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The Corporate Governance Movement, Banks and the Financial Crisis

Brian R. Cheffins*

Abstract

This paper discusses why a “corporate governance movement” that commenced in the United States in the 1970s became an entrenched feature of American capitalism and describes how the chronology differed in a potentially crucial way for banks. The paper explains corporate governance’s emergence and staying power by reference to changing market conditions and a deregulation trend that provided executives with unprecedented managerial discretion as the 20th century drew to a close. With banking the historical pattern paralleled general trends in large measure. Still, while the “imperial” CEO who achieved prominence in the 1980s became outmoded for the most part after corporate scandals at the start of the 2000s, this was not the case with large financial companies. The continued boldness of “star” CEOs in the financial services industry plausibly contributed to the market turmoil of 2008 but the financial crisis emphatically ended the corporate governance “free pass” banks had enjoyed.

Keywords: corporate governance, banks, financial crisis, board of directors, agency costs, chief executive officers

JEL Codes: G30, G34, G38, K22, N22

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INTRODUCTION

It has been well known since at least the 1932 publication of Adolf Berle and Gardiner Means' *The Modern Corporation and Private Property* that shareholder passivity creates latitude for top executives of U.S. public companies to impose what are now commonly referred to as agency costs on investors.¹ Nevertheless, it was only in the 1970s that debates in the United States about managerial accountability, board structure and shareholder rights began to be explicitly channelled through the term "corporate governance".² The change went well beyond mere terminology as a "corporate governance movement" quickly emerged.³ This would ultimately evolve into a "corporate governance complex" composed of a dense array of public institutions, private firms and academic centers dedicated to the pursuit of "better" corporate governance.⁴

The basic chronology of corporate governance's arrival and subsequent development has been traced elsewhere.⁵ Still, while there has been analysis of what happened when, a topic which has been gone largely unexplored is *why* the corporate governance movement gained momentum in the U.S. when it did and then endured through ensuing decades. If it was well-known at least as far back as the 1930s that managerial accountability was

¹ ADOLF BERLE AND GARDINER MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932); the pioneering work on agency cost theory was Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

² Brian R. Cheffins, *Introduction*, *THE HISTORY OF MODERN U.S. CORPORATE GOVERNANCE* ix, ix (Brian R. Cheffins, ed., 2011).

³ Daniel Fischel coined the term in the early 1980s: Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982).

⁴ Suzanne Stevens and Michael Rudnick, *What Berle and Means Have Wrought*, *THE DEAL MAGAZINE*, May 14, 2010, available online at http://www.shareholderforum.com/e-mtg/Library/20100514_Deal.htm (accessed Feb. 17, 2014).

⁵ Cheffins, *Introduction*, *supra* note 2; Brian R. Cheffins, *The History of Corporate Governance* in *THE OXFORD HANDBOOK OF CORPORATE GOVERNANCE* 46 (Mike Wright, Donald Siegel, Kevin Keasey and Igor Filatotchev, eds., 2013).

potentially lacking in publicly traded companies, why was the corporate governance movement postponed for nearly half a century? And with corporate governance's arrival being belated in the first place what caused interest in the topic to be sustained as the 20th century drew to a close and the 21st century began? Even though Ronald Gilson suggested as far back as 1996 that the next generation of corporate governance scholarship would be dynamic, examining how and why existing institutions responded to a changing array of problems,⁶ these important questions have gone largely unaddressed thus far.

This paper offers conjectures on why the corporate governance movement gained momentum when it did and proved resilient thereafter, with the primary purpose in this particular context being to offer insights concerning the inter-relationship between the corporate governance of U.S. banks and the financial crisis. A key point the paper makes is that a reconfiguration of the business environment affecting executives, directors and shareholders helps to explain the chronology of corporate governance's arrival and its staying power. As the 20th century drew to a close, changing market conditions and a deregulation movement affecting a wide range of industries were providing executives with unprecedented discretion in relation to companies growing in size. In this milieu, corporate governance could provide a salutary check on U.S. executives, thereby ensuring it would not be a mere 1970s fad.

Despite numerous lapses, such as various high-profile corporate scandals occurring in the early 2000s, a case can be made that in the U.S. standards of managerial accountability have now largely caught up with changes to the business environment. Law professor Ed

⁶ Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter*, 74 WASH. U.L.Q. 327, 345 (1996). See also Stacey Kole and Kenneth Lehn, *Deregulation, the Evolution of Corporate Governance Structure, and Survival*, 87 AMER. ECON. REV. 421, 425 (1997) (quoting Gilson, *ibid.* to the effect "how a system of governance moves from one equilibrium to the next may come to attract more interest than the characteristics of a particular equilibrium").

Rock has posited, for instance, in a 2013 article that “the central problem of U.S. corporate law for the last eighty years--the separation of ownership and control--has largely been solved.”⁷ Perhaps, then, four decades after the corporate governance movement began a corporate governance equilibrium of sorts has been (re)established in corporate America.

This paper argues that with banking the historical pattern parallels general trends in large measure but also varies from the basic narrative in an important way. Due to a combination of deregulation, technological change and financial innovation banking was transformed between the 1970s and the mid-2000s from a “boring” business to a business that was anything but. As part of this transformation senior bank executives had managerial latitude their mid-20th century predecessors could have barely envisaged.

Given the trends affecting banking, to the extent that corporate governance can and does provide a salutary check on executives operating with substantial latitude, a marked strengthening in the corporate governance in banks would have been anticipated. There was movement in this direction. Nevertheless, while non-financial companies were unmistakably chastened by the corporate governance scandals of the early 2000s and by the corporate governance reforms introduced by the federal Sarbanes-Oxley Act of 2002 (SOX)⁸ during the mid-2000s the banking sector received something of a governance “free pass”. In particular, high profile bank CEOs were able to continue to operate with discretion substantially withdrawn from newly subdued chief executives of non-financial companies.

The additional managerial latitude which changing market conditions and deregulation afforded to top executives as the 20th century drew to a close was exemplified by the emergence of “celebrity” or “imperial” CEOs who, it was widely believed, could

⁷ Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1909 (2013).

⁸ Pub.L. 107-204, 116 Stat. 745.

transform corporate fortunes in a way their bureaucratic forerunners could not. Generally speaking this conception of the chief executive officer (CEO) quickly became outmoded in the subdued post-Enron/Sarbanes-Oxley corporate governance environment. During the mid-2000s, however, “star” chief executives remained prevalent in large financial companies and their boldness arguably put their firms at risk as the financial crisis loomed and plausibly contributed to the market turmoil of 2008.

The financial crisis proved to be something of a corporate governance equalizer for U.S. financial companies. Banks are now being run less flamboyantly than was the case immediately prior to the onset of the crisis, much as non-financial companies operated in a more restrained way after the corporate scandals and legislative reforms of the early 2000s. However, unlike with changes affecting the non-financial companies of the early 2000s this occurred primarily because of pressure from regulators rather than as a result of market-oriented corporate governance trends. Ironically, though, corporate governance reforms in the Dodd-Frank Act of 2010,⁹ the primary federal legislative response to the financial crisis, potentially operate at cross-purposes to regulatory pressure on banks and their executives to be “boring”.

I. THE HISTORY OF THE CORPORATE GOVERNANCE MOVEMENT – A PRÉCIS¹⁰

In the decades immediately following World War II, amidst widespread corporate prosperity, senior executives of U.S. public companies for the most part fulfilled faithfully the responsibilities associated with their stewardship of corporate assets. Correspondingly, while proposals had been made to foster managerial accountability that would be familiar to

⁹ Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (hereinafter Dodd-Frank Act), Pub. L. 111-203.

¹⁰ What follows draws upon Cheffins, *Introduction*, *supra* note 2; Cheffins, *History*, *supra* note 5, xi-xxvii; Brian R. Cheffins, *Did Corporate Governance “Fail” During the 2008 Stock Market Meltdown? The Case of the S&P 500*, 65 BUS. LAWYER 1, 5-11 (2009). Footnotes supporting the propositions advanced here are available from these sources.

modern students of corporate governance – William Douglas argued as far back as 1934 in favor of statutory rules requiring a majority of board seats to be occupied by individuals not affiliated with management¹¹ -- the internal governance of companies was not a high priority. Matters began to change in the 1970s, when the term corporate governance first came into vogue in the United States. Executives and directors began to struggle to maintain control over sprawling corporate empires built in the 1950s and the 1960s, a trend the 1970 collapse of Penn Central, a large railway-based conglomerate, underscored. Revelations shortly thereafter of bribery and illicit kickbacks involving dozens of U.S. public companies prompted fresh concerns, quite often couched in terms of corporate governance, about insufficient managerial accountability.

When the phrase corporate governance first achieved prominence in the 1970s it seemingly connoted that the corporation was a political structure to be governed, a characterization that was out-of-step with the market-oriented *zeitgeist* of the 1980s and was at odds with the increasingly popular characterization of the corporation as a “nexus of contracts”. Nevertheless, when in the late 1980s and early 1990s institutional investors demonstrated a growing willingness to engage in shareholder activism, initially to contest the adoption of anti-takeover devices by the companies in which they owned shares and later to pressure companies to increase the use of performance-oriented managerial compensation and to lobby for the relaxation of rules that created obstacles to shareholder intervention in corporate affairs, they often invoked the rhetoric of corporate governance in so doing. With the phrase “corporate governance” becoming increasingly associated with the preservation and promotion of shareholder value academic economists, who were just beginning to turn

¹¹ William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305, 1314-15 (1934); see also ROBERT A. GORDON, BUSINESS LEADERSHIP IN THE LARGE CORPORATION 347-50 (1945).

their attention to the internal control systems of publicly held corporations, embraced the term and thereby enhanced its intellectual credibility.

During the 1990s the promotion of shareholder rights and the fostering of boardroom accountability became topics of interest globally, rather than merely in the United States. In the same way that “corporate governance” was the short-hand typically invoked to capture what was on the agenda in the United States, the term gained currency internationally. As of 1999 the corporate governance movement had progressed to the point where a *Financial Times* columnist observed that “The 1990s have been the decade of corporate governance.”¹² Correspondingly, when during the early 2000s scandals rocked major U.S. public companies such as Enron and WorldCom and when the financial crisis occurred in 2008 “corporate governance” would be the term that academics, policymakers, investors and corporate executives around the world deployed when analyzing issues relating to board structure, executive pay and shareholder involvement in publicly traded companies.¹³

II. EXPLAINING CORPORATE GOVERNANCE’S ARRIVAL AND STAYING POWER

A. A New Style of Corporate Leadership

Why didn’t corporate governance end up as a 1970s fad in the same way as leisure suits, waterbeds, platform shoes and Pet Rocks? Corporate governance’s staying power in the U.S. was due partly to changing patterns of share ownership.¹⁴ Between the 1960s and the 2000s pension funds, mutual funds and other institutional shareholders supplanted private

¹² *Moves to Halt Another Decade of Excess*, FIN. TIMES, August 5, 1999, 10.

¹³ A by-product was that “corporate governance” was referred to in newspaper reports and academic papers considerably more often after Enron than was the case in the 1990s – Lucian A. Bebchuk, Alma Cohen and Charles C.Y. Yang, *Learning and the Disappearing Association Between Governance and Returns*, 108 J. FIN. ECON. 323, 329-30 (2013).

¹⁴ On the points raised here, see Cheffins, *Introduction*, *supra* note 2, xix; Cheffins, *History*, *supra* note 5, 52-53; Bengt Holmstrom and Steven N. Kaplan, *The State of U.S. Corporate Governance: What’s Right and What’s Wrong?*, 15(3) J. APP. CORP. FIN. 8, 11, 14 (2005).

“retail” investors as the dominant owners of shares in publicly traded U.S. companies. Due to pronounced collective action problems and a lack of relevant expertise private investors were ill-suited to step forward and keep executives of public companies in check. Institutional investors were by no means ideal shareholder activists. They were, however, better resourced than retail investors. They were also becoming more strongly motivated to take corrective action due to the increased prevalence of share ownership stakes large enough to preclude use of the “Wall Street Rule”, oriented around selling out of underperforming companies.

The durability of the corporate governance movement was not merely a product, however, of shareholders who were better situated and more strongly motivated to intervene. A point thus far largely unacknowledged in the corporate governance literature is that dramatic changes affecting the manner in which U.S. public companies conducted business likely played a significant role. As the 20th century drew to a close senior executives were in charge of larger companies than their mid-20th century predecessors and had greater managerial latitude, meaning that there was more at stake for investors than ever before. The enhanced discretion executives had available to them could potentially be exercised in a manner prejudicial to the interests of shareholders.¹⁵ Improved corporate governance could in turn plausibly function as a beneficial corrective. A logical corollary was that corporate governance had staying power 1970s fads lacked.

C.K. Prahalad and Yves Doz captured an important part of what was going on in a 2000 article on chief executive officers and wealth creation. They remarked upon “a new

¹⁵ Catherine M. Daily and Jonathan L. Johnson, *Sources of CEO Power and Firm Financial Performance: A Longitudinal Assessment*, 23 J. MGMT. 97, 105 (1997) (“It may be...that CEOs possessing high levels of power misuse their power for their own benefit at the expense of shareholders.”)

style of corporate leadership – one that includes a public persona for the CEO.”¹⁶ They asked whether “a more visible corporate leadership reflect(ed) a new reality in the internal governance of large corporations?”¹⁷ Prahalad and Doz answered yes, saying that due to various key changes in the business environment “top management cannot take a ‘hands off’ approach or content themselves with effective stewardship of the assets they inherit at the beginning of their tenure.”¹⁸ They continued “The role of top management is no longer just control and coordination, it is anticipating, leading and managing change....”¹⁹

Prahalad and Doz did not specify when executives focused merely on control and coordination but it would seem they had in mind the “managerial capitalism” prevalent during the 1950s and 1960s, characterized by Jeffrey Gordon as “the high-water mark of managerialism in U.S. corporate governance.”²⁰ David Skeel has said of large corporations of this era “The qualities that were rewarded in most companies were dependability and loyalty, not creativity. The most prominent CEOs were more likely to be corporate bureaucrats than entrepreneurial geniuses.”²¹ To the extent this characterization is accurate, given the economic prosperity the U.S. enjoyed during the decades immediately following World War II it is hardly surprising that corporate governance was not a high priority.

