200	**9**	**49**
Balance sheet (at year end)									
Investment securities	$	**347,555**	312,925	264,353	235,199	222,613	172,654	**11%**	**15**
Loans		**916,559**	862,551	822,286	798,351	769,631	757,267	**6**	**4**
Allowance for loan losses		**11,545**	12,319	14,502	17,060	19,372	23,022	**(6)**	**(13)**
Goodwill		**25,529**	25,705	25,637	25,637	25,115	24,770	**(1)**	**1**
Assets		**1,787,632**	1,687,155	1,523,502	1,421,746	1,313,867	1,258,128	**6**	**7**
Deposits		**1,223,312**	1,168,310	1,079,177	1,002,835	920,070	847,942	**5**	**8**
Long-term debt		**199,536**	183,943	152,998	127,379	125,354	156,983	**8**	**5**
Wells Forgo stockholders' equity		**192,998**	184,394	170,142	157,554	140,241	126,408	**5**	**9**
Noncontrolling interests		**893**	868	866	1,357	1,446	1,481	**3**	**(10)**
Total equity		**193,891**	185,262	171,008	158,911	141,687	127,889	**5**	**9**

Source: Wells Fargo Annual report (2015).

To provide some historical context, the long history of the bank begins in the 19th century: *Wells, Fargo & Company* was founded in March 1852 by Henry Wells and William George Fargo. Both founders had previously been involved in establishing the American Express Company. The company was established in response to the demand for banking and express services generated by the California Gold Rush: Wells Fargo played a pivotal role in handling the banking and express business associated with the California Gold Rush. This involved the purchase, sale, and transport of gold dust, bullion, and other goods from the West to the East Coast. In the following decade, Wells Fargo expanded its operations, operating the western portion of the Pony Express (a short-lived but iconic mail delivery service that relied on horseback riders) from Salt Lake City to San Francisco. In 1866, a significant consolidation occurred, bringing together almost all Western stagecoach lines, sustaining the company's presence well into the early 20th century. In 1905, Wells Fargo's banking operations in California were separated from its express operations and merged with Nevada National Bank. Numerous further mergers occurred, and in 1969, the holding company Wells Fargo & Company was established. By the early 21st century, Wells Fargo had

grown into one of the largest and most respected banks in the U.S., offering a wide range of financial services including banking, mortgages, insurance, and financial management. [32]

2.3.2 Malpractices and Governance Failures

One of the earliest allegations of malpractice that involved Wells Fargo aggressive selling policies was published in late 2013 by the *Los Angeles Times*. The article documented that the bank, that bragged in earnings reports of its ability in "cross-selling" financial products, exerted excessive pressure to sell to its employees, resulting in ethical breaches, labor lawsuits and customer complaints. They reported that, to reach the unrealistic sales quotas set by upper management, personnel opened unnecessary accounts for customers, ordered credit cards without the customers' knowledge, and falsified client signatures on legal documents.[33]

On May 4, 2015, Los Angeles City Attorney Mike Feuer filed a civil enforcement case against Wells Fargo, bringing attention to the widespread fraudulent practices. Subsequently, on September 8, 2016, Wells Fargo reached a $185 million settlement with the Consumer Financial Protection Bureau (CFPB), the Office of the Comptroller of the Currency (OCC), and the Office of the Los Angeles City Attorney (Shichor and Heeren, 2020). By the end of 2018, the company encountered further civil and criminal lawsuits, amounting to an approximate total of $2.7 billion.[34]

Witman (2018) illustrates some key elements of the scandal. The first element concerns sales pressure: branch staff, including tellers and personal bankers, faced significant pressure to sell products, driven not only by the potential for earning incentives but also by the fear of job loss. Personal bankers were particularly viewed as salespeople responsible for achieving specific sales targets within set time periods. Regular conference calls held by branch, district, and regional managers intensified the pressure on line employees by scrutinizing daily progress against sales goals. Competition among regions, even without explicit incentives, further motivated staff to meet aggressive sales targets. The high employee turnover rates observed was also an indicator of bad organizational health. Various reasons contributed to employee departures, including resignations, firings for failure to meet quotas, and firings for ethical rule violations. Numerous employees left

[32] Chandler, R. (2019). *Wells Fargo | American corporation.* In: Encyclopædia Britannica. [online] Available at: https://www.britannica.com/topic/Wells-Fargo-American-corporation.

[33] E. Scott Reckard (2013). *Wells Fargo's pressure-cooker sales culture comes at a cost.* Los Angeles Times. Available at: https://www.latimes.com/business/la-fi-wells-fargo-sale-pressure-20131222-story.html.

[34] Pennsylvania Office of Attorney General. (2018). *Attorney General Shapiro Announces $575 Million 50-State Settlement with Wells Fargo Bank*. Available at: https://www.attorneygeneral.gov/taking-action/attorney-general-shapiro-announces-575-million-50-state-settlement-with-wells-fargo-bank-for-opening-unauthorized-accounts-and-charging-consumers-for-unnecessary-auto-insurance-mortgage-fees/.

the company due to the pressure and ethical concerns. The organization's culture of high turnover facilitated rapid career progression, but also emphasized the systemic nature of the issue. Wells Fargo reported over 5,300 terminations for failure to comply with ethics rules, with a focus on customer consent requirements. Most terminations were at the non-management level, and rates varied by region, with California, Arizona, and Florida experiencing the highest numbers of alleged violations and resignations related to these issues.

The practice of selling to family members and staff was prevalent as employees faced pressure to meet daily quotas: Wells Fargo staff frequently opened accounts in the names of friends or family members. The board's investigative report highlighted extreme cases, such as a branch manager having "a teenage daughter with 24 accounts, an adult daughter with 18 accounts, a husband with 21 accounts, a brother with 14 accounts, and a father with 4 accounts"[35]. In addition, several Wells Fargo employees experienced accounts being opened for them without their consent, including credit protection services with a monthly fee. The "Jump into January" campaign with especially high targets seemed to exacerbate the behavior of opening accounts for friends and family. Employees claimed they were asked to identify friends and family for whom they could open accounts at the beginning of January. Friends and family were considered easy sales targets throughout the year, leading to the unauthorized account openings. It was alleged that at least one district-level manager taught employees how to hide family relationships in the online systems used by the bank to detect such activity. Overall, the practice of selling to friends and family members reflected the extreme pressure on employees to meet sales targets, leading to unethical behaviors such as opening unauthorized accounts and manipulating the system to conceal these activities.

Some unethical behaviors by the bank's staff were particularly egregious and harmful: employees went beyond opening accounts for family members and engaged in deceptive practices, such as selling unnecessary accounts or adding additional accounts to customers' records without their knowledge. This exploitation was especially observed with customers who were not native English speakers or were elderly, making them more susceptible to manipulation. Employees reportedly convinced these clients to open unnecessary accounts or added accounts after they had left the bank. While some of these accounts were "harmless" with no immediate impact, the accumulation

[35] Independent Directors of the Board of Wells Fargo & Company (2017). *Sales Practices Investigation Report*, p.36

of multiple accounts, including unused credit lines, could negatively impact credit scores and expose customers to potential frauds and other risks.

Wells Fargo had internal audit and risk management functions, with the Community Banking division having dedicated units for both functions; these units reported directly to the President of the Community Bank and indirectly to their respective units in the corporate office. Corporate risk and audit leaders, in turn, reported to the board, providing the Community Bank with stronger control over the raw data seen by the board. The organizational decision to have the Community Bank control raw data presented both advantages and disadvantages: pros included localized control and potentially faster response to issues, while cons involved the risk of information manipulation or selective reporting. The Chief Operational Risk Officer, Caryl Athanasiu, did not consider compensation issues or sales practices as her responsibility. She focused on creating risk management programs and only supported business units in the event of serious breakdowns, excluding unforeseen reputational risks like those arising from the scandal. The Community Bank units sometimes leveraged their control to remove information from reports to the Board. In 2013, Claudia Russ Anderson, Community Banking Risk Officer, convinced Chief Risk Officer Michael Loughlin to exclude information about sales practices from a board report, claiming that the report made the problem seem "so much worse than it is". Overall, the organizational structure and decision-making around information control within Wells Fargo's internal audit and risk management functions had implications for the oversight and reporting of issues, contributing to a lack of transparency and potentially allowing unethical practices to go unaddressed (Witman, 2018).

