CHAPTER 1. CORPORATE GOVERNANCE[1]

1.1 The birth and development of corporate governance

The evolutionary path of *corporate governance* developed over time in different countries which were faced with the need to create transparency, often following financial scandals of national and international importance.

The term *corporate governance* identifies the object of a very wide and complex study that has been at the centre of political and economic debate in important industrialised countries for some time (Winter and Rimmel, 2001). This expression is used to indicate a set of rules, reports, processes and corporate systems that define the distribution of rights and responsibilities within the company. Yet, it also indicates the structure which is used to establish business objectives, the instruments to meet them and to control its performance (OCSE, 1999)[2].

The main objective of *corporate governance* is that of providing appropriate incentives to the management in order to converge control and ownership objectives to allow the realisation of growth in the company share price with a view to the average/long term.

The question of *corporate governance* has gained growing importance following the development of global financial markets, the increasing international diversification of investments by pension funds and investment funds and following company internationalisation.

The different financial scandals of recent years have demonstrated the existence of shortcomings within corporate governance systems attributable, in particular, to scarce transparency between managers, shareholders and *stakeholders.* In fact, the prevalence of opportunistic behaviours of members of company governance bodies has highlighted the need for intervention of national and international importance by the various authorities responsible for market vigilance and regulation. The need for corporate *governance,* dictated by

[1] For academic reasons Section 1.1 is to be attributed to Franco Rubino, Section 1.2 is to be attributed to Graziella Sicoli, Sections 1.3 and 1.5 are to be attributed to Maurizio Rija, and Sections 1.4 is to be attributed to Paolo Tenuta.

[2] Such a definition was made by the OCSE in 1999 in *"Corporate Governance Codes and Principles - OCSE";* in particular, the code states that: *"Corporate governance [...] involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and of monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently* (Winter and Rimmel, 2001).

knowledge and rationality, was suggested by the desire to maintain positive relations between the business and the environment especially, as mentioned previously, faced with the growing globalisation of financial markets (Salvioni, 2002).

In particular, the reduction of spatial and temporal borders and the increasing importance of different international financial vigilance organs have required increased uniformity of *corporate governance* rules and mechanisms in various countries. Even in the context of a globalised world, different countries have developed their own sensitivity to the themes of *corporate governance,* affected by institutional characteristics, by the corporate law model, by the constraints imposed by supervisory boards and by the principles and uses of each nation.

In the 1990s, the discussion on *governance* started to be more shocking following the collapse of financial empires (Escohotado, 1997)[3] which invoked the need for new rules of *corporate governance*[4].

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[3] In 1985, the BCCI had some 400 branches in more than 70 countries; it resulted as being the seventh bank in the world with a nominal capital of close to 40 billion lire. Its influence in the United States led it to secretly possess control of First American Bank shares, illegally holding 300 branches from New York to Florida; control managed by C. Clifford , former Secretary of Defense and personal advisor to several presidents. In 1988, some bank executives were jailed in the United States for laundering money from the drug market, even if the company continued to operate without interference. In the spring of 1990, an audit by Price-Waterhouse determined that, at least in England, the world of holdings was "a complete chaos". The Ministry, however, did not intervene in the matter, which a little later involved, for the Minister, the accusation of having collaborated in the swindle of about $10 billion from small and medium English depositors. It was not until the summer of 1991 that the governor of the Bank of England defined the BCCI a "rotten fraud" and, with an unprecedented operation in the history of the bank, all the branches in Europe and the United States were closed all at once. Along with the scandal arrived the revelation that this company had an illicit network formed by more than one thousand five hundred employees who were dedicated, all round the world to the purchasing of foreign weapons and uniforms, spying, kidnaps and crimes as cover for the trafficking of drugs and the laundering of its money. (Escohotado, 1997).