¹⁶ C.K. Prahalad and Yves Doz, *The CEO: A Visible Hand in Wealth Creation?*, 13(3) J. APP. CORP. FIN. 20, 20 (2000).

¹⁷ *Ibid.*

¹⁸ *Ibid.*

¹⁹ *Ibid.*

²⁰ Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STANFORD L. REV. 1465, 1511 (2007); see also GERALD F. DAVIS, *MANAGED BY THE MARKETS: HOW FINANCE RE-SHAPED AMERICA* 63 (2009) (identifying the period from 1920 until the 1980s as the era of managerial capitalism, with the 1950s being when the managerial “soulful” corporation came to dominance).

²¹ DAVID SKEEL, *ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM* 108 (2005).

While Prahalad and Doz insightfully drew attention to a new style of corporate leadership that implied the need for a reconfiguration of the governance of publicly traded companies, various caveats are in order. First, the transformation of the managerial function they remarked upon was not novel in 2000 but instead can be traced back at least a couple of decades earlier. In the years immediately following Chrysler's 1978 much-heralded hiring of the flamboyant Lee Iacocca to execute a corporate turnaround, numerous major U.S. public companies turned to youthful (by conventional CEO standards), dynamic individuals to take charge.²² Correspondingly, by the mid-1980s the media was hailing "A New Breed of CEO" bringing "new excitement to rusty companies"²³ while at the same time bemoaning a new "me-first" attitude among top management.²⁴

Second, while as the 20th century drew to a close there was awareness of a new style of corporate leadership, it is not feasible to measure the magnitude of the change with precision. Empirical testing of the discretion CEOs have available to them is an under-explored topic,²⁵ perhaps because it may not be possible to define CEO power satisfactorily along a single measureable dimension.²⁶ However, there is some quantitative evidence indicating the chief executive role did increase in prominence in the 1980s and 1990s. A growing "CEO pay slice" -- the ratio of CEO total compensation to the average of the pay of the other two highest paid officers in U.S. public companies rose from 1.29: 1 in the 1960s to

²² ROY C. SMITH AND INGO WALTER, *GOVERNING THE MODERN CORPORATIONS: CAPITAL MARKETS, CORPORATE CONTROL AND ECONOMIC PERFORMANCE* 106 (2006).

²³ N.R. Kleinfield, *A New Breed of CEO*, N.Y. TIMES, Dec. 1, 1985, SM 76.

²⁴ Ann Crittenden, *The Age of "Me-First" Management*, N.Y. TIMES, Aug. 19, 1984, F1.

²⁵ Brian K. Boyd and Steve Gove, *Managerial Constraint: The Intersection Between Organizational Task Environment and Discretion* in *RESEARCH METHODOLOGY IN STRATEGY AND MANAGEMENT*, vol. 3, 4 (working paper version, 2013) (D. Ketchen and D. Bergh, eds., forthcoming) (saying searches had revealed only 16 empirical tests of managerial discretion).

²⁶ Adair Morse, Vikram Nanda and Amit Seru, *Are Incentive Contracts Rigged by Powerful CEOs?*, J. FIN. 1779, 1792 (2011).

1.58: 1 in the 1980s and to 2.58: 1 in the early 2000s²⁷ -- arguably reflected the growing importance of the CEO as compared to other senior executives.²⁸ The proliferation of CEO awards, used by Ulrike Malmendier and Geoffrey Tate to identify “superstar CEOs”,²⁹ similarly demonstrates the growing prominence of chief executives. While during from the mid-1970s to the mid-1980s only the now defunct *Financial World* magazine identified and made awards to CEOs numerous publications began to do likewise in the late 1980s (e.g. *Business Week*, *Chief Executive*, *Industry Week*) as did various others around 2000 (e.g. *Forbes*, *Morningstar.com*, *Time/CNN*).³⁰

Third, having identified “a new style of corporate leadership” Prahalad and Doz did not explain in any detail in their 2000 paper why the shift to senior corporate executives leading and managing change had occurred. Given that CEOs are likely to be granted wider latitude when their firms are performing well,³¹ Prahalad and Doz’s “new style” of management may have been partially attributable to a dramatic rise in share prices occurring during the “The Roaring Nineties.”³² However, even if healthy shareholder returns contributed to the occurrence of the “celebrity CEO” phenomenon, various additional factors can be identified that reoriented the managerial function in U.S. public companies in a manner that set the stage for corporate governance to act as a potentially salutary corrective. One was that companies were becoming bigger, meaning that investors had more to lose if executives squandered the new latitude available to them.

²⁷ Carola Frydman and Raven E. Saks, *Executive Compensation: A New View from a Long-Term Perspective*, 23 REV. FIN. STUD. 2099, 2112-13 (2010).

²⁸ Lucian Bebchuk, K.J. Martijn Cremers and Urs Peyer, *The CEO Pay Slice*, 102 J. FIN. ECON. 199, 200 (2011).

²⁹ Ulrike Malmendier and Geoffrey Tate, *Superstar CEOs*, 124 Q.J. ECON. 1593 (2009).

³⁰ *Ibid.*, 1599-1600, 1635-36.

³¹ Daily and Johnson, *supra* note 15, 104.

³² JOSEPH E. STIGLITZ, *THE ROARING NINETIES* 3, 5 (2003).

B. Bigger Companies

All else being equal the more there is at stake, the more worthwhile it will be for careful oversight to occur. By extension, the greater the value of assets under the control of public company executives, the more emphasis there should be on corporate governance. This logic may well help to explain corporate governance's emergence in the 1970s and subsequent entrenchment as an essential feature of U.S. capitalism. Major U.S. public companies were becoming larger across various dimensions as corporate governance came to the fore and became well-established. The executives in charge correspondingly merited closer scrutiny, particularly given that their companies were operating in a more volatile market environment due to deregulation, increased competition and technological advances reducing barriers to entry in many industries.³³

It might be surprising that large American companies were becoming bigger as corporate governance came into vogue. After all, corporate "downsizing" occurring in the late 1980s and early 1990s was much ballyhooed.³⁴ Moreover, leading U.S. companies achieved a degree of global economic dominance in the managerialist era immediately following World War II that was not sustained fully thereafter.³⁵ For instance, as of 1955 General Motors generated a proportion of America's entire gross national product roughly equivalent to Italy's entire GNP.³⁶ Nevertheless, on various measures major U.S. public companies grew significantly bigger as the corporate governance movement took hold.

³³ ROBERT REICH, *SUPERCAPITALISM: THE BATTLE FOR DEMOCRACY IN AN AGE OF BIG BUSINESS 50-70* (2009) (identifying factors that disrupted corporate stability in the U.S. as the 20th century drew to a close); see further *infra* Part II.C and Part II.D. .

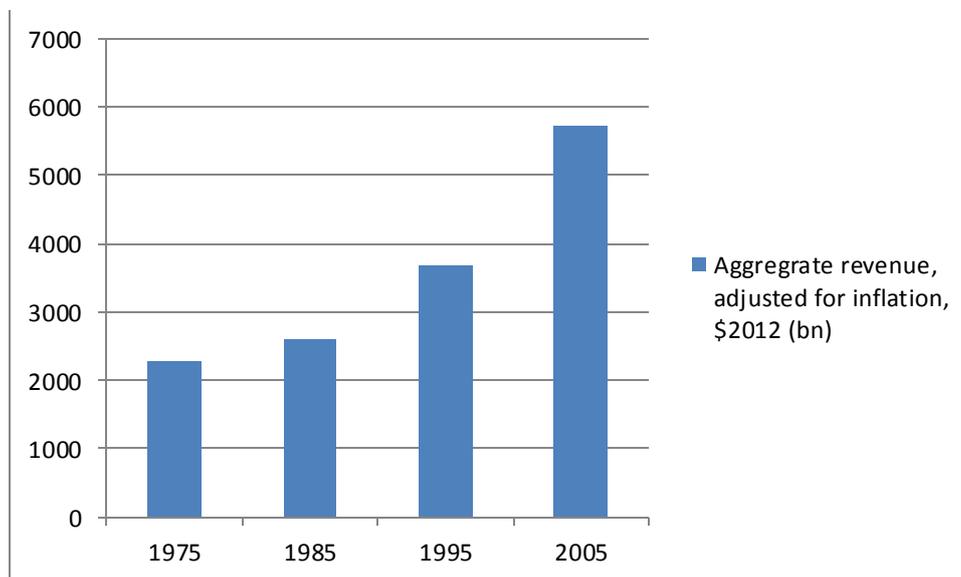
³⁴ WYATT WELLS, *AMERICAN CAPITALISM, 1945-2000* 145-46 (2003).

³⁵ REICH, *supra* note 33, 52.

³⁶ *Ibid.*, 29-30.

According to a 2001 article in the *Wall Street Journal* arguing that a merger wave in the 1990s had given rise to numerous new corporate behemoths, by 2001 more than 50 U.S. public companies had more than 100,000 employees whereas only 18 did in the mid-1980s.³⁷ Moreover, total sales of the top 100 non-oil-U.S. firms increased from 20 per cent of U.S. GDP in 1980 to 25 per cent in 2009.³⁸ Similarly, the aggregate revenue of Fortune 500 firms more than doubled between 1975 and 2005, adjusting for inflation (Fig. 1).

Figure 1: Aggregate Revenue of Fortune 500 companies, 1975-2005



Sources: compiled from data available at

http://money.cnn.com/magazines/fortune/fortune500_archive/full/2005 (accessed Sept. 18,

2013); adjustments for inflation made using CPI via

<http://www.measuringworth.com/uscompare/> (accessed Sept. 18, 2013).

The market capitalization of U.S. public companies grew even more rapidly than the revenues of such firms as the corporate governance movement consolidated.³⁹ The average

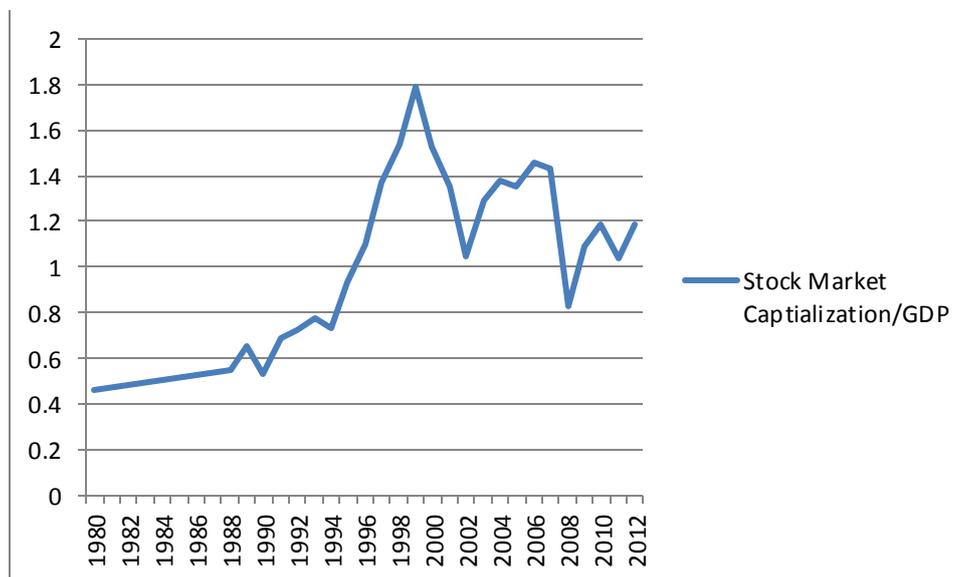
³⁷ Matt Murray, *Critical Mass*, WALL ST. J., Feb. 8, 2001, A1.

³⁸ Xavier Gabaix, *The Granular Origins of Aggregate Fluctuations*, 79 *ECONOMETRICA* 733, 734 (2011).

³⁹ Marianne Bertrand, *CEOs*, 1 *ANN. REV. ECON.* 121, 137 (2009).

market value of the largest 500 publicly traded U.S. companies increased six-fold in real terms between 1980 and 2003.⁴⁰ There similarly was a substantial increase in the size of the U.S. stock market relative to the economy, even making allowances for the “bear” markets associated with the dot.com stock market crash and subsequently the financial crisis (Fig. 2). With more being at stake for investors, it is not surprising that bolstering managerial accountability through improved corporate governance moved on to the priority list.

Figure 2: Value of All Listed U.S. Stocks/GDP, 1980-2012



Sources: Rajan and Zingales (data for 1980)⁴¹; World Bank (data for 1988-2012)⁴²

C. Deregulation

Deregulation likely was an additional catalyst for corporate governance’s rise to prominence and its subsequent staying power.⁴³ In the United States deregulation

⁴⁰ Xavier Gabaix and Augustin Landier, *Why Has CEO Pay Increased So Much?*, 123 Q.J. ECON. 49, 72, 94 (2008) (reporting additionally that the increase was even more substantial for the top 100 firms).