2.3.3 Consequences

The Wells Fargo cross-selling scandal had significant consequences on the bank's stakeholders. The impact on bank's customers was considerable: around 85.000 accounts that were opened without customers' permission resulting in fees for the defrauded clients totaling $2 million. Additionally, customers' credit scores may have been negatively impacted: account opened for unknowing customers had annual fees that resulted in missed or late payments, affecting consumers' credit scores. Employees of Wells Fargo occasionally moved money from an existing customer's account into the new one, leading to fines for insufficient funds or late fees. The National Association of Consumer Advocates' executive director, Ira Rheingold, claimed that it would have directly affected someone's credit score. "It's possible that you weren't approved for a mortgage or that you were overcharged." The impact on credit score could have an effect that

goes beyond the clients' budget. Phone companies, employers, and even prospective landlords routinely check credit scores. It could become difficult for someone to open another checking account if they had too many overdraft fees from unapproved accounts. Something that affects the credit report and credit score can potentially have a significant impact on a consumer's entire financial life.[36] To address the situation, the bank settled for $142 million in March 2017 with consumers who had unauthorized accounts opened in their names. The settlement aimed to repay fraudulent fees and provide damages to those affected. It's worth noting that the bank's use of private arbitration might have prevented customers from pursuing legal action.[37]

On an immediate level, Wells Fargo faced regulatory action from multiple agencies. As a US-based financial institutions, several federal financial regulators have overlapping oversight authority of Wells Fargo, including the Office of the Comptroller of the Currency (OCC), Federal Reserve, and Federal Deposit Insurance Corporation (FDIC), which have safety and soundness authority. The OCC is the principal prudential regulator of Wells Fargo's bank division; it oversees the company's internal controls, management of operational and reputational risks, and deposit and lending operations, while the Federal Reserve oversees the bank holding corporation. The Consumer Financial Protection Bureau (CFPB) governs and oversees Wells Fargo's consumer protection compliance.[38]

When CEO John Stumpf spoke before the United States Senate, the story around the crisis shifted dramatically. Senators chastised the corporation for committing fraud against its consumers, putting undue pressure on lower-level staff, and failing to hold senior management accountable. They were particularly scathing of the board's failure to take back large compensation from John Stumpf and former retail banking boss Carrie Tolstedt, who departed earlier in the summer with a compensation package valued $124.6 million. After the hearing, the board instructed Stumpf to give up $41 million and Tolstedt $19 million in outstanding, unvested stock bonuses. It was one of the greatest clawbacks on CEO compensation in history, as well as the largest for a financial

[36] Zarroli, J. (2016). *Wells Fargo's Unauthorized Accounts Likely Hurt Customers' Credit Scores.* NPR.org. Available at: https://www.npr.org/2016/09/26/495501008/wells-fargos-unauthorized-accounts-likely-hurt-customers-credit-scores.
[37] Lam, B. (2017). *Wells Fargo's $110 Million Settlement.* The Atlantic. 29 Mar. Available at: https://www.theatlantic.com/business/archive/2017/03/wells-fargos-settlement/521232/.
[38] Congressional Research Service (2020). *Wells Fargo. A Timeline of Recent Consumer Protection and Corporate Governance Scandals*. Available at: https://crsreports.congress.gov/product/pdf/IF/IF11129.

organization. Neither executive earned a 2016 bonus, and Stumpf agreed to forego a paycheck while the probe was ongoing (Tayan, 2019).

In October 2016 Wells Fargo's chief executive officer, John Stumpf, retired and was replaced by the chief operating officer, Timothy Sloan, as the new CEO. Following other issues related to Wells Fargo's auto-loan insurance and mortgage practices, that led to a $1 billion settlement with the CFPB and the OCC, Sloan retired in March 2019.

In *Figure 6*, we can observe the impact of events connected with the scandals on stock price.

Figure 6. Wells Fargo stock price (Tayan, 2019)

1. Wells Fargo announces $185 million settlement with CFPB and OCC.
2. Stumpf resigns as CEO; replaced by Sloan.
3. Wells Fargo board of directors releases report of independent investigation.
4. Wells Fargo annual meeting; 9 directors reelected with less than 75 percent support.
5. Wells Fargo discloses auto loan insurance violations; mortgage product violations.
6. Wells Fargo increases the number of potentially unauthorized consumer accounts to 3.5 million.
7. Federal Reserve imposes asset cap on Wells Fargo; the bank enters into a consent order.
8. Wells Fargo announces $1 billion settlement with CFPB and OCC.

Note: Prices of the KBW Bank Index re-indexed to coincide with Wells Fargo stock price as of July 1, 2016.

Source: Yahoo! Finance.

Wells Fargo's troubles severely harmed the company. The bank's reputation has been damaged, forcing it to spend extensively on settlements, attorneys, and risk management system improvements. Since the troubles erupted in September 2016 to February 2020, Wells Fargo's

stock fell 5%, while the S&P 500 rose of 55%. In the same timeframe, banking rivals JPMorgan Chase (JPM) and Bank of America (BAC) more than quadrupled their worth.[39]

The success of the financial services sector is contingent upon the public's perception of its trustworthiness, and this is the reason that led Wells Fargo to suffer more from the scandal than a company in a different sector of the economy. This case of corporate malpractice underscored the need for stronger regulations to protect consumers from fraudulent activities by financial institutions. It served as a catalyst for discussions around banking rules and regulations, particularly relating to customer protection and rights. Regulatory bodies began looking into stricter regulations concerning product sales goals and incentives, employee conduct, and whistleblowing procedures within financial institutions.

The focus on cross-selling products and meeting specific sales targets by senior leadership pressured employees to sell unnecessary products and open unauthorized accounts. The decentralized corporate structure of Wells Fargo is suggested to have contributed to the problem by obscuring the scale and nature of issues, allowing certain areas to operate without proper oversight and hindering corporate risk management. Moreover, Wells Fargo's delayed disclosure of the potential damage resulting from these events may have impacted investors' ability to assess and respond to the potential risks and damages associated with the bank's practices. Overall, these issues underscore once again the importance of effective corporate governance in maintaining transparency, accountability, and risk management within publicly traded companies.[40]

[39] Matt, E. (2020). *US government fines Wells Fargo $3 billion for its 'staggering' fake-accounts scandal*. Feb 24. CNN. Available at: https://edition.cnn.com/2020/02/21/business/wells-fargo-settlement-doj-sec/index.html.
[40] Congressional Research Service (2020). *Wells Fargo. A Timeline of Recent Consumer Protection and Corporate Governance Scandals*. Available at: https://crsreports.congress.gov/product/pdf/IF/IF11129.

CHAPTER 3. REFORM

3.1 Regulatory Reforms of Corporate Governance

As numerous corporate scandals have proven, a lack of healthy corporate governance can lead to disastrous consequences for the involved stakeholders, and sometimes for whole industries or even economies. Market failures, like those we analyzed in the previous chapters, emphasize the need for ethical governance principles to guide institutions, and for strong and efficient regulation and supervision to monitor those whose choices shape corporate behavior. In fact, very often major corporate scandals and bankruptcies allowed to clearly recognize vulnerabilities and systemic deficiencies, prompting regulatory authorities and industry stakeholders to reevaluate existing frameworks and implement measures to address the root causes of market failures.

3.1.1 Role of Governance in Risk Taking

Excessive risk-taking in the financial sector has led to systemic problems and the failure of numerous institutions, and it is recognized as one of the main factors that led to the Global Financial Crisis. Reforms of corporate governance should be based on a thorough understanding of the underlying factors that lead to excessive risk taking in banks. By considering how incentives (such as compensation and ownership) and controls (such as board structure and the risk-management framework) shape risk taking, some regulatory initiatives can be taken to contribute to prudent risk taking in banks and thus foster financial stability.

The International Monetary Fund (IMF, 2014) conducted an empirical analysis to investigate how certain corporate governance dimensions (*Table 4*) impact risk-taking in financial institutions. The dependent variables were normalized so that higher values signify more risk. The findings are summarized in the graph reported in *Figure 7*.

Four governance characteristics have been robustly related with *lower* risk-taking in banks (as represented in the graph in *Figure 8)*:

- Board independence,
- Presence of risk committees in the board,
- Share of equity-based compensation in total compensation of CEO,
- Share of equity owned by institutional investors.

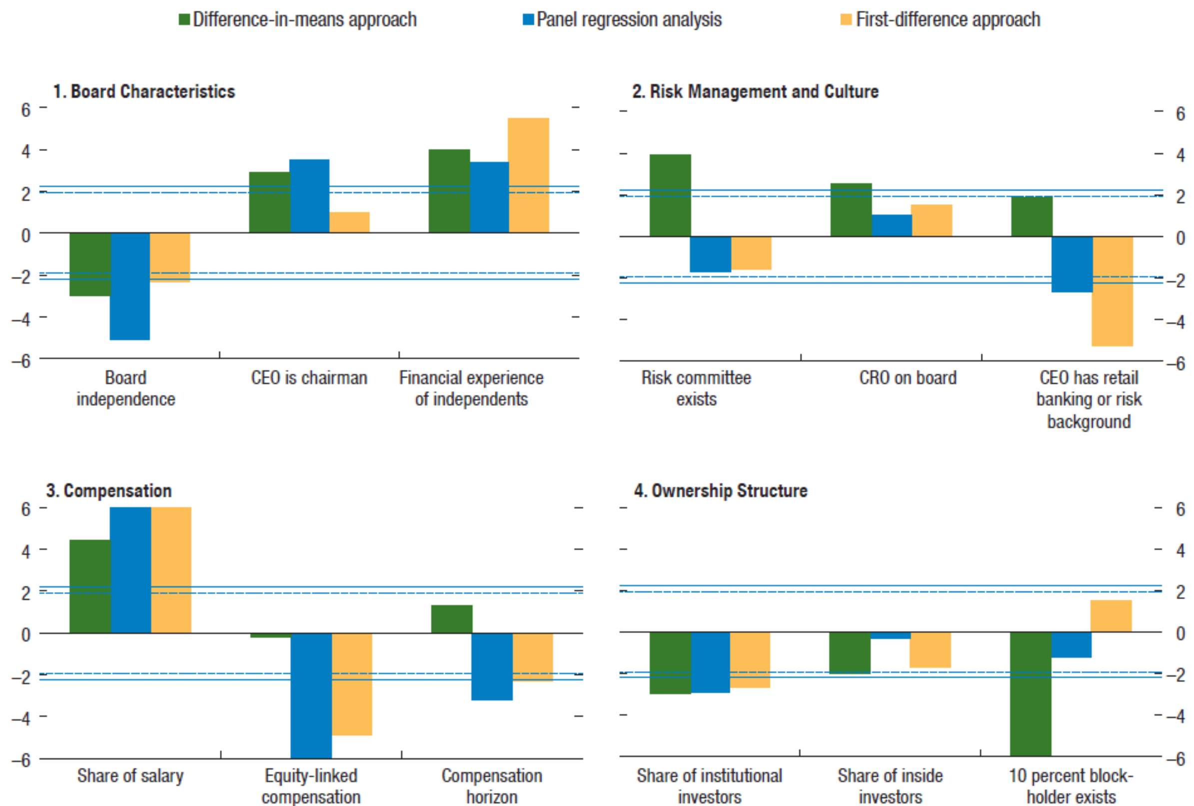
It is worth noting that equity-based compensation and institutional ownership are associated with *increased* risk taking if the bank is close to default (due to a phenomenon called "gambling for resurrection"), but the opposite is true if the default probability is low. In fact, corporate insiders (managers) or institutional investors that hold a higher fraction of the ownership of the company show less risk taking if the bank is financially strong, because they have a lot to lose. When the firm is close to defaulting on its debt, managers and institutional investors have less to lose by taking more risk.