[4] The Cadbury Report (1992) and annexed code of best practice were published, which emphasized the role of outside advisers and independent audit committees in balancing and controlling the steering power of the executive directors. In subsequent years, many industrialised countries followed the British example, favouring the creation of committees that were entrusted with the task of drawing up codes of conduct for corporate governance, including the publication in Italy in 1999 of the Code of Self-regulation of listed companies, the so-called “Preda Code”. In 2002 in the United States, a few months after the collapse of the energy giant Enron, Congress passed the Sarbanes-Oxley Act, which strictly regulated the behavior of the various players who revolve around the company. Following the example of the USA, the interventions by national legislators in various countries multiplied. Thus, the High Report (2003) was published in Britain, the Vienot II Report was updated in France (2003), and the Code of Listed Companies (2004) was adopted in Japan. In Italy, there was the Corporate Law Reform (2003), the Savings Act (2005) and the Code of Conduct (2006). Furthermore, in Italy, with Legislative Decree 32/2007, Article 1, the transposition of the mandatory part of Directive n. 2003/51 / EC occurred, which redesigned the Report on the Management of limited liability companies that prepare their financial statements in ordinary

Seeking to frame conceptually the object of the study, it is necessary to note that the term *governance* presents different meanings in economic, political and social fields; for the present work, only the economic meaning is considered.

The concept of "*governance*" was used by Coase in 1937 in his article to refer to coordination mechanisms within the company that reduce transaction costs arising from the market (Coase, 1937). The aim was to respond to the need for verification, control and responsibility of the company towards its own shareholders and consumers.

In 1979, the term was reclaimed by Williamson in his theory on transaction costs used to describe, more generally, those forms of economic organisation alternative to the market and to hierarchy. In this theory, *governance* designates the ways of coordinating individual actions, and not only organisational ones, different from hierarchies and from the market, through which social order is constructed (Williamson, 1979).

Furthermore, in this sector, the concept of *governance* assumes two further different meanings that, following the typification proposed by Rhodes, can be defined by the "minimal State" and by "corporate governance" (Rhodes, 1996).

The "minimal State" theory is supported by liberal economists, according to whom the decrease in public spending in economics is not translated as a reduction of public services offered as it is followed by an increase in actions of private entities which, through organisation and management of the "market" or of the "quasi-market", satisfy collective needs.

The meaning of "corporate governance" instead, identifies the set of procedures associated with the process of decision making, of performance and company control, as well as the execution of systems capable of directing it globally to satisfy the reasonable expectations of transparency of those who hold interests in it.

The entities that confer resources manifest a series of expectations that the company is held to satisfy regarding, in the first place, the meeting of economic expectations linked to the growth of its value and, consequently, the resources invested in it by financial backers (Di Giandomenico, 2007).

However, the expectations that the company must meet are not only reduced to economic expectations; in fact, the company is also held to fulfil satisfaction of expectations of a social and environmental character towards a large category of interlocutors (Salvioni and Bosetti, 2006). It is therefore necessary to seek to

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form. Even more recently, a new wave of regulation has emerged globally, always following financial scandals, such as those of Lehman Brothers and Goldman Sachs. As evidence of the heated debate on the need for transparent governance, on May 28, 2010, the OECD Ministerial Summit, under Italian Presidency, gave a green light to the declaration on "Global legal standards", i.e. a code of twelve common rules on the economy and finance based on the principles of ethics, transparency and fairness. Moreover, in Washington on July 21, 2010, the US President, Barack Obama, signed a law reforming the financial system. The new approved rules represent the broadest overhaul of financial rules since the Great Depression, and aim to prevent the recurrence of crises like that of 2008.

balance the different expectations (economic, social and environmental) in order to obtain a wide consensus from subjects that, in one way or another, revolve around the company (Cantino, 2007). The interlocutors of the company expect an efficient administration that is permeated by transparency and which is opportunely monitored, capable of overcoming the informative requests necessary for the realisation of evaluation processes fundamental in guaranteeing the durable continuation of positive relations with the company itself. Although the concept of corporate governance has been given various definitions in the economic literature, there has not yet been a shared definition (Eells, 1960; Shleifer and Vishny, 1997; Zingales, 1998; Monks and Minow, 2004; Daily, et al., 2003; Huse, 2006) [5].