⁴¹ Raghuram G. Rajan and Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the 20th Century*, 69 J. FIN. ECON. 5, 15 (2003).

⁴² Data derived from <http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS> (accessed Feb. 17, 2014).

commenced during the Jimmy Carter administration with the airline and trucking industries, moved into full swing under Ronald Reagan in areas such as oil and gas and antitrust enforcement and continued in the 1990s with electricity and telecommunications.⁴⁴ This process likely intensified managerial agency cost problems and prompted the adoption of more rigorous corporate governance as a counter-reaction.⁴⁵

All else being equal, senior executives running a company in an industry which is heavily regulated will have less discretion than their counterparts in industries that do not face such restrictions.⁴⁶ Deregulation occurring as the 20th century drew to a close correspondingly should have increased the importance of the managerial function in firms affected, with constraints on the development of pricing schemes, distribution patterns and innovative products unravelling and with the removal of regulatory “safety nets” introducing substantial down-side risk for lagging firms.⁴⁷ At the same time, deregulation, by inducing increased instability in the business environment, would have increased the costs of observing managerial performance, thereby enhancing the value of governance mechanisms designed to keep potentially wayward executives in check.⁴⁸ The corporate governance movement plausibly developed as at least a partial counterweight to higher agency costs deregulation potentially engendered.

⁴³ Prahalad and Dozy explicitly drew attention to deregulation as a factor contributing to the growing importance of CEOs: *supra* note 16, 20.

⁴⁴ SKEEL, ICARUS, *supra* note 21, 119-20, 198.

⁴⁵ Kole and Lehn, *supra* note 6, 421, 425.

⁴⁶ Donald C. Hambrick and Eric Abrahamson, *Assessing Managerial Discretion Across Industries: A Multimethod Approach*, 38 ACAD. MGMT. J. 1427, 1429 (1995); Sydney Finkelstein and Brian K. Boyd, *How Much Does the CEO Matter? The Role of Managerial Discretion in the Setting of CEO Compensation*, 41 ACAD. MGMT. J. 179, 181 (1998).

⁴⁷ Kole and Lehn, *supra* note 6, 421.

⁴⁸ *Ibid.*, 421, 423.

There is a literature that, consistent with foregoing logic, treats corporate governance and regulation as substitutes.⁴⁹ The point cannot be pressed too hard, however in this particular context. This is because corporate governance will not necessarily be a mere afterthought when companies are tightly regulated. Firms in highly regulated industries in fact often have more robust corporate governance than their counterparts in unregulated industries.⁵⁰ Regulatory pressure stands out as a plausible explanation why. “Safety-first” regulators, knowing they cannot oversee day-to-day operations of regulated firms, could well successfully exhort those firms to upgrade corporate governance and internal monitoring systems to reinforce constraints regulation imposes.⁵¹

D. The Public Company Financial Revolution

A “financial revolution” U.S. public companies experienced as the 20th century drew to a close likely was an additional catalyst for corporate governance’s rise to prominence and subsequent staying power.⁵² Due to a wave of financial innovation business enterprises in this era could take advantage of a wide range of new techniques to finance their existing operations, fresh acquisitions and expansion plans.⁵³ By one estimate, public companies in the U.S. deployed 76 different varieties of innovative securities between 1970 and 1997 to raise over \$1.7 trillion from domestic capital markets.⁵⁴ One by-product was an increase in

⁴⁹ David A. Becher and Melissa B. Frye, *Does Regulation Supplement or Complement Governance?*, 35 J. BANKING. FIN. 736, 738 (2011).

⁵⁰ *Ibid.*, 737.

⁵¹ *Ibid.*, 736.

⁵² Raghuram G. Rajan and Luigi Zingales, *The Influence of the Financial Revolution on the Nature of Firms*, 91 AMER. ECON. REV. 206, 209 (2001) (arguing that with the financial revolution that had been occurring “we would also expect changes in the emphasis of governance.”)

⁵³ RAGHURAM G. RAJAN AND LUIGI ZINGALES, *SAVING CAPITALISM FROM THE CAPITALISTS* 68 (2003).

⁵⁴ Kenneth A. Carow, Gayle R. Erwin and John J. McConnell, *A Survey of U.S. Corporate Financing Innovations: 1970-1997*, J. APP. CORP. FIN., Spring 1999, 55, 68.

corporate indebtedness, with the liabilities of the non-financial business sector climbing from 68 per cent of GDP in 1970 to 129 per cent in 2007.⁵⁵

The financial revolution that occurred in the closing decades of the 20th century had significant implications for executives in publicly traded companies. As Randall Thomas argued in 2004, “The opportunities for American executives expanded tremendously.”⁵⁶ Or as Sydney Finkelstein, Donald Hambrick and Albert Cannella observed in 2009, “Beyond the obvious trend of deregulation...societal and economic trends...have expanded the choices for senior executives.”⁵⁷

The improved ability of firms to challenge vertically integrated “first movers” that dominated numerous key sectors of the U.S. economy during the middle of the 20th century illustrates how the financial revolution opened up opportunities for corporate executives. The dominant first-movers traditionally had little to fear from rivals because potential upstarts lacked the financial firepower to muster a serious challenge.⁵⁸ As the 20th century drew to a close, however, the growing availability of finance eroded the advantages previously unassailable incumbents had, with technology often accelerating the process by allowing new entrants to replicate the specialized resources of first-movers with minimal fuss.⁵⁹

⁵⁵ SIMON JOHNSON AND JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 68, n. 41 (2010). See also Robin Greenwood and David Scharfstein, *The Growth of Finance*, 27(2) J. ECON. PERSP. 3, 21, 24 (2013) (indicating value of credit extended to companies grew from 31 per cent of GDP in 1980 to 50 per cent in 2007).

⁵⁶ Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven*, 57 VAND. L. REV. 1228 (2004).

⁵⁷ SYDNEY FINKELSTEIN, DONALD HAMBRICK AND ALBERT CANNELLA, STRATEGIC LEADERSHIP: THEORY AND RESEARCH ON EXECUTIVES, TOP MANAGEMENT TEAMS, AND BOARDS 30 (2009).

⁵⁸ RAJAN AND ZINGALES, *supra* note 53, 36-41.

⁵⁹ *Ibid.*, 70-72, 77-79.

While improved access to finance would have given executives of public companies increased room to manoeuvre, debt increases risk.⁶⁰ The financial revolution U.S. public companies experienced correspondingly should have magnified concerns shareholders would have had that management might squander the new opportunities available. This in turn should have increased investor receptivity to the idea that corporate governance had a beneficial agency cost reduction role to play. Hence, an important collateral effect of the liberating but potentially disruptive finance revolution public companies experienced may well have been to help to foster and sustain corporate governance's rise to prominence.

E. A New Corporate Governance Equilibrium (?)

While deregulation, a financial revolution and technological change all could have plausibly fostered receptivity to more robust corporate governance, self-corrective mechanisms would have come into play that could have meant accountability gaps would not have been a source of serious concern despite a potential expansion of managerial discretion. Increased borrowing should have imposed a check on executives of the public companies of the 1980s and 1990s because they would have been apprehensive about their companies generating sufficient revenue to service growing debt burdens.⁶¹ Moreover, markets for products and services, as bolstered by technology and deregulation, should have been a more potent disciplinary mechanism than would have been the case during the managerialist heyday of the 1950s and 1960s.⁶²

⁶⁰ JOHNSON AND KWAK, *supra* note 55, 68.

⁶¹ Mark J. Roe, *The Institutions of Corporate Governance* in HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 371, 385 (Claude Ménard and Mary M. Shirley, eds., 2005).

⁶² Franklin Allen and Douglas Gale, *Corporate Governance and Competition* in CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES 23, 77-78 (Xavier Evans, ed., 2000).

While increased debt and more robust competition from rivals should have helped to keep executives on their toes, as the 20th century drew to a close there was a general consensus that, consistent with Prahalad and Doz's identification of "a more visible corporate leadership",⁶³ executives had scope to create (and presumably destroy) value in a way that they did not previously. Roy Smith and Ingo Walter have said of the 1980s,

"Companies with charismatic, results-oriented chief executives with bold strategies and good media skills were rewarded with higher stock prices, and their CEOs were in turn rewarded with more generous compensation packages. CEOs recognized the pattern, and many adapted themselves to benefit from it."⁶⁴

By 1999 matters had progressed to the point where, as the *Economist* observed, "Many investors in America...believe that bosses have more influence over their companies than they used to..."⁶⁵ The *Economist* itself seemed to agree, saying in an editorial the same year "An able chief executive has extraordinary power to make or break a company."⁶⁶ The upshot, as Rakesh Khurana said in his 2002 book *Searching for a Corporate Savior*, was that the definition of an effective CEO had changed "from that of competent manager to charismatic leader."⁶⁷ It would seem, therefore, that whatever additional discipline greater debt and more competitive markets might have imposed on U.S. public companies senior executives had expanded discretion available to them the exercise of which corporate governance could help to keep within tolerable bounds.

⁶³ *Supra* note 17 and accompanying text.

⁶⁴ SMITH AND WALTER, *supra* note 22, 106-7.

⁶⁵ *The Best...and the Rest: A Survey of Pay*, *ECONOMIST*, May 8, 1999, 14.

⁶⁶ *Firing the Boss*, *ECONOMIST*, October 30, 1999, 17.

⁶⁷ RAKESH KHURANA, *SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOs* 71 (2002).

Alan Greenspan, chairman of the Federal Reserve of the United States from 1987 to 2006, said in Congressional testimony in 2002 that in public companies the chief executive was “the fulcrum of governance”.⁶⁸ This implies that the era of the “celebrity” or “imperial” CEO⁶⁹ should have coincided with a bolstering of corporate governance that would provide a beneficial check on the new style of corporate leadership by ensuring that the right people were hired, that those in charge were suitably incentivized and that underperformers were required to move on. This indeed occurred. From the mid-1980s through the 1990s boards were strengthened, executive pay was restructured to align pay more closely with performance and shareholders became increasingly willing to step forward to influence managerial turnover.⁷⁰ The *Economist* observed in 1999 that a spate of CEO dismissals occurring in the early 1990s had “change(d) the balance of power between shareholders and boards at big American firms” and suggested “incompetent chief executives in large companies (were) rarer than they were in 1990.”⁷¹ Economists Bengt Holmstrom and Steven Kaplan struck a similar chord in a 2001 survey of corporate governance, saying that “since the mid-1980s, the U.S. style of corporate governance had reinvented itself” and predicted that “a more market-oriented corporate governance than existed up to the early 1980s is here to stay.”⁷²

The corporate scandals affecting Enron, WorldCom and various other prominent U.S. public companies in the early 2000s would quickly make these favourable assessments of

⁶⁸ Andrew Hill, *A Tarnished Icon of the American Way*, FIN. TIMES, July 22, 2002, 21.

⁶⁹ On the terminology, see SMITH AND WALTER, *supra* note 22, 110; GIDEON HATCH, *FAT CATS: THE STRANGE CULT OF THE CEO* 85 (2004).

⁷⁰ Cheffins, *Did*, *supra* note 10, 9.

⁷¹ *Thank You and Goodbye*, ECONOMIST, Oct. 30, 1999, 91.

⁷² Bengt Holmstrom and Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15(2) J. ECON. PERSP. 121, 140, 141 (2001).

U.S. corporate governance seem somewhat naive. Corporate governance, however, did not stand still. The Sarbanes-Oxley Act of 2002 imposed various new governance-related requirements on publicly traded companies. Moreover, according to former S.E.C. chairman Arthur Levitt, the scandals that prompted SOX's enactment accelerated "a cultural change in corporate America" oriented around tougher boards and increasingly active shareholders.⁷³ Levitt indeed claimed in 2005 in the wake of dismissals of CEOs at well-known public companies such as Hewlett-Packard and Disney that the days of "the autocratic, muscular CEO" were gone -- "[t]he imperial CEO [was] no more."⁷⁴

There was widespread agreement at the time that Levitt's assessment was on the mark. A *Financial Times* columnist said in 2005 corporate scandals occurring as the decade had opened "marked the beginning of the end of the imperial chief executive."⁷⁵ Robert Dilenschneider, founder of a public relations firm with clients comprising one-third of the Fortune 500,⁷⁶ argued the same year that "What's needed now is a different kind of CEO: Men and women who shed the trappings of imperial power (and) work with their boards of directors."⁷⁷

The consensus that the corporate scandals of the early 2000s and SOX's enactment had prompted "a governance revolution"⁷⁸ was sustained thereafter. According to a 2007 *Wall Street Journal* article entitled "After the Revolt", the CEO dismissals occurring in the

⁷³ Arthur Levitt, *The Imperial CEO is No More*, WALL ST. J., March 17, 2005, A16.

⁷⁴ *Ibid.*

⁷⁵ Joshua Chaffin, *Exit the Emperor Bosses, Leaving a Legacy of Prudence*, FIN. TIMES, March 19, 2005, 11.

⁷⁶ Richard Lee and Olivia Just, *Q&A with Robert Dilenschneider*, STAMFORD ADVOCATE, February 17, 2012, available at <http://www.stamfordadvocate.com/news/article/Q-A-with-Robert-Dilenschneider-3336510.php> (last visited Feb. 17, 2014).

⁷⁷ Robert L. Dilenschneider, *When CEOs Roamed the Earth*, WALL ST. J., March 15, 2005, B2.