Table 4. Governance characteristics used as explanatory variables in the empirical analysis (IMF, 2014)

Risk drivers	Variables	Description
Board characteristics	Board independence	Share of independent board members (as reported by each bank)[1]
	CEO is chairman	Dummy = 1 if CEO is also a chairman of the board
	Financial experience	Average of independent board members' financial experience as a share of their total professional experiences[2]
Risk management	Risk committee	Dummy = 1 if there is a board risk committee
	CRO board member	Dummy = 1 if the CRO is a member of the board
	CEO background	Dummy = 1 if the CEO has retail banking or risk experience but no investment banking experience
Compensation practices	Share of salary	Share of salary in total calculated CEO compensation
	Equity-linked compensation	Share of equity-linked compensation in total calculated CEO compensation
	Compensation horizon	Maximum time horizon to reach full senior executive compensation
	Level of compensation	Total calculated CEO compensation adjusted for bank size
Ownership	Institutional investors	Share of firm that is owned by institutional investors
	Inside investors	Share of firm that is owned by inside investors
	Large shareholder	Dummy = 1 if there is a blockholder owning at least 10 percent of the firm

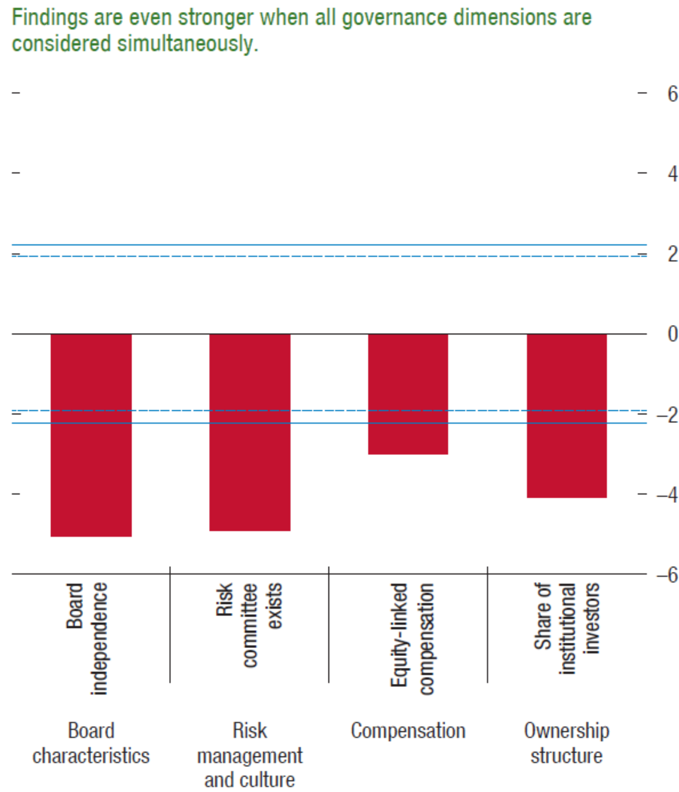
Source: IMF staff.
Note: CEO = chief executive officer; CRO = chief risk officer.
[1]Independent board members are defined as directors who are not employees of the bank (currently or in the past few years) and do not have a direct relationship with the bank. The exact definition varies by jurisdiction. For example, large shareholders may or may not be considered independent. In banks with a two-tier board structure, only the supervisory board is considered.
[2]Formally, it is the average (across all independent directors) of the share of individual directors' financial sector experience to their total experience.

Figure 7. Bank Governance and Risk Taking (z-statistics) (IMF, 2018)



Sources: Bankscope; BoardEx; Standard and Poor's Capital IQ database; Thomson Reuters Datastream; and IMF staff estimates.
Note: The figures show Stouffer's z-statistics—a measure that summarizes the joint statistical significance of a number of t-tests having the same null hypothesis. In this case, it gives a statistical indication of the significance of the effect of each explanatory variable on risk as measured jointly by the regressions with the different risk variables on the left side of the equation. The significance levels were adjusted using the Benjamini-Hochberg procedure to account for correlation among dependent variables. Solid and dashed lines indicate 5 and 10 percent levels of significance, respectively. CEO = chief executive officer; CRO = chief risk officer.

Figure 8. Summary of main findings: impact on risk taking (z-statistics) (IMF, 2014)



Based on this empirical evidence, the IMF suggested to policymakers some areas of focus for corporate governance reform of financial institutions, focusing on remuneration practices and on the role of the board of directors.

Reforms of compensation practices should improve the link between compensation and the various sources of risk as well as extend the horizon over which compensation is granted to better capture such risks. Some possible measures are:

- Design compensation packages that incorporate a variety of performance metrics, including financial and non-financial indicators, to better reflect the diverse sources of risk a company may face;
- Tie compensation to long-term value creation rather than short-term gains, aligning the interests of executives with the sustained success and stability of the organization;
- Implement extended vesting periods for equity-based compensation, requiring executives to hold onto their shares for a longer duration to encourages a focus on long-term success rather than short-term fluctuations;

- Introduce clawback provisions that allow companies to reclaim executive bonuses or other forms of compensation in the event of financial restatements or misconduct, even after the initial award;
- Strengthen the role of the board of directors in overseeing compensation practices and risk management, including independent assessments of the alignment between compensation and risk.

The IMF also advanced some proposals regarding board oversight:

- Include creditors in board representation ensures a more balanced consideration of the interests of all stakeholders, not just shareholders. This approach aims to enhance monitoring and mitigate the incentive for risk-shifting.
- A sufficient number of board members should be independent. Furthermore, independent directors need to be qualified and capable of overseeing management.
- Bank boards should be mandated to form an independent risk committee.
- The role of the CEO and top leadership in shaping an organization's risk culture is crucial. Supervisors should evaluate bank risk culture and governance regularly.

3.1.2 Reforms in the Financial Sector

Corporate governance, as a fundamental pillar of financial stability, has emerged as a focal point in reform initiatives of the financial sector. Market failures clearly underscore the need for enhanced governance structures to prevent unethical behavior, ensure transparency, and protect the interests of stakeholders. Consequently, regulatory responses have been directed towards strengthening governance mechanisms, emphasizing the importance of board oversight, board member independence appropriate risk management, and compensation policies.

In the ever-evolving landscape of the financial sector, the imperative for reforms has become increasingly pronounced, particularly in the aftermath of the Global Financial Crisis (GFC). As financial markets continue to grow in complexity and interconnectedness, the need for robust regulatory frameworks that ensures stability, transparency, and efficiency has never been more crucial.

Multiple academics and institutions recognized that severe shortcomings in corporate governance in the financial sector were among the primary causes of the corporate failures that led to the GFC. Kirkpatrick (2009) underlined how corporate governance routines have been found to fail in safeguarding against excessive risk taking in financial services companies. Many weaknesses have

been identified, such as the failure of risk management systems due to ineffective corporate governance procedures. Information about exposures often did not reach the board and senior management, and risk management was often activity-based rather than enterprise-based. Boards approved strategies but did not establish suitable metrics to monitor implementation. Company disclosures about foreseeable risk factors and monitoring systems were also lacking. Accounting standards and regulatory requirements were found insufficient in some areas, leading to a review by relevant standard setters. Remuneration systems were not appropriately related to the companies' strategy and risk appetite: compensation practices encouraged risk-taking across banks, and when returns were high, they rewarded it generously.

Market discipline and self-regulation were ineffective in preventing excessive risk-taking. The originate-to-distribute model, in which mortgage originators sold loans to be securitized and sold to third-party investors, reduced incentives for good credit underwriting. Investors accepted the ratings assigned to these products without much scrutiny. The existence of implicit guarantees eroded market discipline and distorted incentives for risk taking, as seen with government-sponsored enterprises in the United States that were heavily involved in purchasing securitized bank loans, as well as with "too-big-to-fail" institutions (IMF, 2018).