The theme of corporate governance is not to be considered the exclusive prerogative of a sole corporate field, but it involves a multiplicity of themes inherent to the company. In such a direction, it is possible to identify five different analysis perspectives (Pugliese, 2008).

- *corporate governance and accounting:* connected to the poor functioning of *governance* mechanisms, often accounting rules are to be found with gaps and which are easily avoided with the complicity of banks and external auditors. With the aim of reaching a steady trend in accounting, an international process of harmonisation and improvement of rules, of principles and of accounting procedures relating to the formation of accounts has been implemented for some time. The growing globalisation of the economy, pushing companies to move to markets around the world, means that accounts assume an importance beyond simple national boundaries. Therefore, besides a national practice present in all countries, an international practice has been established for some time;
- *corporate governance and law:* legislative interventions have the aim of obtaining a greater protection of investors and, in particular, of small savers without, however, creating excessive legal constraints that are incoherent with the present reality in a set country;
- *corporate governance and finance:* since 1976, with the first work by Jensen and Meckling *corporate governance* has been the privileged sphere

[5] With the term corporate governance Eells indicates the structure and functioning of corporate policy and, therefore corporate governance (Eells, 1960). For Shleifer and Vishny, corporate governance deals with the complex system of rules that must ensure a return on the capital provided by the investors. Those mechanisms directed towards the regulation of the agency relationship between an apex of top executives and a base, often wider and fractioned, of holders of rights of ownership (Shleifer and Vishny, 1997). For Zingales, governance is a synonym of the exercise of authority, direction and control (Zingales, 1998). Monks and Minow represent corporate governance as the set of relations between the board of directors, owners and managers (Monks and Minow, 2004). Daily, Dalton and Cannella conceive governance as the determination of the different uses to which organizational resources are destined and the resolution of conflicts between the myriad of organisation participants (Daily et al., 2003). For Huse, corporate governance is defined as the interaction between the coalitions of internal actors, external actors and board members, with the aim of creating profit (Huse, 2006).

of finance scholars who set research on the optimal financial structure for maximisation of *shareholder value* as their main objective (Meckling and Jensen, 1976). Research on the minimisation of agency costs has always constituted one of the most debated topics in financial subjects. The internationalisation of financial markets and the growing cross-border operativity of many intermediaries and investors has lead corporate governance to be conditioned by extremely different interests, which are, however, present in owners of venture capital. Institutional investors, in fact, can have investment logics that are strongly contrasting, above all if compared on a temporal plane. Pension funds, *hedge funds*, *private equity funds, sovereign funds,* and so on, all with objectives of earning, and with different perspectives regarding the time of return on investments and connected techniques of financial engineering for the covering of risks;

- *corporate governance and political economics.* For some, policy makers have the objective of improving institutional arrangements and corporate governance mechanisms; the main reasons for this, on the one hand, are to be found in the fact that *governance* systems have an impact on the competitiveness of the country, linked to its ability to attract resources from firms and foreign investors in the capital market and, on the other hand, in the interest of the State in maintaining a leading role in those sectors considered as strategic for the country's development;
- *corporate governance and business economics:* such a relation concerns the way in which *governance* models affect organizational structures, the determination of corporate strategies, information systems, internal control systems and, more generally, on the process of value creation.

1.2 Ownership and control: main contributions

The question of separation between company ownership and control is fundamental in the topic of *corporate governance*. The growing spread of ownership of companies and, consequently, the ever more accentuated separation between ownership and control emphasise the need to protect all the entities that, for various reasons, bring venture capital to the business. The greater complexity of *inter* and *intra* business relationships leads to an increase in information needs and the need for greater controls (Pugliese, 2008). Furthermore, the rapidity with which information spreads within economic-financial environments gives rise to the need for control of the truthfulness of new communications, above all to avoid amplification phenomena that often lead to speculation that mainly goes against small investors (Salvioni, 2009). Economic literature has analysed the problem of corporate governance above all in terms of a problem connected to the relation of agency which occurs each time that an individual designates another person to