⁷⁸ John Plender, *It's the Revolution, Stupid*, FIN. TIMES, March 21, 2005, 20.

mid-2000s represented a “new, post-revolutionary generation of power in corporate America” exemplified by CEOs “on shorter leashes, more beholden to their boards of directors.”⁷⁹

Greenspan observed in a chapter on corporate governance in a 2007 memoir that “the autocratic-CEO paradigm appears to be the only arrangement that allows for effective functioning of the corporation” but conceded that “In the aftermath of the Enron and WorldCom scandals, the power of the corporate CEO has been diminished and that of the board of directors and shareholders enhanced.”⁸⁰

By 2010 the reorientation of U.S. corporate governance away from celebrity CEOs had reached the point where Marcel Kahan and Ed Rock could characterize U.S. chief executives as “Embattled”.⁸¹ This coincided with a general maturation of corporate governance in U.S. public companies. As Omari Simmons argued in a 2013 law review article, “Over the past thirty years, corporate governance, despite occasional bumps, has undoubtedly improved.”⁸² Arguably, then, in the wake of the corporate scandals and legislative reforms of the early 2000s there was a reasonably fully executed transition from an equilibrium oriented around the constrained form of capitalism in place during the managerialist heyday of the 1950s and 1960s in favour of an equilibrium suited to the more freewheeling market conditions that emerged thereafter.⁸³ The rise of corporate governance and its continued prominence stand out as legacies of this process.

III. CORPORATE GOVERNANCE COMES TO THE FORE – THE CASE OF BANKS

⁷⁹ Alan Murray, *After the Revolt*, WALL ST. J., May 5, 2007, A1.

⁸⁰ ALAN GREENSPAN, *THE AGE OF TURBULENCE: ADVENTURES IN A NEW WORLD* 429, 436 (2007).

⁸¹ Marcel Kahan and Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 989, 989 (2010).

⁸² Omari Simmons, *The Corporate Immune System: Governance from the Inside Out*, [2013] U. ILL. L. REV. 1131, 1135.

⁸³ Cf. James C. Woolery, *Bridging the Chasm Between Boards and Shareholders*, WALL ST. J., October 10, 2013, A17 (saying that with boards being “extremely cautious” and seeking “steady shareholder returns” cash balances were at an all-time high.)

A. Why the History Matters

Deficient corporate governance at U.S. financial firms has been identified as a potential cause of the financial crisis.⁸⁴ Whether this is an appropriate diagnosis is not entirely clear. The U.S. system of corporate governance performed tolerably well under difficult conditions as the crisis loomed⁸⁵ and empirical research on pre-financial crisis governance arrangements in publicly traded bank holding companies and non-financial firms indicates that on average banks were no worse governed than non-financial firms.⁸⁶ Still, while in general terms corporate governance in banks may not have been markedly sub-standard as the financial crisis approached, governance arrangements in financial companies were not identical to those in non-financial companies.⁸⁷ Distinctive corporate governance features of banks may in turn have contributed to the onset of the financial crisis.

Part IV of the paper will identify a potentially crucial governance distinction between financial companies and their non-financial counterparts, this being that the “imperial” CEO side-lined for the most part due to the corporate governance turmoil of the early 2000s remained a prominent feature in the financial sector immediately prior to the onset of the financial crisis. Arguably, due to this corporate governance “free pass”, autocratic chief executives of banks had scope to pursue misguided policies that jeopardized their firms, the

⁸⁴ Christopher M. Bruner, *Corporate Governance in a Time of Crisis*, 36 J. CORP. L. 309, 316 (2011) (“Government officials and taxpayers reeling in the wake of this catastrophe have naturally sought to determine why the crisis occurred, and who is to blame. Unsurprisingly, bank boards and officers have found themselves in the crosshairs....”); Simone M. Sepe, *Regulating Risk and Corporate Governance in Banks*, 62 EMORY L.J. 327, 327 (2012) (saying that for those wondering what prompted the aggressive risk taking by U.S. banks that reputedly helped to precipitate the financial crisis “One popular answer points to the failure of bank governance.”)

⁸⁵ Cheffins, *Did, supra* note 10, 61.

⁸⁶ Renée Birgit Adams, *Governance and the Financial Crisis*, 12 INT. REV. FIN. 7, 27 (2012).

⁸⁷ *Ibid.* (indicating that with respect to board structure and executive pay corporate governance in banks did differ in various material respects).

financial sector generally and ultimately the entire U.S. economy. This Part of the paper will set the scene by indicating that the trends that helped to bring corporate governance to the fore with U.S. public companies generally, namely executives running larger corporations with more discretion than they had in the heyday of managerial capitalism, were relevant to financial companies. Part IV will then discuss how the chronology took a potentially significant twist with financial companies.

B. Bigger Banks

One likely reason why corporate governance became entrenched as part of U.S. corporate life in the manner it did as the 20th century drew to a close was that more was at stake, in the sense that major publicly traded companies were becoming considerably larger along various dimensions.⁸⁸ This trend was, if anything, more pronounced with financial firms over the same period. The size of the financial sector grew markedly, comprising 8.3 per cent of U.S. GDP in 2006 as compared with 4.9 per cent in 1980.⁸⁹ Similarly, the financial services industry generated 40 per cent of total domestic corporate profits in 2007 as compared with 10 per cent in the early 1980s and the industry's share of stock market value grew from 6 per cent to 19 per cent over the same period.⁹⁰

The financial sector was not simply getting bigger. In addition, the dominant firms -- the ones most likely to be prominent publicly traded corporations -- were more than keeping pace. The assets of the six largest U.S. commercial banks increased fourfold as a proportion

⁸⁸ See *supra* Part II.B.

⁸⁹ Greenwood and Scharfstein, *supra* note 55, 3.

⁹⁰ *What Went Wrong?*, ECONOMIST, March 22, 2008, 91, 92; Arthur E. Wilmarth, *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 1003 (2009). Cf. NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES, THE FINANCIAL CRISIS INQUIRY REPORT 64 (2011) (indicating that financial sector profits were 15 per cent of corporate profits in 1980, 33 per cent in 2003 and 27 per cent in 2006).

of GDP between 1994 and 2009.⁹¹ Likewise, among companies large enough to be part of the S&P 500 stock market index, the market value of financial firms amounted to 22.3 per cent of the S&P 500 in early 2007 as compared to 8.8 per cent in 1989 and 13 per cent in 1999.⁹²

C. Deregulation

Deregulation, as was the case with the emergence of bigger firms, not only likely contributed to the growing prominence of corporate governance between the 1970s and the 2000s⁹³ but also probably was a more pronounced trend with banks than it was generally. In response to widespread banking failures occurring during the Great Depression, the U.S. federal government put in place a regulatory regime which prioritized eliminating risk and ensuring banking stability.⁹⁴ By virtue of the Banking Act of 1933,⁹⁵ supplemented by the Bank Holding Company Act of 1956⁹⁶ and other measures, the commercial banking industry became one of the most heavily regulated sectors of the U.S. economy.⁹⁷

An important way in which banking was regulated was to cordon banks off from market forces by barring potential competitors, such as securities firms, from engaging in

⁹¹ Charles W. Murdock, *The Big Banks: Background, Deregulation, Financial Innovation, and Too Big to Fail*, 90 DEN. UNIV. L. REV. 505, 543 (2012).

⁹² *Still Vulnerable*, ECONOMIST, April 19, 2008, 85; William W. Bratton and Michael W. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 717 (2010).

⁹³ See *supra* Part II.C.

⁹⁴ Michael Klausner, *An Economic Analysis of Bank Regulatory Reform: The Financial Institutions Safety and Consumer Choice Act 1991*, 69 WASH. U.L.Q. 695, 695 (1991); Michael Taylor, *The Search for a New Regulatory Paradigm*, 49 MERCER L. REV. 793, 795 (1998).

⁹⁵ Pub.L. No. 73–66, 48 Stat. 162.

⁹⁶ Pub.L. No. 84–511, 70 Stat. 134.

⁹⁷ Ross N. Dickens and George Philippatos, *The Impact of Market Contestability on the Systematic Risk of US Bank Stocks*, 4 APP. FIN. ECON. 315, 315 (1994).

core aspects of banking.⁹⁸ Concomitantly, banks were largely precluded from carrying out business activities unrelated to banking, meaning in this context taking deposits and making loans.⁹⁹ Banks were also protected from competition within their own industry.¹⁰⁰ Bank charters were rationed by state and federal bank regulators and the Banking Act of 1933 authorized the Federal Reserve Board to impose ceilings on rates of interest payable on bank deposits.¹⁰¹ Moreover, the 1933 and 1956 legislation supplemented pre-existing federal and state laws designed to ensure banking remained geographically fragmented.¹⁰²

With strict regulation in place, for nearly fifty years after the enactment of the Banking Act of 1933 the United States experienced an era of “boring” banking.¹⁰³ Commercial banking was characterized by stable profits and a very low failure rate;¹⁰⁴ with an average of fewer than six banks among thousands failing per year between 1942 and 1980.¹⁰⁵ Bankers were said to follow a 3-6-3 business model, borrowing at 3 per cent,

⁹⁸ Klausner, *supra* note 94, 695; Helen A. Garten, *Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age*, 57 *FORDHAM L. REV.* 501, 516-17 (1989).

⁹⁹ Klausner, *supra* note 94, 696, 698-703; Garten, *supra* note 98, 509-10.

¹⁰⁰ Klausner, *supra* note 94, 695, 720; ROBERT E. LITAN, *AMERICAN FINANCE FOR THE 21ST CENTURY* 26 (1998).

¹⁰¹ Klausner, *Economic*, *supra* note 94, 695; Garten, *Regulatory*, *supra* note 98, 511 (interest rate restrictions); Michael C. Keeley, *Deposit Insurance, Risk, and Market Power in Banking*, 80 *AMER. ECON. REV.* 1183, 1185 (1990) (charter restrictions).

¹⁰² DAVIS, *MANAGED*, *supra* note 20, 109; Klausner, *supra* note 94, 695, 698, 703-5; for a summary of the contribution of the 1933 and 1956 banking legislation in this regard, see ROBERT E. LITAN, *WHAT SHOULD BANKS DO?* 26-27, 29-30 (1987)

¹⁰³ JOHNSON AND KWAK, *supra* note 55, 62-63; Murdock, *supra* note 91, 513.

¹⁰⁴ Garten, *supra* note 98, 508-9.

¹⁰⁵ Timothy A. Canova, *The Transformation of U.S. Banking and Finance: From Regulated Competition to Free-Market Receivership*, 60 *BROOKLYN L. REV.* 1295, 1330 (1995) (failures); James R. Barth, Tong Li and Wenling Lu, *Bank Regulation in the United States*, 56 *CESFIO ECON. STUD.* 112, 117-18 (2010) (providing data on the total number of commercial banks at five-year intervals from 1940 to 1980; the lowest figure was 13,503 in 1960).

lending at 6 per cent and golfing by 3 o'clock.¹⁰⁶ George Moore, who led the worldwide expansion of First National City Bank (later Citibank and Citigroup) in the 1950s and was chairman of the board from 1967 to 1970, said in his 1987 memoir "banking is the surest, safest, easiest business I have seen or known."¹⁰⁷

Investment banking, though riskier than commercial banking, was also subject to constraints in the decades following the Depression that meant firms were run along conservative lines.¹⁰⁸ Investment banks were not regulated for safety and soundness in the same way as commercial banks.¹⁰⁹ Still, the provisions in the 1933 banking legislation that came to be known as the Glass-Steagall Act reduced considerably the freedom of action of investment banks by prohibiting any entity carrying out securities underwriting from engaging in deposit banking.¹¹⁰ The organizational form investment banks deployed also fostered prudence.

For a number of decades following the enactment of Glass-Steagall investment banks were general partnerships where the partners were personally liable for debts of their firms.¹¹¹ The fact that partners' personal wealth was at stake if things went seriously awry fostered a conservative mind set.¹¹² For instance, Goldman Sachs' first business principle was that their

¹⁰⁶ JOHNSON AND KWAK, *supra* note 55, 53; Murdock, *supra* note 91, 513; Klausner, *supra* note 94, 725, n. 106.

¹⁰⁷ GEORGE S. MOORE, *THE BANKER'S LIFE* 146 (1987)

¹⁰⁸ JOHNSON AND KWAK, *supra* note 55, 62.

¹⁰⁹ Claire Hill and Richard Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 SEATTLE UNIV. L. REV. 1173, 1177 (2010).

¹¹⁰ Banking Act of 1933, s. 21.

¹¹¹ Hill and Painter, *supra* note 109, 1177.

¹¹² *Ibid.*; Murdock, *supra* note 91, 513; NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES, *supra* note 90, 61 (quoting Peter Solomon, a former Lehman Brothers partner as saying "Since they were personally liable as partners, they took risk very seriously").

clients' interests came first, with its partnership structure encouraging bankers to be "greedy, but long-term greedy."¹¹³ The fact that investment banks were partnerships also imposed limits on growth because in a highly cyclical industry they lacked sufficient permanent capital to underwrite every major transaction they could theoretically work on and to expand operations in a systematic way.¹¹⁴ This all began to change in 1970 when the New York Stock Exchange repealed a rule precluding its members from being publicly owned.¹¹⁵ Prompted initially by the need to finance back-office computerization required due to rapidly growing transaction volume,¹¹⁶ over the next two decades most major investment banks went public, thus marking the end of the partner liability regime that helped to foster conservatism among such firms.¹¹⁷

Change was also afoot with commercial banks. During the 1970s and 1980s it was becoming increasingly evident "the legal regime originally designed to protect the banking industry by walling competitors out of the banks' profitable preserve had begun instead to trap banks within a shrinking market."¹¹⁸ Investment banks, mutual funds and the finance arms of major industrial and commercial companies took advantage of rapidly evolving technology to develop innovative financial products that provided stiff competition for banks'

¹¹³ Mary Kissel, *How the Banker Went to Vegas*, WALL ST. J., October 10, 2013, A15.