One of the first post-crisis message advanced by the IMF and other international institutions was that supervisors needed the ability and the will to take decisive actions and apply stricter oversight to banks. This strategy was also reflected in the updated sectoral standards, which placed more of an emphasis on prompt and efficient supervision rather than regulation alone. Systemic institutions and risks must receive more attention in order to meet these standards. Since the financial crisis, numerous regulatory bodies have updated their methods to conduct more thorough investigations of systemic institutions. For instance, the US started the *Comprehensive Capital Analysis and Review* to more thoroughly assess the resilience of its main financial institutions. Some jurisdictions, such as Brazil, divided or tiered their institutions, recognizing that a one-fits-all approach to banking regulation may be inadequate. In the Eurozone, increased supervision was based on the systemic importance of institutions. Russia centralized the supervision of its systemic banks. In China, the Netherlands, Sweden, Switzerland, and the United Kingdom, *Financial Sector Assessment Programs* (FSAPs) have investigated how supervisory intensity has been interpreted and considered its adequacy, frequently noting a lack of supervisory resources. Overall, one-quarter of systemic jurisdictions' post-crisis FSAPs expressed concern that the appropriate balance of supervisory resources was not being devoted to systemic institutions, or that their monitoring was

insufficient. Several factors that could compromise the *independence* of the supervisory authorities have also been identified in various jurisdictions, representing a key vulnerability in ensuring financial stability.

After the crisis, the scope of bank supervision has grown to include aspects of corporate governance, and the Basel Core Principles for Banking Supervision (*Core Principles*) have become more stringent in this regard. Widespread recognition that banks' corporate governance should prioritize risk appetite and risk management have emerged. Between 2011 and 2018, more than half of FSAPs in 25 systemic jurisdictions identified gaps, deficiencies, or weaknesses in the financial sector's corporate governance. However, some progress can be recognized. By 2017, most jurisdictions had regulations addressing compensation packages in the financial sector, and a survey of governance practices in major banks conducted by the Financial Stability Board (FSB) discovered that most institutions recognized the board's responsibility (assisted by committees) to determine an appropriate level of risk-taking. Most jurisdictions at the time required independent directors to chair key board committees, and additional efforts were aided by legislative and supervisory initiatives. By 2018, for example, the Single Supervisory Mechanism had already conducted thematic reviews of governance in European banks; the Russian authorities were newly empowered with relevant legislation; and the Brazilian supervisory agency had intensified and reorganized its supervisory processes, using corporate governance findings as the foundation for its assessments.

The principles for sound compensation practices and their implementation standards have been substantially implemented in almost all major FSB-member jurisdictions. However, it is still unclear whether some important measures, like the ability to clawback compensation paid in the event that deficient performance is discovered, can be enforced legally. Additionally, there is a chance that compensation agreements will be redesigned to circumvent these provisions and create undue incentives for taking unnecessary risks.

The International Monetary Fund summarized in the *Global Financial Stability Report* of October 2014[41] some of the most influential reforms of corporate governance of the financial sector implemented as a response to the Global Financial Crisis, including initiatives undertaken by the

[41] International Monetary Fund (2014). *Global Financial Stability Report, October 2014: Risk Taking, Liquidity, and Shadow Banking: Curbing Excess while Promoting Growth.* Washington, D.C.: International Monetary Fund.

Financial Stability Board (FSB), and the Basel Committee on Banking Supervision (BCBS) to reform their standards. We can summarize them in the table below:

Jurisdiction/ Organization	Legislation/ Initiative	Governance dimension	Measures
United States	Dodd-Frank Act (2010)	Compensation	"Say on pay". Listed businesses must hold a nonbinding vote on executive salary every three years, with an additional vote every six years to determine the frequency of the "vote on pay." "Say on golden parachute". Listed firms must hold a nonbinding vote on "golden parachute" remuneration when considering a takeover deal. "Increased disclosure and transparency". Companies must report: (1) the relationship between executive compensation and financial success (including share value and dividend distribution), (2) the median pay in the firm (excluding CEO), the CEO's total pay, and its ratio, and (3) any hedging against declines in securities issued to employees or directors. "Integrity and accuracy of executive compensation". New requirements for compensation committee independence and clawback mechanisms to reclaim excess payments due to misreported financial data.
		Board of Directors	Risk management. Banks and financial businesses with assets over $10 billion are required to have a separate board risk committee led by an expert with experience managing large-scale risks. The Federal Reserve may also extend this requirement to bank holding companies with assets under $10 billion.
	SEC proxy rules	Board of Directors	Banks must identify the scope of the board's risk oversight responsibilities in their annual reports.
		Compensation	Companies must consider: (1) the potential negative impact of pay policies on the company, and (2) the relationship between compensation policies and risk-taking incentives.
European Union	CRD IV and CRR	Board of Directors	Banks with a one-tier board structure must have a separate CEO and Chairman, unless permitted by competent authorities. Large banks must establish a nomination committee with clear tasks, including self-evaluation. Requires the board to have "a broad range of experiences" and enough collective expertise to evaluate dangers. Limits the number of directorships (subject to supervisory permission). Increases the individual board members' responsibilities: assessing and challenging management requires expertise, integrity, and independence. Promotes diversity on boards.
		Compensation	The variable-to-fixed pay ratio is set at 1:1, but can be expanded to 2:1 with approval from a super-majority of voting shareholders (65% if quorum exists, 75% otherwise). Long-term deferred instruments with a vesting time of at least five years may exempt up to 25% of variable pay from ratio requirements.

Jurisdiction/ Organization	Legislation/ Initiative	Governance dimension	Measures
			Bonus-malus and clawback clauses must apply to all variable remuneration, including non-statutory amounts. Executives must postpone at least 40% of their bonuses, with a maximum of 60% for top executives. Rules apply to MRTs (senior management, risk takers, control functions, and those earning equal pay).
Canada	Ontario Securities Commission	Board Structure	Director term limits. Comply or explain.
	Toronto Stock Exchange	Board Structure	Majority votes needed to confirm directors.
Bank for International Settlement	BCBS Principle for Enhancing Corporate Governance	Various	Sets principles for sound corporate governance in six major areas: 1. Board practices 2. Senior management 3. Risk management and internal controls 4. Compensation 5. Complex and opaque corporate structures 6. Disclosure and transparency
Financial Stability Board	FSB Principles and Standards for Sound Compensation Standards	Compensation	Principles for effective governance of compensation: 1. Board must oversee the design of compensation policies. 2. Board must monitor and review compensation system. 3. Financial and risk-control functions must be independent and have appropriate authority, and compensation must be independent of business functions. 4. Compensation must be adjusted for all forms of risk. 5. Compensation must be symmetric with risk outcomes. 6. Compensation schedules must be sensitive to time horizon of risks. 7. Mix of cash, equity, and other forms of pay must be consistent with risk alignment. 8. Supervisory review of compensation practices must be rigorous and sustained; supervisors must include compensation practices in risk assessment of firms. 9. There should be a comprehensive and timely disclosure of compensation practices, as well as risk-management control practices.

Note: BCBS = Basel Committee on Banking Supervision; CRD IV = Capital Requirements Directive (European Union Directive 2013/36/EU); CRR = Capital Requirements Regulation (European Union Regulation (EU) No. 575/2013); FSB = Financial Stability Board; MRT = material risk taker.

3.1.3 Focus on the European Union

Corporate governance in the banking industry came under intense scrutiny after the nearly catastrophic failure of numerous European banks, which was caused by a number of disastrous corporate and regulatory policies, appalling board decisions, and inadequate management control.

As a result, there is a general consensus in academic and policy-making circles that bank corporate governance was in terrible shape prior to the Great Financial Crisis. These opinions have clearly outlined the steps needed to create a safer financial industry. To improve board capacity, shareholder monitoring, and remove perverse incentives, higher governance standards and modified compensation structures would be added to capital, liquidity, and other regulatory reforms (Avgouleas and Cullen, 2014).

The European Commission (EC) responded to these concerns in June 2010, by releasing a *Green Paper* (a report of policy proposals for debate and discussion) titled "The EU corporate governance framework", on the topic of reform of corporate governance in financial institutions[42]. The Green Paper acknowledged that while corporate governance did not directly cause the financial crisis (GFC), the lack of effective control mechanisms significantly contributed to excessive risk-taking by financial institutions. It identified several functional failures in corporate governance in financial institutions prior to the GFC, that are summarized in the following points:

- *Deficient Board Oversight and Control*. This was driven by a failure to challenge executives and a lack of expertise among non-executive directors. Weak risk management was a result, attributed to boards and senior management not fully understanding the risks associated with traded financial products. There was excessive reliance on credit ratings, and insufficient consideration of aggregate risks across firms.
- *Insufficient Shareholder Control.* There was a mismatch between the interests of shareholders and the long-term interests of financial institutions. Structural obstacles to effective engagement between shareholders and management were identified, including monitoring costs, voting restrictions, and the limited holding periods of many bank shareholders.
- *Supervisory Failure.* There was a failure of supervisory bodies to effectively monitor bank governance. Regulatory competence was fragmented, and potential conflicts of interest between financial institutions and their auditors were noted.

The release of the Green Paper marked a significant step in the drive to reform bank corporate governance in the EU. The reform objectives included addressing the identified failures in board oversight, improving shareholder control mechanisms, and enhancing supervisory effectiveness.

[42] European Commission (2011). *GREEN PAPER The EU corporate governance framework*, Publications Office of the European Union. Available at: https://op.europa.eu/en/publication-detail/-/publication/3eed7997-d40b-4984-8080-31d7c4e91fb2/language-en.

The Commission suggested in its Green Paper to take the following actions be taken in response to these findings:

(i) *Increased independence and skill among board members.* Independence and expertise among board members at EU financial institutions was needed to guarantee efficient management oversight. In order to support this, the establishment of a specialized risk supervision committee within the board of directors, along with elevated status for the chief risk officer, to help board members assess business strategies;

(ii) *Standardized shareholder "stewardship code" and transparency.* The Commission proposed the implementation of a standardized shareholder "stewardship code" at EU banks. This code would follow a "comply or explain" basis, meaning that banks would either comply with the code or provide explanations for any deviations. The recommendation also included heightened transparency on voting policies. It was necessary to conduct more surveillance of asset managers' conflicts of interest and incentives. Furthermore, a binding shareholder vote should be required for certain corporate policies, such as the compensation of senior managers and board members.

(iii) *Increased national supervisory resources and strengthened pan-European governance oversight.* The Commission called for an increase in national supervisory resources and the strengthening of pan-European corporate governance oversight. Board of directors were encouraged to enhance cooperation, and governance supervisors were proposed to have a duty to ensure the correct functioning and effectiveness of boards of directors. Periodic reviews of the risk management functions within financial institutions were recommended as part of this oversight.

In summary, the recommendations provided aimed to address the identified failures in corporate governance by promoting increased independence and skill among board members, introducing standardized shareholder stewardship codes, and enhancing supervisory oversight at both national and pan-European levels. These measures were designed to improve the effectiveness of boards of directors and mitigate risks associated with corporate governance in the financial sector within the European Union.

One of the most impactful reforms among those implemented in the European Union in the wake of the GFC concerns the implementation of the *Single Supervisory Mechanism* (SSM), also known as *European Banking Supervision*. In 2013, the Council of the European Union approved the *"*Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the

European Central Bank concerning policies relating to the prudential supervision of credit institutions", establishing the SSM as a system to supervise banks in the euro area and other participating EU countries. On November 4, 2014, the SSM Regulation entered into force. It is significant that European Banking Supervision is written as a regulation rather than a directive. Regulations are legally binding, and, unlike directives, Member States are not free to choose how to implement them into national law.

The primary objective of the Single Supervisory Mechanism was "to ensure that the rules applicable to the financial sector are adequately implemented, to preserve financial stability and ensure confidence in the financial system as a whole"[43]. Under the SSM, the ECB directly supervises the larger banks that are designated as Significant Institutions (SI). The other banks, known as Less Significant Institutions (LSI), are directly supervised by national banking supervisors, with an indirect supervisory oversight of the ECB. As of late 2022, the ECB *directly* supervised 113 Significant Institutions in the 21 countries within its geographical scope of authority, representing around 85% of the banking system's total assets.[44]

The significance of a financial institution is determined based on factors such as size, importance to the domestic banking sector, or whether they have received public funds for recapitalization. The criteria that determined the status as Significant Institution applied by the ECB are specified in *Table 5* below:

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[43] Scheinert, C. (2023). *European System of Financial Supervision (ESFS) | Fact Sheets on the European Union | European Parliament.* Available at: https://www.europarl.europa.eu/factsheets/en/sheet/84/european-system-of-financial-supervision-esfs-.

[44] European Central Bank (2023). *ECB Annual Report on supervisory activities 2022*. doi: https://doi.org/10.2866/704273.

Table 5. Significance criteria[45]

Size	the total value of its assets exceeds €30 billion
Economic importance	for the specific country or the EU economy as a whole
Cross-border activities	the total value of its assets exceeds €5 billion and the ratio of its cross-border assets/liabilities in more than one other participating Member State to its total assets/liabilities is above 20%
Direct public financial assistance	it has requested or received funding from the European Stability Mechanism or the European Financial Stability Facility

Moreover, a supervised bank can be considered significant if it is one of the three most significant banks established in a particular country. The ECB performs regular reviews of all authorized banks in the participating nations. Banks' status might change as a result of normal commercial activity or one-time occurrences like mergers and acquisitions. In such circumstances, the ECB works with the national supervisors to organize the transfer of supervisory responsibilities. Vice versa, if a significant bank fails to achieve the criteria for three consecutive years, it may be categorized as less significant. Direct supervisory responsibility is subsequently returned to the appropriate national body.

As we mentioned, after the reform, the ECB directly oversees significant institutions. The ECB holds the authority to:

- Conduct supervisory reviews, on-site inspections, and investigations;
- Grant or withdraw banking licenses;
- Evaluate a bank's acquisition and disposal of qualifying holdings;
- Establish higher capital requirements (buffers) to address current or future financial crises:
- Impose sanctions for any violation of EU law on credit institutions, financial holding companies, and mixed financial holding companies.

One of the SSM's primary goals is to strengthen governance in European banks, particularly the fitness and appropriateness of management and key function holders. The aspects of supervision in the SSM are multilayered. Banks in participating member states are stressed, managed, and

[45] European Central Bank (2021). *Criteria for determining significance.* European Central Bank - Banking supervision. Available at: https://www.bankingsupervision.europa.eu/banking/list/criteria/html/index.en.html.

evaluated from multiple angles and using a variety of tools. Beginning with a stress test and an Asset Quality Review (AQR), the supervisors implemented practices such as the Supervisory Review and Evaluation Process, on-site inspections in high-risk areas, and model investigations. Furthermore, the ECB is responsible for giving permission to credit institutions and making fit and proper decisions by examining the suitability of the management bodies of large banks within the SSM. The changes in the regulatory framework undertaken with the SSM has been viewed by some scholars, like Braendle (2018), as successfully meeting the objective of ensuring the safety and soundness of the European banking system. This implies that the regulatory adjustments are contributing to the stability and health of the banking sector in the European Union. Braendle (2018) also underlines that there is room for improvement, specifically in two areas: proportionality and transparency of supervisory practices. Proportionality refers to the need for regulations to be tailored to the size and complexity of banks, ensuring that the regulatory burden is proportionate to the risk posed by each institution; transparency in supervisory practices indicates a call for clearer and more open communication about the regulatory processes and decision-making. Moreover, he claims that there is room for improvement in the regulatory framework's influence on banks' profitability. The current regulations may be impacting banks' ability to generate profits, and there may be a need for adjustments to strike a balance between stability and profitability.

In terms of corporate governance, a dangerous aspect of the harmonization of governance standards undertaken under the Single Supervisory Mechanism is raised by Binder (2015). The ECB's goals are to define best practices and promote consistency, while also taking into account the proportionality principle in terms of market structure and business model diversity. These goals appear to be mutually exclusive. Over time, the ECB's objective to converge may result in more consolidated and streamlined business models and governance frameworks in monitored banks.

3.2 Challenges and Future Trends

The financial sector operates in a dynamic environment, constantly influenced by global events, technological advancements, and evolving market dynamics. A delicate equilibrium must be reached to facilitate responsible business practices, foster innovation, and protect the interests of all stakeholders. The regulatory landscape must evolve with the changing dynamics of the business environment, striking a delicate balance between encouraging growth and ensuring ethical and sustainable corporate conduct.

In the following pages we will focus on some themes that came into relevance in recent years and are becoming more and more influential in shaping regulatory reform of the financial sector, particularly regarding corporate governance. These areas include the ESG principles, the emerging relevance of FinTech and crypto-assets, and the increased sensibility of regulators to financial customers' protection.

3.2.1 Environmental, Social, and Governance (ESG) Principles

The interest in environmental, social, and governance (ESG) matters has experienced significant growth in recent years. Investors and corporate stakeholders are increasingly recognizing the importance of considering non-financial factors when evaluating companies. ESG criteria are a set of standards that investors use to assess a company's performance in areas beyond traditional financial metrics.

The three components of ESG represent different aspects of a company's impact:

- Environmental (E): focuses on a company's impact on the environment. It includes factors such as carbon emissions, waste management, water usage, and renewable energy initiatives.
- Social (S): encompasses a company's relationships with its employees, customers, suppliers, and the communities in which it operates. Social factors include labor practices, diversity and inclusion, community engagement, and human rights.
- Governance (G): addresses the internal controls and structures within a company. It includes issues such as board composition, executive compensation, shareholder rights, and overall corporate governance practices. The "G" covers the governing of the "E" and the "S" categories.

The surge in interest and investment in environmental, social, and governance (ESG) themes reflects a broader shift in the financial landscape, where sustainability and responsible business

practices are becoming increasingly important. Some statistics reported below[46] highlight the growing momentum behind ESG investing:

- In the U.S., net flows into ESG funds soared to $20.6 billion in 2019, nearly four times the previous annual record set in 2018.
- In Europe, ESG funds attracted a remarkable $132 billion in inflows in 2019.
- Over 70% of funds focused on ESG investments outperformed their counterparts in the first four months of 2020.
- Nearly 60% of ESG funds outperformed the wider market over the past decade.