¹¹⁴ Terry Robards, *Wall St. Watches and Hopes, as Bache Offers Shares*, N.Y. TIMES, Sept. 12, 1971, F2 (discussing reasons for Bache & Co., then the nation's second-largest brokerage house, going public); CHARLES R. GEISST, *THE LAST PARTNERSHIPS: INSIDE THE GREAT WALL STREET MONEY DYNASTIES* 6-7, 227, 314-15 (2001).

¹¹⁵ Hill and Painter, *supra* note 109, 1177; ALAN D. MORRISON AND WILLIAM J. WILHELM, *INVESTMENT BANKING: INSTITUTIONS, POLITICS, AND LAW* 278 (2007).

¹¹⁶ MORRISON AND WILHELM, *supra* note 115, 237-38, 277-78.

¹¹⁷ Hill and Painter, *supra* note 109, 1177; NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES, *supra* note 90, 62; Christopher M. Bruner, *Conceptions of Corporate Purpose in Post-Crisis Financial Firms*, 36 SEATTLE UNIV. L. REV. 541, 549 (2013).

¹¹⁸ Klausner, *supra* note 94, 696.

deposit and loan services.¹¹⁹ Bank customers began leaving in droves, evidenced by a massive outflow from bank accounts sparked by the high inflation and rising interest rates of the 1970s.¹²⁰

To permit banks to counteract the shift to deposit substitutes Congress largely phased out interest rate controls during the early and mid-1980s.¹²¹ Additional bank deregulation soon followed. In 1994, Congress put in place a national framework for interstate banking, culminating a process various states had begun in the late 1970s.¹²² Similarly, the 1999 Gramm-Leach-Bliley Act¹²³ was the key final chapter in a dismantling of barriers between commercial and investment banking as it expressly permitted the creation of full-service financial holding companies.¹²⁴

Deregulation duly helped to transform the formerly “boring” banking sector. Banks responded to the unleashing of market forces by engaging in an unprecedented wave of consolidation which caused the number of banking organizations in the U.S. to fall from almost 15,000 in 1980 to under 8,000 in 2008.¹²⁵ Larger banks, for their part, moved into new lines of business with the intention of creating financial “supermarkets” that could

¹¹⁹ *Ibid.*, 727.

¹²⁰ *Ibid.*; LITAN, *supra* note 102, 34-35; Canova, *supra* note 105, 1309-10; Arthur E. Wilmarth, *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks* [2002] UNIV. ILL. L. REV. 217, 239-40.

¹²¹ LITAN, *supra* note 102, 35; Canova, *supra* note 105, 1310, 1315-16, 1319-20; Wilmarth, *supra* note 120, 239-40.

¹²² Barth, Li and Lu, *supra* note 105, 123-24, 126-27, Kevin J. Stiroh, *How Did Banking Holding Companies Prosper in the 1990s?*, 24 J. BANKING FIN. 1703, 1706-7 (2000).

¹²³ Pub.L. 106–102, 113 Stat. 1338.

¹²⁴ Barth, Li and Lu, *Bank*, *supra* note 105, 127-30; Wilmarth, *supra* note 120, 318-20, 331; Roberta S. Karmel, *Is the Public Utility Holding Company Act a Model for Breaking Up the Banks That are “Too-Big-to-Fail?”*, 62 HASTINGS L.J. 821, 834-35 (2011).

¹²⁵ Wilmarth, *supra* note 90, 972-76; Barth, Li and Lu, *Bank*, *supra* note 105, 130; Lawrence G. Baxter, *Betting Big: Value, Caution and Accountability in an Era of Large Banks and Complex Finance*, 31 REV. BANKING FIN. L. 765, 791-92 (2011-12).

provide a full range of financial services to customers.¹²⁶ Deregulation, in sum, provided senior executives of major financial firms with the sort of expanded managerial latitude to which corporate governance theoretically could operate as a beneficial corrective.

D. “Bright New Finance”

A late 20th century finance “revolution” U.S. public companies experienced expanded opportunities available to American executives and in so doing likely helped to bring corporate governance to prominence.¹²⁷ The financial landscape for banks similarly changed markedly, and in ways that should have increased managerial latitude and thereby made governance a higher priority. Major investment banks experienced a pronounced financial transformation due to converting themselves into publicly traded firms, which greatly facilitated their access to capital.¹²⁸ Moreover, leading investment banks, which were already highly leveraged by 2000, became more so as the financial crisis approached. While prosperous large non-financial companies rarely have equity representing less than 30 per cent of assets,¹²⁹ the equivalent figure for the largest U.S. investment banks fell from 3.7 per cent in 2000 to just 2.8 per cent in 2007.¹³⁰

The largest U.S. commercial banks also became increasingly highly leveraged as the financial crisis approached, with equity representing 6.6 per cent of assets in 2000 but only

¹²⁶ JOHNSON AND KWAK, *supra* note 55, 85-86.

¹²⁷ See *supra* Part II.D.

¹²⁸ *Supra* notes 116-17 and accompanying text.

¹²⁹ ANAT ADMATI AND MARTIN HELLWIG, THE BANKERS’ NEW CLOTHES: WHAT’S WRONG WITH BANKING AND WHAT TO DO ABOUT IT 30 (2013).

¹³⁰ Derived from data provided by Viral Acharya, Irvind Gujral, Nirupama Kulkarni and Hyun Shon, *Dividends and Bank Capital in the Financial Crisis of 2007-2009*, NBER Working Paper No. 16896, 11 (2011). On a 2004 de-regulatory move by the S.E.C. that helps to explain the trend, see Murdock, *supra* note 91, 521-22; John C. Coffee, *Systematic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 818 (2011).

4.5 per cent in 2007.¹³¹ This trend, however, needs to be put into context. Corporations vary widely with respect to their use of debt and banks pretty much universally have compared to non-financial firms less equity relative to assets.¹³² Hence, even during the conservative 3-6-3 banking era U.S. banks had equity levels hovering around 6 per cent of assets.¹³³ Moreover, in contrast with the trend for the largest banks, on an aggregate basis leverage became less pronounced in the banking sector as the financial crisis approached. Likely due to the introduction of laws requiring regulators to intervene when banks failed to meet specified minimum capital requirements, among commercial banks generally equity represented nearly 10 per cent of assets by the mid-2000s.¹³⁴

Though with commercial banks there was no uniform trend with leverage, a corporate finance-related reconfiguration still marked the end of the cautious 3-6-3 era. Banking was already moving out of the “boring” category by late 1980s, with national commercial banks ranking 36th out of 70 industries in a study measuring managerial discretion by reference to industry characteristics such as market growth, capital intensity, product differentiability and

¹³¹ Derived from data provided by Acharya, Gujral, Kulkarni and Shon, *supra* note 130, 11.

¹³² ADMATI AND HELLWIG, *supra* note 129, 30; Stergios Leventis, Panagiotis Dimitropoulos, and Stephen Owusu-Ansah, *Corporate Governance and Accounting Conservatism: Evidence from the Banking Industry*, 21 CORP. GOV.: INT’L. REV. 264, 266 (2013).

¹³³ Viral Acharya, Hamid Mehran, Till Schuermann and Anjan Thakor, *Robust Capital Regulation*, Federal Reserve Bank of New York Staff Report No. 490, 17 (2011). While Acharya *et al.* indicate the equity level held steady at 6 per cent from the late 1940s to the early 1990s, other sources indicate leverage in fact increased at various banks between the mid-1970s and mid-1980s: Garten, *supra* note 98, 534; Keeley, *supra* note 101, 1184-85.

¹³⁴ Acharya, Mehran, Schuermann and Thakor, *supra* note 133, 17 (providing data and citing the impact of the Federal Deposit Insurance Corporation Improvement Act of 1991, P.L. 102-242; 105 Stat. 2236). For a summary of the minimum capital regime the 1991 legislation introduced, see MATHIAS DEWATRIPONT AND JEAN TIROLE, *THE PRUDENTIAL REGULATION OF BANKS* 62-63 (1994). Banking regulators in the U.S. in fact first introduced rudimentary across the board capital rules for banks in the early 1980s and bolstered regulation as the 1980s drew to a close to implement an international risk-based accord promulgated by the Basel Committee: Garten, *supra* note 98, 536; Wilmarth, *supra* note 120, 457-58.

demand instability (variation in growth rates).¹³⁵ During the 1990s numerous major banks adopted increasingly aggressive strategies with assets they held and with loans they made, meaning they had a riskier asset/liability mix even when equity capital was being boosted.¹³⁶ The process continued apace in the 2000s, with the “megabanks” that were emerging during this era making increasingly risky loans, engaging heavily in the manufacturing of securities (securitization) and bolstering trading of complex financial assets.¹³⁷ As William Bratton and Michael Wachter observed in 2010, “Such a change in business strategy meant a move to greater expected returns and greater risk.”¹³⁸

The *Economist* characterized the changes to banking fostered by deregulation and financial innovation as the replacement of “traditional banking” with “bright new finance”.¹³⁹ From a corporate governance perspective a key corollary of this shift was that, as was the case with the corporate finance revolution affecting non-financial companies, top executives of investment and commercial banks would have had greater managerial latitude than their counterparts immediately following World War II. Given this, and given that banks were

¹³⁵ Hambrick and Abrahamson, in a 1995 paper (*Assessing*, *supra* note 46), ranked managerial discretion in 17 industries on the basis on ratings by academics, ratings by security analysts and objective industry data compiled between 1985 and 1989 (see at 1431-35). Hambrick and two different co-authors subsequently extended the analysis to 53 additional industries, including national commercial banking, but only relied on objective industry data in so doing: FINKELSTEIN, HAMBRICK AND CANNELLA, *supra* note 57, 29-30.

¹³⁶ Wilmarth, *supra* note 120, 445; cf. Allen E. Berger and Loretta J. Mester, *Explaining the Dramatic Changes in Performance of US Banks: Technological Change, Deregulation, and Dynamic Changes in Competition*, 12 J. FIN. INTERMEDIATION 57, 84 (2003) (indicating that a lower incidence of bank failures in the 1990s as compared with the 1980s suggested that banks became less risky).

¹³⁷ JOHNSON AND KWAK, *supra* note 55, 86; Bratton and Wachter, *supra* note 92, 720.

¹³⁸ Bratton and Wachter, *supra* note 92, 720.

¹³⁹ *When Fortune Frowned: A Special Report on the World Economy*, ECONOMIST, October 11, 2008, 10 (paraphrasing Paul Volcker’s reference to a “bright new financial system”).

getting bigger and were operating in an increasingly deregulated environment “bright new finance” logically should have been accompanied by more robust corporate governance.

Corporate governance indeed did grow in prominence with U.S. banks as the 20th century drew to a close. The proportion of board seats held by outside directors of large bank holding companies was higher than it was for industrial companies.¹⁴⁰ Banks substantially increased their use of incentive-oriented executive compensation.¹⁴¹ Boards and institutional shareholders also began taking more aggressive measures to discipline poorly performing bank executives.¹⁴² David Skeel even observed in 1999 that “More than ever before, the governance of U.S. banks...has come to resemble the governance of other U.S. firms.”¹⁴³

Skeel did not go so far as to claim that corporate governance arrangements in banks had become functionally identical to those in non-financial firms. Instead, he said “it would be a mistake to conclude that bank...governance will soon look just like nonfinancial firm governance.”¹⁴⁴ This was a prudent concession because, even if the corporate governance movement had a substantial impact on the banking sector, the corporate governance of banks and non-financial companies continued to differ in significant ways immediately prior to the financial crisis.¹⁴⁵ We will turn now to distinctive features of bank governance that plausibly contributed to the onset of the financial crisis, with the most prominent being a corporate governance “free pass” banks enjoyed due primarily to delivering robust financial results in comparison to other companies.

¹⁴⁰ Renée Adams, *Is Corporate Governance Different for Bank Holding Companies?*, FRBNY ECON. POLICY REV., April 2003, 123, 129 (Table B), 131.

¹⁴¹ David A. Skeel, *The Market Revolution in Bank and Insurance Firm Governance: Its Logic and Limits*, 77 WASH. U.L.Q. 433, 447 (1999).

¹⁴² Wilmarth, *supra* note 120, 291-92.

¹⁴³ Skeel, *supra* note 141, 433.

¹⁴⁴ *Ibid.*, 448.

¹⁴⁵ *Supra* note 87 and related discussion.

IV. PRE-FINANCIAL CRISIS CORPORATE GOVERNANCE: HOW BANKS DIFFERED

A. Persistence of the Imperial CEO

The Enron and WorldCom debacles and the 2002 enactment of SOX eclipsed the “imperial CEO” who initially achieved prominence in U.S. public companies in the 1980s.¹⁴⁶ Matters were different with financial companies, where powerful, charismatic CEOs remained a prominent feature throughout the mid-2000s. For instance, Stan O’Neal, who as chief executive of Merrill Lynch from 2002 and 2007 drove the company to make large, ill-advised bets on mortgage securities that imperilled its future and fuelled the mortgage boom that helped to precipitate the financial crisis, had an autocratic leadership style fostered by his hiring of a youthful management team that lacked the experience or stature to challenge him.¹⁴⁷

O’Neal was by no means exceptional. Chuck Prince, who became Citigroup’s CEO in 2003 and its chairman of the board in 2006, was described in 2005 by *American Banker* magazine as the “king within the walls of Citigroup”¹⁴⁸ to whom Citigroup’s board reputedly was “willing to give more and more rope.”¹⁴⁹ In 2007 the *New York Times* characterized Jimmy Cayne, chief executive and chairman of the board of Bear Stearns just prior to its hastily engineered rescue in March 2008 by J.P Morgan, as a throwback “to an earlier era of Wall Street partnerships tightly controlled by the towering will and stubborn dictates of their

¹⁴⁶ *Supra* notes 73 to 77 and accompanying text.