Consumers and investors are placing an increasing value on ESG considerations, indicating a shift towards sustainable and socially responsible investing; industry leaders are responding to this trend by adopting various measures, including issuing comprehensive sustainability reports. This trend is not only a response to investor demand but also a recognition of the business and investment opportunities embedded in ESG considerations. Companies that prioritize ESG factors are not only aligning with societal expectations but are also positioning themselves for long-term success by mitigating risks, attracting responsible investors, and contributing to a more sustainable future.

The financial industry faces increasing pressure to align with environmental goals and to address social issues (such as diversity, inclusion, and social justice). Corporate governance must adapt to ensure responsible decision-making. Regulators are emphasizing ESG risk management, disclosure, and sustainable finance practices.

Government regulations certainly have an impact on ESG investing, but they don't control what lenders and investors do with their money (with a few notable exceptions, like China and Russia). Instead, they usually control the mechanisms of capital flow for investments as well as information disclosure to provide lenders and investors with sufficient data to make informed decisions. When it comes to regulating, influencing, and directing the financial sector toward sustainable lending and investing, policymakers are still learning the ropes. The banking laws themselves are one of the main obstacles to this growing emphasis on climate risk. In 2009, international banking regulations were negotiated in Basel, Switzerland, and are referred to as Basel III because they were the third ones to be negotiated in the city. Through the Basel III agreement, banks are now required to maintain appropriate leverage ratios and maintain specific levels of reserve capital on

[46] Deckelbaum, A., Karp, B., Curran, D., Johnson, J.C., Lynch, L. and Bergman, M. (2020). *Introduction to ESG.* The Harvard Law School Forum on Corporate Governance. Available at: https://corpgov.law.harvard.edu/2020/08/01/introduction-to-esg/.

hand, as part of a set of reforms aimed at reducing risk in the global banking industry. Preventing banks from engaging in long-term lending was one of the agreement's outcomes, as this practice was seen as high-risk following the 2008 financial crisis. At the end of the COP 21 conference in Paris six years later, governments from all over the world agreed to limit greenhouse gas emissions, obliquely advocating for long-term actions with long-term financing. We currently live in a world where Basel III and COP 21 are in conflict (Eckhart, 2020).

Any changes to the vast and intricate regulatory framework affecting ESG investing would be challenging due to its historical path-dependency. The flow of capital from bad to good, brown to green, and carbon-emitting to climate change-mitigating is impacted by a broad range of government regulations and guidelines that exist today in addition to the SDGs and the Paris Climate Change Accord. Additionally, businesses and investors have access to a vast range of voluntary guidelines and tools that help direct strategy and disclosure. The following pages examine this intricate web of rules, policies, guidelines, standards, and frameworks.

In order to help investors who are interested in pursuing sustainable or ESG investing strategies, a number of *guidelines* have been developed. Some have been independently developed by industry associations or multi-stakeholder initiatives, while others have been established by international governing bodies like the United Nations. These international standards are all voluntary and serve mainly to improve the financial markets' efficiency and comparability. These guidelines comprise sets of aligning principles and commitments to provide common direction for addressing environmental and social challenges, as well as reporting and disclosure guidance from organizations like the Carbon Disclosure Project (CDP) and the Task Force on Climate-related Financial Disclosures (TCFD).

Another of the primary instruments that governments employ to encourage environmentally conscious and sustainable behavior in general is the establishment of *regulated markets*. A regulated market is one in which the government retains some degree of power or influence, for example, by deciding who can enter the market or by imposing rules on businesses, like exchanging emissions allowances. As an alternative, a regulated market can limit the annual number of emissions certificates entered in an effort to affect the price of the tradeable commodity. These days, there are a number of significant regulated markets with broad coverage, especially in the energy and climate change sectors. A popular market-based instrument for limiting emissions of greenhouse gases and other pollutants through a "market" mechanism is carbon trading, also known

as emissions trading. Businesses trade emissions in the carbon markets using credits that offset or pay for emissions reductions, or through cap-and-trade programs. The European Trading System (ETS) is the biggest and most watched market. Numerous other nations, including China (in its provinces), the United States (regionally), and others have also established similar markets.

Green bonds are bonds that are issued with the intention of using the proceeds for projects that are focused on sustainability. A company or municipality might, for instance, issue bonds to fund energy-saving initiatives. One of the most popular financial tools for addressing climate change and advancing sustainability is the green bond. The goal of several industry and government-led initiatives has been to establish guidelines for the issuance of green bonds. Encouraging trust in the sponsors who are issuing green bonds with measurable environmental benefits is the aim of these initiatives. In order to lower the expense of looking for and vetting green investment opportunities, they are also used to streamline the investment process. The European Union has formalized a proposal to regulate the issuance of green bonds, and China has released a regulation pertaining to green bonds. Apart from the new laws, a number of voluntary guidelines have been established for the labeling of green bonds. The idea behind voluntary labeling is to draw in investors looking to show a return on their investment, either because they see potential returns on green bonds or because they are required by internal policy to make a specific amount of environmental investment.

Apart from the previously mentioned targeted regulations and initiatives, there exist several wider regulations pertaining to the banking and securities sectors that exert a noteworthy influence on ESG and sustainability investments, encompassing both favorable and unfavorable outcomes. Banking regulators supervise nearly all aspects of banks' business operations, but they normally have no say over who a bank serves or how their clients' money is used. Governments and banking regulations, on the other hand, have largely concentrated on evaluating the risks that banks are taking by lending to clients who in turn face climate risks since the 2015 Paris Agreement. Related initiatives like the TCFD, which advocates for increased disclosure of climate risks faced by businesses, assist these assessment efforts (Eckhart, 2020).

Sustainable finance became the top priority for EU legislation pertaining to financial markets, as well as the regulatory and supervisory agendas of EU and national supervisors and competent authorities of the financial sector, following the release of the "EU Action Plan for Sustainable Finance" by the European Commission in March 2018. A variety of financial products have been

introduced to the financial markets in recent years marketed in the accompanying press releases as the "first ever" green, social, sustainability-linked, ESG-linked, climate change, inclusion, or other bond or loan of a certain kind. The differences and similarities between these products – as well as the terminology employed – are not always evident at first look. Due to this, financial market participants have been accused by investors, regulators, supervisors, and special interest groups of "greenwashing" the financial products they issue, use, or invest in. Greenwashing is the phrase used to describe the use of language that sounds more "green" or environmentally friendly than the products actually are (Driessen, 2021). One of the goals of European legislation is to detect and stop greenwashing. It appears inevitable that there will be a strict monitoring system and associated sanctions mechanism, particularly for businesses that attempt to use greenwashing as a cover for breaking laws and regulations (Eckhart, 2020).

3.2.2 FinTech and Crypto-assets

FinTech innovations, blockchain, and cryptocurrencies are rapidly reshaping the financial landscape. Regulators need to strike a balance between fostering innovation and safeguarding stability. As the financial sector becomes more and more intertwined with IT, artificial intelligence applications and other technological advances, new challenges appears and regulators grapple with defining clear frameworks for regulating digital assets, addressing risks, and protecting consumers.

The term "FinTech" is a neologism that originates from combining the words "financial" and "technology", and it is used to describe how modern technologies – including those associated with the Internet, like cloud computing, but also Machine Learning and Artificial Intelligence – are becoming increasingly connected to business activities typical of the financial services sector, like loans, mortgages, payments, monetary transfers and various other banking activities. The word *FinTech* is also used to describe the innovators and disruptors in the financial industry who utilize the widespread availability of communication technologies, particularly through automated information processing and the Internet. Compared to traditional financial services, these organizations' new business models promise greater flexibility, efficiency and security. Companies that invest in FinTech include start-ups, established technology giants and established financial institutions (Gomber, Koch and Siering, 2017).

FinTech innovations bring greater opportunities but also greater risks. In the latest years there have been several governance scandals involving major FinTech firms. The collapse of Wirecard AG, a German FinTech company with publicly traded shares, was a major scandal. Previously, it was the

largest FinTech company in Europe and one of the largest globally. Wirecard declared bankruptcy in 2020 due to widespread accounting fraud, leaving approximately €2 billion in unaccounted-for financial assets. The company's share price fell from €191 to €1.28, resulting in a loss of approximately $7 billion for investors. In light of the scandal, the supervisory board, the accounting, control, and compliance departments, as well as other internal corporate governance mechanisms, were judged widely inadequate and lacking the necessary expertise to manage the company (Teichmann, Boticiu and Sergi, 2023).

Another case which garnered a lot of attention is the collapse of FTX, one of the largest corporate failures since the GFC. FTX was the world's fourth-largest cryptocurrency exchange by volume in 2022. The company's collapse in November 2023 resulted from astounding governance lapses, financial mismanagement and fraud, including deceitful inter-company transfers of customer funds, lack of standard internal controls, and undisclosed related party transactions. Investors lost approximately $8 billion. The shockwave due to the collapse caused an estimated loss of more than $200 billion in the global cryptocurrency market (Cornelli *et al.*, 2023). Aside from FTX, there have been several other scandals in the cryptocurrency market. In May 2022, the cryptocurrency market experienced difficulties, causing TerraLuna (a leading stablecoin) to drop from a high of US $115 to a low of US $2, resulting in an estimated $40 billion loss for investors. The TerraLuna collapse led to a $450 billion drop in cryptocurrency market value. Significant collapses of other cryptocurrency lending platforms, such as Celsius Network LLC and Voyager Digital Holdings, Inc., have also resulted in the loss of billions of dollars' worth of customer investments (Levitin, 2023).

The research by Alade (2023) investigates the unfortunate parallels in governance flaws that led to the failure of these FinTech firms and of pre-GFC traditional financial firms. The following points summarize some his findings:

- *Board oversight/Internal controls failure.* Poor oversight by the board of directors was common among pre-GFC financial firms and failed FinTech firms. Traditional financial institutions experienced challenges in the past with board member availability and capacity. The executive directors often neglected their responsibilities as directors of the companies by taking on too many obligations. Furthermore, a few of the non-executive directors lacked banking experience. For example, of the 11 board members of Lehman Brothers, one (the only executive director) held the dual roles of Chairman and CEO, while nine of the ten non-executive

directors lacked any relevant banking experience. Analogously, even though Wirecard's business had grown more complex, its supervisory board, which had only three members for the majority of its existence, was understaffed. It also lacked a board committee specifically focused on compliance, risk, and audit since the supervisory board was still in charge of these duties.

- *Risk management practices.* Pre-GFC financial institutions, such as Lehman Brothers, and Bear Stearns, were not completely aware of the risks connected to their business models. The degree of innovation in the financial services sector and the rise in complexity of financial products prior to the Great Financial Crisis exceeded the capabilities of the industry's risk management (measuring and monitoring) tools. Regarding FinTech, an example of poor risk management is FTX. Concerning the degree of risk attached to the assets and liabilities as well as their liquidity, there were notable disparities or mismatches between FTX's assets and liabilities. The majority of FTX's balance sheet reserves were made up of tokens that the founders created, so when the value of these tokens plummeted, FTX's liquidity position was jeopardized. Inadequate risk management also led to the collapse of Celsius, one of the main cryptocurrency lending platforms. Similarly, Wirecard's demise can also be explained by the disregard for the dangers involved in its digital payments business.
- *Ineffective regulatory and supervisory models*. The financial system is highly dynamic, but the regulatory framework did not adequately adjust to the innovations that occurred in the system prior to the Great Financial Crisis as well as in connection with FinTech. Before the GFC, investment banks were allowed to function as "consolidated supervised entities" by the U.S. Securities and Exchange Commission (SEC). The SEC provided supervisory oversight over the entire financial institution's operations. Regretfully, it lacked the capability to oversee or assess these consolidated entities, which at the relevant time held assets valued at almost US $4 trillion and have grown to be crucial to the financial sector. The failure in pre-GFC regulatory approach also extended to the UK with the use of "light-touch" regulatory methods by the Financial Services Authority (FSA). A dysfunctional regulatory framework is also symptomatic of the scandals that are occurring in the FinTech industry. Despite the market's size and growing integration with the rest of the financial system, regulators generally permit the cryptocurrency market to function without significant oversight. By taking advantage of the lax regulatory oversight surrounding the cryptocurrency market, FTX was able to evade adhering to standard precautions for financial services. Similar oversight failures by the regulatory authorities were noted in the Wirecard scandal. The primary financial regulator in

> Germany, the Federal Financial Supervisory Authority (BAfin), disregarded multiple accusations of accounting manipulations made against Wirecard.

Alade (2023) argues that the post-GFC corporate governance reforms are currently failing to enhance the governance of FinTech companies. This is a crucial argument since FinTech companies are just as likely as traditional financial organizations, if not more so, to generate systemic risks. To prevent another Great Financial Crisis, the corporate governance practices currently in place in the financial services sector need to be reassessed and modified in light of the difficulties posed by the algorithm-based operations of FinTech companies and other unique characteristics. There is still much to be done to enhance the foundation of FinTech, including updating the liability framework for directors and managers, strengthening ties between regulators on a local and global level, and increasing the use of the so-called RegTech and SupTech (the integration of technology with financial regulation and supervision in order to enhance monitoring and compliance). A lot still needs to be done to consolidate the corporate governance architecture of the financial sector to discipline the FinTech phenomenon.

The widespread availability and adoption of FinTech has inexorably led to the introduction of numerous laws and regulations by various governments that are specifically focused on FinTech products and services. Different approaches have been implemented by regulators to address the complexities associated with these innovations.

Figure 9. Process to Identify Regulatory Approaches and Policy Responses Towards FinTech (World Bank, 2020)

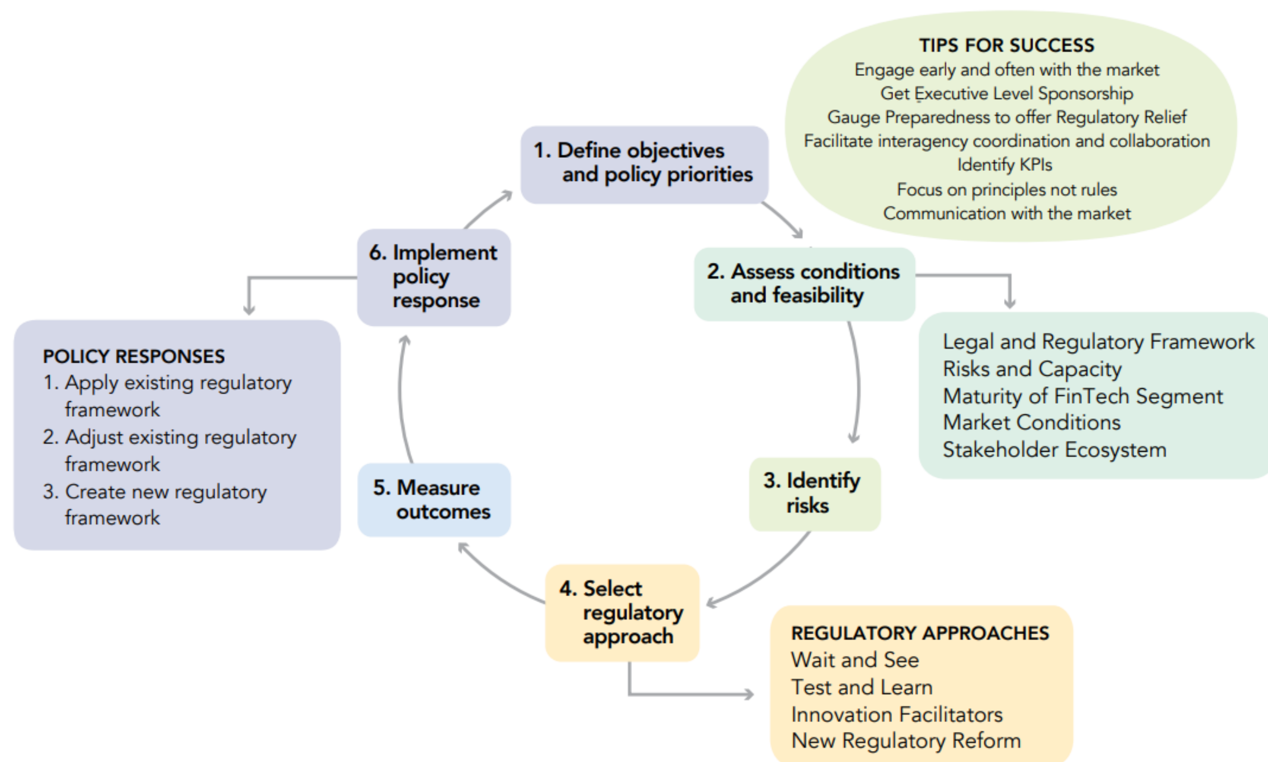

Figure 9 shows the process used to identify regulatory approaches and design appropriate policy responses in relation to FinTech suggested by the World Bank (2020). The regulatory approaches are various, each with advantages and disadvantages, and should be carefully selected by regulators, taking into considerations the specific risks and the characteristics of the market that they regulate.

The "wait and see" approach require no legislative reform; existing regulation continues to be upheld while regulators informally monitor trends to determine when and where formal intervention is required. This has been the most common way of approaching cryptocurrencies until lately. With this kind of approach, authorities treat FinTech companies and their services the same as traditional financial services, regardless of the mode of delivery. This is known as a technology-neutral approach to FinTech and presents high risks for consumers' protection, therefore it is unadvised to adopt it indefinitely.

Another possible method used for regulating FinTech is the "test and learn" methodology. For every FinTech product, a unique framework must be developed under this regulatory approach. One of the risks is that it is challenging to guarantee fairness and an even playing field; conflicts

with competition may occur. Moreover inadequate supervision and monitoring, or misuse of dispensation, can put consumers at risk.

The UK's Financial Conduct Authority created the *regulatory sandbox*, which is categorized as an "innovation facilitator" and it is another approach to FinTech regulation, that was then adopted in other jurisdictions. A regulatory sandbox is a framework that enables FinTech companies to test their products, services, or solutions in the market within a well-defined space and timeframe set by the regulators, but free from burdensome regulations. It differs from the "test and learn" strategy in that the regulators' monitoring in the latter case is done at a distance and necessitates oversight to be carried out in an open market setting, free from ring-fencing or other controls.