¹⁴⁷ GREG FARRELL, CRASH OF THE TITANS: GREED, HUBRIS, THE FALL OF MERRILL LYNCH, AND THE NEAR COLLAPSE OF BANK OF AMERICA 64-65 (2010); see also Susanne Craig, Randall Smith and Serena Ng, *Merrill Aims to Raise Billions More*, WALL ST. J., July 29, 2008, A1 (discussing the nature of Merrill Lynch’s mortgage bets).

¹⁴⁸ *The A Listers*, AMERICAN BANKER, March 2005, 43.

¹⁴⁹ David Enrich, *For Rubin Pressure’s On*, WALL ST. J., November 5, 2007, C1.

managing partners.”¹⁵⁰ Angelo Mozilo, co-founder of mortgage lender Countrywide Financial and chief executive when the company was sold to Bank of America at a financial crisis-related knockdown price in early 2008, had a managerial style that provided scope for a “friends of Angelo” list that afforded politicians access to loans under favourable terms.¹⁵¹ He was also described in a 2000 *Forbes* article as “the Rommel of the mortgage business” and “[t]he bad boy of the mortgage industry.”¹⁵²

Mozilo and Richard Fuld, chairman and chief executive of Lehman Brothers from 1994 until its September 2008 bankruptcy that amounted to “ground zero” of the financial crisis, were both included in *Barron’s* 2007 list of the world’s 30 best CEOs. *Barron’s* said of Fuld that he “brings passion and competitiveness that are powerful even by (Wall) Street standards.”¹⁵³ Fuld was also described in a 2009 book on the firm’s collapse as “King Richard” who “turned Lehman’s board of directors into a kind of irrelevant lower chamber.”¹⁵⁴

The persistence of the imperial CEO in the banking sector had potentially significant implications, with excessive deference to powerful chief executives standing out as a potential cause of the financial crisis. As the crisis played out one charge levelled against financial companies and their corporate governance was that boards had been too complacent about risks management was running, with *American Banker* magazine suggesting in a 2008 cover story “At far too many banks...the attitude was to let the good times roll when

¹⁵⁰ Landon Thomas, *Not a Jolly Season for Top 2 Bankers*, NEW YORK TIMES, December 21, 2007, 1. On the rescue, see JEFF MADRICK, *AGE OF GREED: THE TRIUMPH OF FINANCE AND THE DECLINE OF AMERICA, 1970 TO THE PRESENT* 384-85 (2011).

¹⁵¹ *A Case of Note*, ECONOMIST, September 28, 2013, 79.

¹⁵² Bernard Condon, *Last Man Standing*, FORBES, Nov. 27, 2000, 108.

¹⁵³ Andrew Bary, *The World’s Best CEOs*, BARRON’S, March 26, 2007.

¹⁵⁴ LARRY MACDONALD, *A COLOSSAL FAILURE OF COMMON SENSE: THE INCREDIBLE INSIDE STORY OF THE COLLAPSE OF LEHMAN BROTHERS* 97, 224 (2009).

executives should have been nibbling their fingernails down to the quick.”¹⁵⁵ Another criticism was that boards missed the plot when setting executive pay, arguably contributing “to the mortgage boom and financial bust by encouraging their celebrity CEOs to take risks so they could make even bigger numbers.”¹⁵⁶ Charges levelled against governance in financial firms are, moreover, not merely of historical interest. A *Financial Times* columnist argued in 2012 that “if the U.S. again places its trust in the autocratic instincts of a new generation of corporate leaders, it will lay the foundation for the next (financial crisis).”¹⁵⁷

Why did financial companies get what appeared to be a mid-2000s corporate governance “free pass” in the form of tolerance of free-wheeling celebrity CEOs? The regulatory terrain applicable to banks is a possible explanation, though ultimately not a persuasive one. Other distinctive features of banks could have played a role, particularly a bias bank shareholders may have had in favor of managers “rolling the dice”. What was probably most important, however, was that financial companies delivered robust shareholder returns in comparison to other firms, thereby insulating them, at least temporarily, from the corporate governance pressures their non-financial counterparts encountered.

B. Regulation

Regulation and corporate governance are potentially substitutes,¹⁵⁸ with careful oversight by regulators arguably reducing the need for boards and shareholders to monitor management closely. Correspondingly, to the extent that regulators supervise bank management rigorously such oversight could render corporate governance scrutiny

¹⁵⁵ Glen Fest, *Risk Without Reward*, AMERICAN BANKER, February 2008, 26.

¹⁵⁶ Keith Epstein, *CEO Pay: The Steroids Era*, BUSINESSWEEK.COM, March 10, 2008.

¹⁵⁷ Andrew Hill, *Baby Steps Won't Fix Broken US Governance*, FIN. TIMES, July 12, 2011, 12.

¹⁵⁸ *Supra* note 49 and related discussion.

superfluous.¹⁵⁹ Perhaps, then, the corporate governance “free pass” was issued to banks in the years immediately preceding the financial crisis because of an implicit assumption regulation was ensuring executives were not going off the track.

Direct oversight of governance arrangements has traditionally not been a feature of U.S. banking regulation.¹⁶⁰ Nevertheless various features of the regulatory scheme applicable to banks extend implicitly into the corporate governance realm.¹⁶¹ As early as 1933 federal banking law authorized the removal of directors of banks operating under federal jurisdiction who had engaged in unsafe or unsound banking practices.¹⁶² In 1989 the authority to suspend and remove top management was enhanced, with action being permitted upon determination of substantial financial loss or damage or financial gain or other benefit.¹⁶³ Moreover, pursuant to a legislative mandate introduced in 1991 requiring federal banking regulators to develop standards to maintain safety and soundness in the banking sector, banks were put under an onus to set up internal control systems so as to improve the ability of managers to

¹⁵⁹ Hugh Grove, Lorenzo Patelli, Lisa M. Victoravich and Pisun Xu, *Corporate Governance and Performance in the Wake of the Financial Crisis: Evidence from US Commercial Banks*, 19 CORP. GOV: INT’L. REV. 418, 41 (2011) (“(R)egulatory oversight is considered to be an active monitoring force, which might limit the incentives of boards or blockholders to monitor.”); Jens Hagendorff, Michael Collins and Kevin Keasey, *Board Monitoring, Regulation, and Performance in the Banking Industry: Evidence from the Market for Corporate Control*, 18 CORP. GOV.: INT’L. REV. 381, 382 (2010) (“To the extent that regulators monitor bank management, the need for independent boards to monitor diligently and effectively is reduced....”).

¹⁶⁰ John D. “Jay” Cornet, *Bank Governance: An Independent Director’s Perspective*, 7 N.C. BANKING INST. 1, 2 (2003) (“Despite significant bank regulations, few regulations directly address governance issues”).

¹⁶¹ Michael E. Murphy, *Assuring Risk Management in Banking: The Corporate Governance Dimension*, 36 DEL. J. CORP. L. 121, 126 (2011) (“Banking laws and regulations have frequently extended into the domain of corporate governance”).

¹⁶² Heidi Mandanis Schooner, *Fiduciary Duties’ Demanding Cousin: Bank Director Liability for Unsafe or Unsound Banking Practices*, 63 GEO. WASH. L. REV. 175, 188 (1995) (citing Banking Act of 1933, ch. 89, § 30, 48 Stat. 162, 193-94).

¹⁶³ MICHAEL P. MALLOY, PRINCIPLES OF BANK REGULATION 357 (3rd ed., 2011).

monitor their bank's activities and to ensure compliance with the law.¹⁶⁴ Reforms introduced in 1991 also provided regulators with the power to dismiss officers and directors of seriously undercapitalized banks.¹⁶⁵

While deregulation was a key trend in the banking sector as the 20th century drew to a close,¹⁶⁶ due in part to the rules relating to the disciplining of directors and officers U.S. laws governing risk-taking by banks remained strict by international standards.¹⁶⁷ Moreover, U.S. banks continued to be more heavily regulated than non-financial public companies, and in ways that were potentially relevant for corporate governance. James Fanto observed in a 2006 article contrasting regulation of management of banks and publicly traded companies operating in other sectors,

“The picture of regulation of bank management that emerges...is one of all-encompassing oversight....Historically, in stark contrast to bank management, officers and directors of a typical public company were subject to little substantive regulatory oversight.... The selection of and standards for officers and directors are essentially industry and market issues....”¹⁶⁸

While regulation remained a significant feature of the banking industry during the 2000s and while regulation can theoretically substitute for robust corporate governance, on balance it is unlikely that the regulatory regime under which U.S. banks were operating explains their mid-2000s corporate governance free pass. In general terms, as we have seen,

¹⁶⁴ James Fanto, *Paternalistic Regulation of Public Company Management: Lessons from Bank Regulation*, 58 FLA. L. REV. 860, 875 (2006).

¹⁶⁵ *Ibid.*, 882.

¹⁶⁶ *Supra* notes 121 to 126 and related discussion.

¹⁶⁷ Hagedorff, Collins, and Keasey, *supra* note 159, 385 (scoring the U.S. and a dozen Western European countries on a 12-point scale and giving the U.S., together with the U.K. and Belgium, the highest score of “9”.)

¹⁶⁸ Fanto, *supra* note 164, 886.

regulation and corporate governance can, depending on the stance regulators take, be complements instead of substitutes.¹⁶⁹ Moreover, during the mid-2000s a number of the highest profile financial firms, such as the five leading investment banks (Morgan Stanley, Goldman Sachs, Merrill Lynch, Lehman Brothers and Bear Stearns),¹⁷⁰ were not subject to the banking laws that impinged on directors and officers of commercial banks.

Even with commercial banks that were subject to the full panoply of bank regulation it was well-known that they were operating in a riskier, more adventurous way than their 3-6-3 forerunners, implying that corporate governance should not have been a mere afterthought. The *Economist* said of U.S. banks in 2000 “(B)ank managers, long thought of as sober sorts, have, in effect, tried all sorts of ways to turn banking into a high-growth business. They have bought other banks, slashed costs, gone into pastures new and taken more risk, in many different guises.”¹⁷¹ Or as David Skeel said in 1999, “These are not your father’s financial intermediaries....”¹⁷² Hence, to the extent that financial firms received a corporate governance free pass while managerial discretion was being curtailed more generally post-Enron/SOX, it does not appear that the reason was that regulation rendered corporate governance superfluous.

C. Distinctive Corporate Governance Features of Banks

Regulation aside, financial companies differ from their non-financial counterparts in various ways that can impact on corporate governance.¹⁷³ Banks, for instance, tend to be

¹⁶⁹ *Supra* notes 50 to 51 and related discussion.

¹⁷⁰ On the five investment banks standing out from the rest and on their identity, see *When Fortune*, *supra* note 139, 6; *Paradise Lost: A Special Report on International Banking*, *ECONOMIST*, May 17, 2008, 4.

¹⁷¹ *The Bigger They Are*, *ECONOMIST*, October 28, 2000, 115, 116.

¹⁷² Skeel, *Market*, *supra* note 141, 433.

¹⁷³ The specifics of corporate governance of financial companies only attracted attention somewhat belatedly. See Jonathan Macey and Maureen O’Hara, *The Corporate Governance*

more opaque, in the sense that the quality of bank assets are usually less observable than those of non-financial companies,¹⁷⁴ which in turn makes it more difficult to monitor managerial decision-making.¹⁷⁵ In addition, banks have key creditors (depositors) whose incentives to monitor are attenuated as compared with conventional creditors because deposit insurance provides a safety net.¹⁷⁶ Moreover, banks of a substantial size can, due to interconnectedness with key aspects of the financial system, quite easily become “too big to fail” and shareholders in such firms, being confident of a bailout, have incentives to lobby managers to “roll the dice” to exploit the lower cost of capital such banks enjoy.¹⁷⁷

These differences, while pertinent in a general sense with the corporate governance of banks, seemingly should not have set the stage for a mid-2000s “free pass” for bank executives. Instead, along each dimension the distinctions between banks and non-financial companies imply bank executives would have scope to engage in counterproductive risk-taking unavailable to their non-financial counterparts. Logically, then, boards of banks should have been vigilant monitors rather than dispensers of a “free pass” to management.

of Banks, FRBNY ECON. POLICY REV., April 2003, 91, 91 (saying that despite corporate governance moving to center stage “quickly and decisively”, “very little attention has been paid to the corporate governance of banks.”)

¹⁷⁴ Leventis, Dimitropoulos and Owusu-Ansah, *supra* note 132, 265-66; Donald P. Morgan, *Rating Banks: Risk and Uncertainty in an Opaque Industry*, 92 AMER. ECON. REV. 874 (2002).

¹⁷⁵ Leventis, Dimitropoulos and Owusu-Ansah, *supra* note 132, 266.

¹⁷⁶ *Ibid.*; GEORGE J. BENSTON *ET AL.*, PERSPECTIVES ON SAFE & SOUND BANKING: PAST, PRESENT AND FUTURE 17-19 (1986).