In more rules-based regimes, the first step can be to move to enact new regulations specifically for FinTech products; policymakers that take this stance can also forbid the operation of specific kinds to FinTech companies. Note that the introduction of regulation prior to properly understanding new markets and technologies might lead to inappropriately designed regulation, moreover it is more time-consuming as a process and might not be able to respond to rapidly changing market movements.

3.2.3 Consumer Protection and Fairness

Another aspect of the financial industry regulation that has been prioritized by various authorities in the latest years is a heightened emphasis on financial consumers' rights and safeguard. Financial products and services help customers satisfy fundamental needs, build resilience and capture opportunities, but they also come with *risks*. Factors such as information asymmetries and power imbalances, as well as aggressive commercial practices, contribute to enhance these risks. Over the past decade, there has been substantial progress towards strengthening Financial Consumers Protection (FCP) regulatory systems globally. Policymakers are implementing various regulatory initiatives to safeguard consumers from unfair market practices, help them make informed decisions about financial products and services, and improve overall outcomes. Effective regulatory systems require operationalization and supervision. Authorities are focusing on building effective supervisory mechanisms and structures to monitor and apply FCP regulations, promote compliance, and improve consumer outcomes. Supervising FCPs can be challenging due of the

diverse range of financial products, providers, and challenges to address, as well as limited supervisory resources.[47]

Benston (2000) summarized the main regulatory objectives of financial customers protection as follows:

- *Preserving consumers' trust in the financial system.* There are two reasons why government regulation is necessary to protect consumer trust in financial services providers and products: (1) preventing a negative externality from a systemic collapse that could happen if customers lose faith in the system, and (2) achieving a positive externality from customers using financial services to their best advantage. Regulatory measures are in place to ensure that financial institutions operate ethically, transparently, and in a manner that doesn't erode public trust.
- *Ensuring the stability of institutions that consumers depend on.* The stability of financial institutions is crucial for consumer confidence. Regulatory bodies work to establish and enforce rules that promote the stability and soundness of financial institutions, minimizing the risk of failures that could negatively impact consumers.
- *Guaranteeing that consumers are treated fairly and have access to enough information to make "good" decisions.* Regulations should be designed to ensure that financial institutions treat customers with fairness and provide clear and accurate information to consumers, empowering them to make informed decisions about financial products and services.
- *Ensuring fair pricing of financial services*. Regulatory authorities aim to prevent unfair pricing practices in the financial industry. This includes measures to promote transparency in pricing, avoid hidden fees, and ensure that consumers are charged reasonable and competitive rates for financial services.
- *Safeguarding consumers against deception and fraud.* Consumer protection regulations are in place to identify and prevent deceptive practices and fraudulent activities within the financial sector. This involves monitoring and enforcement actions to safeguard consumers from scams, misinformation, and other fraudulent schemes.
- *Preventing insidious forms of discrimination against individuals.* Regulatory bodies need to eliminate discriminatory practices within the financial industry, ensuring that all individuals

[47] World Bank (2022). *An Introduction to Developing a Risk-Based Approach to Financial Consumer Protection Supervision.* The World Bank Open Knowledge Repository (World Bank). doi:https://doi.org/10.1596/38419.

have equal access to financial products and services. This includes addressing subtle forms of discrimination, such as biased lending practices, to promote financial inclusion and equality.

Financial consumer protection should be explicit responsibility of the appropriate oversight bodies, and they should have the power to carry out their mandates. High professional standards should be adhered to by oversight bodies, including the avoidance of conflicts of interest and proper standards for the confidentiality of proprietary and customer information. It should be possible for oversight bodies to do their duties with the necessary adaptability, capability and authority. This could entail changing market surveillance, for example in relation to advancements in sustainable finance or technology, or granting the authority to step in and save consumers from harm in the case of particular, high-risk products. Monitoring organizations must evaluate the efficiency of enforcement and supervision instruments on a regular basis. A few examples of efficient enforcement methods are fines, sanctions, license revocation, changes in trade permits, announcement of enforcement results, restitution, compensation, and other remedies.[48]

It is imperative that financial consumers receive equitable, honest, and fair treatment throughout their entire relationship with financial service providers. All financial services providers and authorized agents should consider treating customers fairly as a fundamental component of their corporate culture and of good governance. Moreover, vulnerable groups should have their needs given particular attention.

As part of a larger financial inclusion and/or literacy strategy, all relevant stakeholders should encourage financial literacy and awareness. In order to promote consumers' financial resilience and well-being, appropriate mechanisms should be created to help them acquire the knowledge, abilities, behaviors, and attitudes necessary to be aware of dangers and opportunities, make educated decisions, know where to find support, and act decisively. These defenses could also include encouraging safe online and digital transactions, increasing public awareness of digital security threats, and improving digital financial literacy. All consumers should have easy access to financial literacy programs, which should include timely and clear information on consumer protection, rights, and duties. These programs should also be accessible, especially to important target groups such those who are vulnerable.

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[48] OECD (2022). *Public Consultation: Draft Recommendation on High-Level Principles on Financial Consumer Protection - OECD.* Available at: https://www.oecd.org/finance/high-level-principles-on-financial-consumer-protection.htm.

In light of the increasingly digital landscape for financial products and services, effective financial consumer protection is more crucial than ever. This trend has been further accelerated by the COVID-19 pandemic response. Financial consumers can benefit greatly from digitalization, that has the potential to support greater financial inclusion and inclusive growth, but there are new risks involved as well. Positive effects include increased speed, convenience, personalization, security, and consumer access to a wider range of goods and services at reduced prices. New types of online theft and fraud, data breaches, invasions of privacy, and incidents involving digital security are among the risks. The methods and policies created and implemented by financial consumer protection authorities must also change and adapt to keep up with the times.[49]

Businesses should make sure that the computer programs or algorithms that support digital financial services, like digital financial advice, are made to provide results for financial consumers that are impartial, consistent, and fair. These results should also take into consideration the customers' needs, financial circumstances, and level of digital literacy. Such programs should have transparent methodology and underlying assumptions that are understandable by the firm and can be provided for clarification. Businesses ought to handle the risks associated with algorithms in the same manner that they handle risks associated with other financial models. This entails making sure that the procedures are followed correctly, ensuring that appropriate oversight is maintained, and having a qualified, impartial third party validate the results.

Financial consumer protection through regulation and good governance is crucial for ensuring the stability and integrity of financial systems. A well-balanced regulatory environment, coupled with strong governance mechanisms, is essential for building a resilient and sustainable financial ecosystem that benefits both consumers and the broader economy. Continued efforts in this direction are necessary to adapt to evolving financial landscapes and address emerging challenges in consumer protection.

[49] OECD (2020), *Financial Consumer Protection Policy Approaches in the Digital Age: Protecting consumers' assets, data and privacy.* www.oecd.org/finance/Financial-Consumer-Protection-Policy-Approaches-in-the-Digital-Age.pdf

CONCLUSIONS

In examining the intricate relationship between corporate governance, regulatory responses, and market failures in the financial services sector, this thesis wanted to better understand the complexities and challenges inherent in maintaining a robust and trustworthy financial system. The exploration of corporate governance mechanisms, particularly within the context of financial institutions, revealed the pivotal role they play in ensuring ethical conduct, appropriate risk management, and the protection of stakeholders' interests.

Corporate governance is intended as the set of rules, practices, and processes by which a company is directed and controlled. A functional system of checks and balances within corporate governance is paramount to ensuring transparency and accountability and preventing cases of fraud and abuse of corporate power.

The case studies of the LIBOR manipulation scandal and the Wells Fargo cross-selling scandal served as illustrative examples of lapses in corporate governance and systemic failures that can arise within financial institutions. The consequences of negligence and frauds can be severe for all the agents involved. These cases, alongside other market failures, underscore the fundamental importance of effective oversight mechanisms and its promptness in preventing and addressing abuses.

The analysis of market failures in financial services provided a comprehensive overview of the vulnerabilities within the system, emphasizing the need for a balanced regulatory framework. The global interconnectedness and systemic importance of financial markets, as well as the evolving nature of financial services, calls for adaptive and forward-thinking regulatory initiatives. We identified some areas that came to the attention of regulators in the latest years, such as ESG principles, evolving technological landscapes like FinTech and cryptocurrencies, and the heightened attention placed by authorities to consumers' rights protection.

In conclusion, the findings of this thesis underscore the importance of a holistic approach to corporate governance and regulation in the financial services sector. A symbiotic relationship between effective governance structures and responsive regulatory frameworks is crucial for preventing market failures and safeguarding the integrity of financial markets. The challenges identified provide avenues for future improvements and emphasize the need for a proactive stance

in shaping the future of corporate governance and regulatory responses in the ever-evolving landscape of a crucial sector like the financial services industry.

Looking forward, this thesis emphasizes the importance of continuous vigilance and collaboration among regulators, industry participants, and other stakeholders. The evolving nature of financial services demands a forward-thinking and agile approach to regulatory and governance frameworks. The lessons learned from market failures provide valuable insights for shaping the future of financial regulation and corporate governance, ultimately contributing to a more resilient and trustworthy financial ecosystem.

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