¹⁷⁷ ADMATI AND HELLWIG, *supra* note 129, 143-45; John C. Coffee, *The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1053 (2012); *cf.* Mark J. Roe, *Structural Degradation Due to Too-Big-to-Fail Finance*, U. PA. L. REV., forthcoming, 24 (acknowledging the connection between the “too big to fail” phenomenon and excess leverage as part of a general exploration of corporate governance problems associated with very large, complex financial firms).

The shareholder angle merits further consideration, however, particularly because various prominent figures in the corporate governance field said shareholders helped to cause the financial crisis.¹⁷⁸ While shareholders in a bank likely to be rescued will be particularly susceptible to a “gung ho” managerial style, all bank shareholders will have a bias in favor of high-risk/high return strategies because they will have a capped downside due to limited liability and will capture the full upside if all goes well.¹⁷⁹ There is empirical evidence implying that boards of at least some banks counterproductively deferred to risk-preferring shareholder preferences as the financial crisis approached. According to a “management insulation index” developed by Daniel Ferreira, David Kershaw, Tom Kirchmaier, and Edmund Schuster to measure how readily a majority coalition of shareholders could capture control of bank boards, U.S. banks that were susceptible to shareholder pressure prior to the financial crisis were prone to engage in potentially risky non-traditional banking activities such as investment banking and the trading of complex securities and were appreciably more likely to be bailed out when the financial crisis hit.¹⁸⁰

D. Stock Market Outperformance

While shareholder preferences may have contributed to the “free pass” bank executives seemingly received as the financial crisis approached, financial outperformance was an even more important reason why the post-Enron/SOX corporate governance trends affecting U.S. public companies generally had a muted immediate impact on financial

¹⁷⁸ Bernard S. Sharfman, *How the Strong Negotiating Position of Wall Street Employees Impacts the Corporate Governance of Financial Firms*, 5 VA. BUS. L. REV. 349, 351-52 (2011) (citing examples); see also Sepe, *supra* note 84, 378-80; Coffee, *supra* note 130, 810-12.

¹⁷⁹ BENSTON ET. AL., *supra* note 176, 176; Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 NW. UNIV. L. REV. 1205, 1210 (2011).

¹⁸⁰ Daniel Ferreira, David Kershaw, Tom Kirchmaier, and Edmund Schuster, *Shareholder Empowerment and Bank Bailouts*, unpublished working paper, (2012), available at <http://ssrn.com/abstract=2170392>.

companies. The corporate governance of publicly traded companies is more likely to be subject to critical scrutiny when financial results are poor.¹⁸¹ Conversely, top executives of companies that are performing well are likely to be granted substantial latitude,¹⁸² and banks fell into the latter category during the early and mid-2000s.

In contrast with many U.S. public companies banks generated strong shareholder returns as the dot.com stock market boom ended and scandals such as Enron rocked corporate America. The corporate governance free pass duly followed. According to a July 2008 *American Banker* article describing how weak financial results banks had been delivering over the previous year had prompted greater vigilance among directors, “the passage of that reform legislation (SOX) coincided with an extended run of profitability in the banking industry, and discussions about the consequences of weak corporate governance were mostly theoretical.”¹⁸³ Or as a stock market analyst said of bank directors at the same time, they “realize they now have to be on top of things, have to be the ones who make sure management is actually accounting for risk....Of course, that always should have been the case, but at least they are stepping up now.”¹⁸⁴ Even shareholders otherwise inclined to lobby for change seemed prepared to cut banks slack post-Enron, with the number of instances

¹⁸¹ See, for example, Iain MacNeil and Xiao Li, *Comply or Explain: Market Discipline and Non-compliance with the Combined Code*, 14 CORP. GOV: INT’L. REV. 486, 492 (2006); Sridhar Arcot, Valentina Bruno and Antoine Faure-Grimaud, *Corporate Governance in the UK: Is the Comply or Explain Approach Working?*, 31 INT’L. REV. L. & ECON. 193, 199 (2010) (indicating that among companies with sub-standard corporate governance, measured by reference to compliance with a corporate governance code applicable to all companies with a primary listing on the London Stock Exchange, shareholders were much more likely to impose pressure on companies to comply after periods of poor performance).

¹⁸² *Supra* note 31 and related discussion.

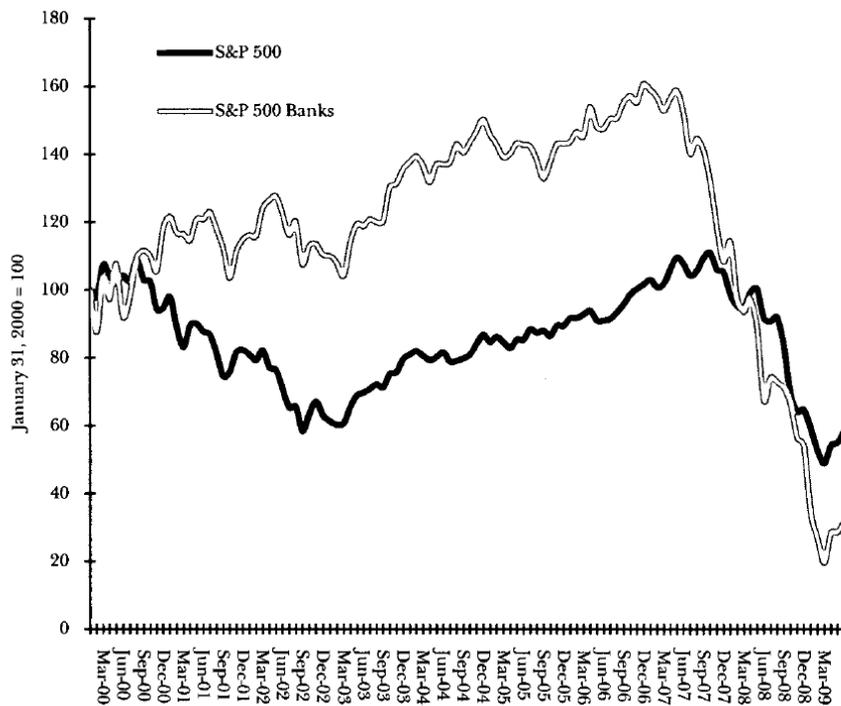
¹⁸³ Kevin Dobbs, *Crisis Casts Bank Boards As Activists*, AM. BANKER, July 14, 2008, 1.

¹⁸⁴ *Ibid.* (quoting Richard X. Bove, an analyst at Ladenburg Thalman & Co.).

where bank shareholders made filings with the SEC indicating an intention to engage in activism falling by nearly one-third in 2002-05 as compared with 1997-2001.¹⁸⁵

The stock market performance of financial companies between 2000 and 2007 reveals why discussions of weak corporate governance were largely “theoretical” prior to the financial crisis. While the S&P 500 dropped nearly 50 per cent between March 2000 and September 2002 as the “dot.com” bull market went into reverse and corporate scandals hit,¹⁸⁶ share prices of banks in the S&P 500 actually increased (Fig. 3). Bank shares then continued to perform well for the next five years while the stock market overall was struggling to recover ground lost during the 2000-02 bear market (Fig. 3).

Figure 3: S&P 500/S&P 500 Banks, 2000-2009



Source: Bratton and Wachter (2010), *supra* note 92, 718.

¹⁸⁵ Raluca A. Roman, *Shareholder Activism in Banking*, unpublished working paper, 42 (Table 1) (2013) (421 instances between 1997 and 2001, an average of 84.25 per year, as compared with 238 between 2002 and 2005, an average of 59.5).

¹⁸⁶ Cheffins, *Did*, *supra* note 10, 10.

The stock market outperformance by banks that likely insulated bank executives from post-Enron/SOX governance scrutiny was backed up solid financial results. Profits financial companies generated increased an average of 13.8 per cent annually in the decade ending in 2006, compared with 8.5 per cent for nonfinancial companies.¹⁸⁷ The underlying difficulty was sustainability. Banks could prosper during the mid-2000s because loan growth was strong and defaults were uncommon due to a reasonably stable economy, rising asset prices and low interest rates.¹⁸⁸ However, financial sector growth was racing ahead of the real economy, leaving banks highly vulnerable. In 2008 the *Economist* likened the financial services industry to the resilient but hapless Looney Tunes cartoon character “Wile E. Coyote, running over the edge of a cliff,” explaining that the industry had “defied gravity by using debt, securitisation and proprietary trading to boost fee income and profits.”¹⁸⁹ When the fall came the corporate governance free pass was emphatically over.

V. BANK CORPORATE GOVERNANCE AND THE FINANCIAL CRISIS: TOWARDS A NEW EQUILIBRIUM

A. In the Midst of the Crisis

In 2006, a robust housing boom that the U.S. had been experiencing ended abruptly and mortgage defaults grew dramatically.¹⁹⁰ In 2007, notable financial companies such as Citigroup, Wachovia, Bank of America, Morgan Stanley, Lehman Brothers and Bear Stearns were in a seriously weakened state due to the deeply troubled U.S. mortgage market.¹⁹¹

¹⁸⁷ Wilmarth, *supra* note 90 at 1003.

¹⁸⁸ *Still Vulnerable*, *supra* note 92; Bratton and Wachter, *supra* note 92, 720; see also *Bouncing Back*, *ECONOMIST*, December 3, 2005, 91 (indicating recent loan-loss rates for U.S. banks were the lowest on record).

¹⁸⁹ *What Went*, *supra* note 90.

¹⁹⁰ JOHNSON AND KWAK, *supra* note 55, 157.

¹⁹¹ DAVID FABER, *AND THEN THE ROOF CAVED IN: HOW WALL STREET’S GREED AND STUPIDITY BROUGHT CAPITALISM TO ITS KNEES* 166 (2009).

Share prices of banks began to fall in mid-2007, a few months prior to the beginning of the “bear” market that would be associated with the financial crisis (Fig. 3). In 2008, the bottom fell out, as share prices of financial companies in the S&P 500 declined nearly 60 per cent.¹⁹²

The onset of the financial crisis ended whatever corporate governance free pass executives of financial companies had enjoyed. The June 2008 *American Banker* article that indicated corporate governance concerns that had been largely theoretical in the banking sector after the enactment of SOX observed “No longer.”¹⁹³ There was, for instance, strong criticism of generous executive pay arrangements of various financial companies embroiled in the crisis.¹⁹⁴ Also, while shareholders generally eschewed challenging publicly bank executives as the financial crisis mounted, perhaps being fearful of making a bad situation worse,¹⁹⁵ 2008 was the year between 1994 and 2010 with the highest number of instances where bank shareholders made filings with the SEC indicating an intention to engage in activism.¹⁹⁶

Boards also stepped up to the plate. Amidst growing criticism of directors of financial companies and various recommendations by shareholder advisory firms to clients to vote against nominations to board seats banks proposed,¹⁹⁷ boards began orchestrating managerial turnover at a rapid clip. Chuck Prince was a prominent casualty. In November 2007 he resigned under pressure as Citigroup’s CEO and chairman of the board and Citigroup split the role of CEO and chairman thereafter, with the implicit mandate of the chairman

¹⁹² Cheffins, *Did, supra* note 10, 17.

¹⁹³ Dobbs, *supra* note 183.

¹⁹⁴ Cheffins, *Did, supra* note 10, 41-44.

¹⁹⁵ *Ibid.*, 47.

¹⁹⁶ Roman, *supra* note 185, 42 (Table 1) (103 instances in 2008; the total did not exceed 100 in any other year).

¹⁹⁷ Cheffins, *Did, supra* note 10, 34-35; *Paradise Lost, supra* note 170, 19.

being to monitor carefully the new CEO's performance.¹⁹⁸ More generally, of the 15 financial companies sufficiently adversely affected by the onset of the financial crisis to be removed from the S&P 500 during 2008 (Citigroup was not one of these), seven fired their CEOs in the months before removal and other senior executives were replaced at three other such firms.¹⁹⁹

B. Aftermath

The end of the corporate governance free pass for financial firms did not forestall the subsequent economic pain the financial crisis would deliver. The stock market swoon continued during the opening months of 2009, with the S&P 500 bottoming out in March after a decline of nearly 55 per cent from October 2007.²⁰⁰ The U.S. economy shrank by 4 per cent in the year following the October 2008 collapse of Lehman Brothers and the unemployment rate more than doubled from the beginning of the recession (4.8 per cent) to October 2009 (10.2 per cent).²⁰¹

In the wake of the financial crisis the corporate governance free pass was not about to be restored. Instead, governance practices in banks received heightened attention.²⁰² The imperial CEO who featured prominently in leading financial companies in mid-2000s was a noteworthy casualty. A columnist for the *Globe & Mail*, a leading Canadian newspaper, picked up early on the point. Writing in early 2009, he observed that historians would be able to “carbon-date that extinct species known as the celebrity CEO” to hearings of the

¹⁹⁸ Dobbs, *supra* note 183.

¹⁹⁹ Cheffins, *Did*, *supra* note 10, 21, 37-39.

²⁰⁰ Historical S&P 500 prices are available at Yahoo! Finance (<http://finance.yahoo.com/>) (accessed Feb. 17, 2014).

²⁰¹ JOHNSON AND KWAK, *supra* note 55, 182-83.

²⁰² Grove, Patelli, Victoravich and Xu, *supra* note 159, 418; GROUP OF THIRTY, TOWARD EFFECTIVE GOVERNANCE OF FINANCIAL INSTITUTIONS 12 (2012).

House Financial Services Committee where members of the Committee grilled chief executives of the eight largest financial firms in the U.S.²⁰³

Subsequent events confirmed the demise of the celebrity CEO in the banking sector. The *Wall Street Journal* suggested in a 2012 article that “The financial industry may be going through the same transformation witnessed by corporate America when imperial CEOs á la Jack Welch (General Electric CEO from 1981 to 2001)...gave way to more understated and more socially aware figures....”²⁰⁴ The newspaper returned to the theme in 2013, saying that “Large banks, burned by years of scandal, often with swashbuckling CEOs at the helm, are turning to new bosses who sport well-polished veneers of boringness.”²⁰⁵ Even JP Morgan Chase, whose CEO and chairman of the board Jamie Dimon was labelled in 2012 the “last star CEO,”²⁰⁶ responded in 2013 to criticism of Dimon’s power by appointing two new independent directors and by designating a “lead independent director” with power to call board meetings and a mandate to guide consideration of CEO succession.²⁰⁷ As for why the change might be good for banks, the Group of Thirty, an international think tank comprised of central bankers and senior bank executives, said in a 2012 report on effective corporate governance:

²⁰³ Sinclair Stewart, *Let Us Prey*, GLOBE & MAIL, March 27, 2009, 42. On the identity of those testifying, see Stacy Kaper, *Spotlight on 8 CEOs, and Pandit Grabs It*, AMERICAN BANKER, February 12, 2009, 1.

²⁰⁴ Francesco Guerrero, *Wall Street Chiefs Set a New Agenda*, WALL ST. J., February 28, 2012, C1.

²⁰⁵ Max Colchester, *Today’s Bank Chiefs Can Spin a Yawn*, WALL ST. J., August 12, 2013, C1.

²⁰⁶ John Gapper, *JPMorgan’s Fiasco Exposes the Myth of an Imperial CEO*, FIN. TIMES (U.S. edition), May 17, 2012, 9.

²⁰⁷ Tom Braithwaite, *JP Morgan Acts to Curb Dimon’s Board Power*, FIN. TIMES, September 10, 2013, 20; Dan Fitzpatrick and Joann S. Lublin, *JP Morgan Juices Up Director’s Job*, WALL ST. J., September 10, 2013, C1.

“Given a choice between a very good CEO and a ‘star’ CEO, the former is preferable to the latter. Very good CEOs tend to get the job done reliably, without undue fanfare... Star CEOs, by contrast, may conflate the institution’s success with their personal goals...and they may start to believe their own press.”²⁰⁸

Arthur Levitt, when he drew attention to the mid-2000s “cultural change in corporate America”²⁰⁹ involving a shift away from celebrity CEOs, attributed the trend primarily to market factors rather than regulation. He said that while Sarbanes-Oxley and related reforms “corrected some of the more egregious structural problems of the 1990s, they are not what are driving this shake-up.”²¹⁰ Levitt identified major institutional shareholders and the media as the primary forces pushing boards “to demand a very different kind of leadership from senior management.”²¹¹

Matters were different with the post-financial crisis switch by banks away from “star” CEOs to a more “boring” managerial approach. Shareholder pressure did help to prompt JP Morgan Chase to bolster the independent element on its board of directors.²¹² Nevertheless, the shift to a less flamboyant post-financial crisis managerial style by major banks was not primarily a market-driven corporate governance trend. Perhaps this was because bank shareholders have reasons to prefer bank executives to be “gung ho”.²¹³ Whatever the reason, it was regulatory pressure that prompted banks to retreat from their free-wheeling pre-financial crisis ways.

²⁰⁸ GROUP OF THIRTY, *supra* note 202, 38.

²⁰⁹ *Supra* notes 73 to 74 and related discussion.

²¹⁰ Levitt, *supra* note 73.

²¹¹ *Ibid.*

²¹² Braithwaite, *supra* note 207.

²¹³ *Supra* note 179 and accompanying text.

JP Morgan Chase's 2013 boardroom reforms were prompted in large part by an effort to shore up its relations with regulators,²¹⁴ with the bank being responsive to change because it was facing the threat of massive financial penalties for alleged post-financial crisis infractions.²¹⁵ Morgan Stanley reoriented itself for similar reasons. According to a 2013 report in the *Wall Street Journal* the firm "upended its culture and ethos...forging a business that more closely resembles the banking industry's old model of eschewing risky bets and collecting reliable fees," with a key change being that "50 full-time government regulators (were) now stationed at Morgan Stanley" who were "prowl(ing) the office floor looking for land mines...."²¹⁶ There were no such regulators at Morgan Stanley as late as 2008.²¹⁷

Regulatory-driven post-financial crisis overhauls such as Morgan Stanley's reputedly were commonplace in major U.S. financial firms.²¹⁸ This is not surprising given that the 2010 Dodd-Frank Act vested regulators with various new powers to restrain risk-taking by banks that might be too big to fail.²¹⁹ For instance, the legislation provided for the establishment of a new Financial Stability Oversight Council that was to have a mandate to identify banks that could create a threat to financial stability, to subject such firms to enhanced supervision and to impose on such firms, in tandem with the Federal Reserve, fresh bank capital requirements and leverage restrictions.²²⁰ The Federal Reserve, for its part, issued in 2012 a supervisory letter providing guidance on its approach to risk-focused

²¹⁴ Fitzpatrick and Lublin, *supra* note 207.

²¹⁵ *Jamie Dimon Stepping Down Isn't Good Enough*, N.Y. POST, October 7, 2013.

²¹⁶ Aaron Lucchetti and Julie Steinberg, *Life on Wall Street Grows Less Risky*, WALL ST. J., September 10, 2013, C1

²¹⁷ *Ibid.*.

²¹⁸ *Ibid.*

²¹⁹ Coffee, *supra* note 177, 1050, 1059; Jonathan R. Macey and James P. Holdcroft, *Failure is an Option: An Ersatz-Antitrust Approach to Financial Regulation*, 120 YALE L.J. 1368, 1390 (2011) ("What the Dodd-Frank Act does instead is increase regulators' discretion and power").

²²⁰ Baxter, *supra* note 125, 845-46; Coffee, *supra* note 177, 1059.

supervision of large financial firms that identified corporate governance as one pillar of its approach and spelled out various steps boards should take to provide the sort of effective corporate governance that would need to be in place for firms to be sustainable under economic, operational or legal stresses.²²¹

While the Federal Reserve identified the bolstering of corporate governance as an aspect of its supervision of large financial firms, corporate governance reform was not a feature of the key bank-specific provisions in the Dodd-Frank Act, namely those focusing on bank holding companies (Title VI), non-bank financial companies (Title I, sub-title C), the Financial Stability Oversight Council (Title I, sub-title A) and on orderly liquidation of “too big to fail” financial companies the Act targeted (Title II).²²² The legislation did contain a sub-title entitled “Strengthening Corporate Governance” with provisions instructing the Securities and Exchange Commission (S.E.C.) to introduce rules requiring companies that had failed to split the chief executive officer and chairman of the board roles to explain why they had failed to do so and authorizing the S.E.C. to develop a “proxy access” rule permitting shareholders with significant stakes to nominate under prescribed circumstances directors on a company’s own proxy card.²²³ These provisions, however, were applicable to all issuers falling under the S.E.C.’s jurisdiction, not just financial companies. Moreover, most of the provisions in the sub-title of the Dodd-Frank Act dealing with the “hot button”

²²¹ Board of Governors of the Federal Reserve System, *To the Officer in Charge of Supervision at Each Reserve Banks and to Domestic and Foreign Large Financial Institutions*, December 17, 2012, 3-5, available at <http://www.federalreserve.gov/bankinfo/srletters/sr1217.htm> (accessed Feb. 17, 2014).

²²² The only reference to “governance” in the sections of the Act addressing these themes is in § 210(h)(2)(F), which deals with the powers of the entity responsible for orderly liquidation of too-big-to-fail banks to set up a bridge financial company:

²²³ Title IX, Sub-title G., encompassing §§ 971-72.

corporate governance topic of executive compensation²²⁴ applied to all publicly traded companies subject to S.E.C. jurisdiction rather than just financial companies.²²⁵

Given the effort made to liberalize proxy access for dissident stockholders and given that key executive compensation reforms focused on the introduction of a shareholder “say on pay” vote and the mandating of additional disclosure to investors,²²⁶ empowering shareholders stands out as the pre-dominant theme in the Dodd-Frank Act provisions dealing with corporate governance.²²⁷ Ironically, corporate governance reforms of the sort Dodd-Frank introduced potentially run counter to the shift toward “boring” banks regulators appear to be promoting. To the extent that the Dodd-Frank Act reforms empower shareholders of banks, this enhances their ability to pressure bank executives to pursue high-risk strategies that regulators seem to oppose,²²⁸ particularly because banks’ primary creditors – the depositors – have little incentive to impose a check on shareholder-backed risk-taking due to deposit insurance the Federal Deposit Insurance Corporation provides.²²⁹

²²⁴ Leo E. Strine, *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 BUS. LAWYER 1079, 1082 (2008).

²²⁵ Title IX, Sub-title E., encompassing §§ 951-57. Section 956, which requires disclosure of executive pay arrangements to regulators, was an exception as it only applies to “covered financial institutions.”

²²⁶ Dodd-Frank Act, § 951 (shareholder voting on executive compensation); § 953 (disclosure).

²²⁷ Bruner, *supra* note 84, 319-20 (emphasizing the shareholder orientation of the Dodd-Frank corporate governance reforms); Sepe, *supra* note 84, 380 (“The measures introduced by the Dodd-Frank Act aim at empowering shareholder voice”); Coffee, *supra* note 177, 1049 (“Dodd Frank partly sided with traditional corporate governance reformers, enacting much of their standard agenda to enhance shareholder power”).

²²⁸ See *supra* note 179 and accompanying text (discussing bank shareholder preferences for high-risk/high-return strategies); Bruner, *Corporate*, *supra* note 84, 321-22; Sepe, *Regulating*, *supra* note 84, 380-81; Coffee, *supra* note 177, 1049, 1055.

²²⁹ *Supra* note 176 and related discussion; see also Lucian A. Bebchuk and Holger Spamann, *Regulating Bankers’ Pay*, 98 GEO. L.J. 247, 255-57 (2010); Kose John, Hamid Mehran and Yiming Qian, *Outside Monitoring and CEO Compensation in the Banking Industry*, 16 J. CORP. FIN. 383, 385 (2010); Robert P. Bartlett, *Making Banks Transparent*, 65 VAND. L. REV. 293, 303-4 (2012).

VI. CONCLUSION

The purpose of this paper has been twofold, namely explaining by reference to dramatic changes affecting the manner in which U.S. public companies conducted business why corporate governance, despite its belated arrival, became much more than a 1970s fad, and describing how and why the chronology was altered in a potentially crucial way for banks. Due to deregulation, technological innovation, improved access to finance and to companies simply getting bigger, corporate governance began to matter more in U.S. public companies as the 20th century drew to a close. Increased emphasis on boardroom monitoring, performance-related executive pay and shareholder activism duly followed. Shortly following major corporate scandals occurring during the early 2000s and the 2002 enactment of the Sarbanes-Oxley Act a new corporate governance equilibrium appeared to coalesce with formerly high-flying celebrity CEOs being put on appreciably shorter leashes.

Similar trends affected the financial services industry, with corporate governance achieving a higher profile during an era of “bright new finance” marked by the emergence of larger banks, deregulation and technological change. Due in large measure, however, to stock market outperformance leading banks were issued with a mid-2000s corporate governance “free pass” that arguably helped to set the stage for the financial crisis. Only in the wake of the 2008-09 economic meltdown U.S. banks arguably helped to precipitate did large financial companies shift to “boring” mode and ditch the imperial CEO model eschewed generally by U.S. public companies after the corporate governance upheavals of the early 2000s.

A key contribution this paper has made is to pick up on Ronald Gilson’s 1996 cue²³⁰ and examine with respect to corporate governance how and why existing institutions

²³⁰ *Supra* note 6 and related discussion.

responded to a changing array of challenges. In so doing, the paper has engaged with issues thus far largely unaddressed in the corporate governance literature and thereby provided fresh historically-related insights into the development of corporate governance. The analysis provided here is by no means definitive. For instance, while the paper has indicated that the star CEOs who rose to prominence as the 20th century drew to a close had their wings clipped post-Enron/SOX with non-financial companies and after the financial crisis with major banks, the intriguing question of whether the financial crisis would have been as severe as it was if bank executives had not been given a corporate governance free pass in the mid-2000s has been left open.

The paper's analysis of *why* celebrity CEOs had their wings clipped when they did is also by no means definitive. We have seen with banks that in the wake of the financial crisis regulators eager to reduce risk took the lead. In contrast, Arthur Levitt, with the "vast cultural change" he said was occurring in boardrooms and executive suites of non-financial companies in the mid-2000s, attributed the change primarily to pressure from major institutional shareholders and the media.²³¹ It is unclear whether Levitt's assessment of the potency of market-oriented agents of change is fully on the mark. For instance, prior to the financial crisis passivity in fact was the default option for major institutional stockholders, with pension funds and mutual funds being reluctant to do more than vote against management proposals which shareholder advisory services opposed.²³² It is beyond the scope of this paper to go further in assessing the contribution of potential agents of change. The paper has nevertheless offered fresh insights concerning the inter-relationship between corporate governance and the financial crisis and has identified factors that brought corporate governance to prominence in banks and public companies more generally, providing in so

²³¹ *Supra* note 211 and related discussion.

²³² Cheffins, *Did*, *supra* note 10, 13.

doing a context within which future historically-oriented research on corporate governance can be conducted.

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