PART III

International University College of Turin

Independent Policy Report

Independent Policy Report

Working Group on Legal Standards

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GENERAL INDEX

Introduction

PART I Global Political Economy and the End of History

PART II Beyond the End of History. Asserting the Primacy of the Law over Economic Power

PART III Legal Standards for the Global Financial Market

Conclusions

PART III

LEGAL STANDARDS FOR THE GLOBAL FINANCIAL MARKET

Abstract

All previous reforms were constructed around harmful dogmas, according to which: (i) crises are inevitable; (ii) markets are self-healing; (iii) crises are a domestic matter. Only by overriding such cultural grid of references a genuinely new approach can be designed. Today, the global institutional framework is a complex, crisis-driven structure: a narrow regulatory culture has created a path-dependent mechanism in which every new legal arrangement was not designed to deal with the growing complexity and globalization of financial markets. Reframing the international architecture implies both the creation of a single, reliable and transparent framework for international bodies, and the establishment of a more consistent domestic architecture for national financial supervisors. Every new authority should fully embrace the conceptual distinction between regulatory powers and supervisory tasks. Such distinction lies at the core of a system based on accountability and transparency principles. To shape a consistent framework for financial market supervision and regulation, financial instability should be directly addressed by setting up regional monitoring agencies and by taxing speculative capital flows. The IMF and the WB - albeit discrete institutions - are de facto highly integrated partners in the making and execution of the system of global financial deregulation that has severely limited the possibility of legitimized political actors to protect themselves against the spreading of the US crisis. The international financial institutions should be reformed in a long-term perspective. Their current role shows the need of a degree of separation of power in any system of global representative government. Before market liberalization, the Western financial system was based on the strict institutional partition between “banking” and “securities”. Socio-economic evolution and technological innovation have favored the legal breaking up of market segregation and the creation of financial conglomerates and giant financial institutions. Unrestrained liberalization and market-friendly controls have contributed to the current financial crisis fostering and exacerbating conflicts of interests and pricing opacity. Mandatory disclosure remedies make information more extensively accessible and affordable to consumers, but they are not alone sufficient to address conflicts of interest and price manipulation. In order to overcome role confusion, re-establishing market segmentation is a necessary step to effective reform. The law should monitor the originate-to-distribute business model. Ex-ante legal control should be provided to guarantee the full understanding of the

relationship. Reviving securitization and its benefits requires deep structural change. However, the reform process does not need to start from scratch. It could draw on from safe and steady financial techniques, such as 'Pfandbriefe' and covered bonds. Ensuring transparency of insurance contracts is another key objective of an effective legal and regulatory framework. However, one should be aware of the ideology according to which in every domain of life uncertainty private insurances are good substitute for public institutions.

With the financial crisis, rating agencies have come under repeated criticism, either for poor responsiveness and delays in modifying ratings in view of market developments, or for the abruptness of unexpected downgrades. Their role should be limited and their activity monitored. The highly favorable legal regime shielding rating agencies from liability should be radically transformed. The possibility to establish an international not-for-profit public or quasi-public institution to carry on reliable rating should be explored.

In the last couple of decades, the shareholder's model of corporate governance has gradually become the dominant mode of organizing listed corporations in the world. This structure is responsible for distorted incentives and weak regulation favoring shortsighted and often predatory corporate choices. This supremacy of optional contract-based law over regulation should be stopped and radically inverted. Short from obeying the logic of economic democracy, the public company structure actually encourages the concentration of irresponsible power. On the contrary, very different models of ownership structure of the systems of large corporations characterized the rise and decline of 20th-century State-owned enterprises in Europe. Basic structural elements of that experience, dismantled in the privatization frenzy at the end of history, should be used in the new public intervention required to overcome the negative effects of the crisis. A significant number of irrationalities affecting the current corporate governance structure are located in property theory - especially in the paradigm of individuals' rationality when following their self interests. To this, it is usually added that the interests of the owners are in line with the interests of the consumers.

The process of labor commodification, reflected in its legal organization, was exacerbated at the end of history. There is a global urgency to reverse this process. The separation of labor law from commercial law institutionalizes a division of the cooperative surplus that is unfair and unsustainable. Any benefits of financial capital mobility must always be synergized with the realities of social capital mobility. Alternatives aiming at the birth of a sustainable global economic law should be explored. Systems of co-decision, profit sharing and employees' ownership structurally facilitate long-term sustainable corporate decision making

3.1 Each new crisis revealed a large number of holes in the global architectural framework. However, instead of creating a new coherent system, the global institutional framework is a complex, crisis-driven structure.

The current international architecture for financial market supervision and regulation is a complex network in which national authorities are paired by a plethora of private and public international and transnational bodies that have emerged since the 1970s. The system's evolution and its sophistication are crisis-driven. Not by chance, the beginning of cooperation between supervisory authorities dates back to the early 1970s, when the Herstatt Bank's failure sent shock waves through the world's financial markets and, subsequently, the G10 Central Banks' Governors decided to establish the Basel Committee for Banking Supervision.

After every crisis a new piece was added to the global puzzle. In 1944 and in 1945 the WB and IMF were respectively created. During the 1970s, new bodies were founded to set standards and to monitor different branches of financial markets. Thus, in 1973 the International Accounting Standard Board (IASB) was established, and in 1983 the International Organization of Securities Commissioners (IOSCO) was founded.

Subsequently in the late 1980s a further specialization was required and several "task forces" were created such as the Financial Action Task Force on Money Laundering (FATF), and the Committee on Payment and Settlement Systems (CPSS). In 1994 and in 1995, respectively, the International Association of Insurance Supervisors (IAIS) and the Egmont Group were created.

The overabundance of these bodies and the Asian crisis pushed policymakers to establish more trustworthy coordination mechanisms in order to ensure global stability. Hence, in 1996 the Joint Forum was established between IOSCO and IAIS, operating under the guidance of the Basel Committee. Moreover, in 1999 the Financial Stability Forum (FSF) and the Financial Stability Institute (FSI) were formed.

With the new millennium, other organizations were created to respond new social and economic needs. Accordingly, in 2004 the International Organization of Pension Supervisors (IOPS) was founded. Nonetheless, the most remarkable institutional implementation of these days is surely represented by the increased role of the European Union in defining a European Financial Market. *Ad hoc* rulemaking procedures involving newly created committees were established - i.e. the Lamfalussy process, putting financial market regulation and harmonization at the top of European policymakers agenda, namely through the European Commission Financial Services Action Plan (FSAP).

While all these bodies and authorities often operate jointly in order to issue codes, guidelines, and best practices, the global order is a *plural order*, in the

sense that there is neither unity nor homogeneity in its structure. All those organizations, indeed, independently from their administrative structure, participate in the (global) governance of financial markets. The standards they prescribe directly affect the national legislations, even if such a mechanism is totally extraneous to a law-making process grounded on democratic values, such as accountability and transparency. In this sense the global institutional framework is governed by an international order composed of heterogeneous bodies representing different interests and with overlapping scopes, aims, and memberships.

The fragmented scenario just presented is the result of a series of short-term policies mostly taken to solve specific needs and to provide a quick answer to a situation of distress.

3.2 A narrow regulatory culture has created a path-dependent mechanism in which every new legal arrangement was not designed to deal with the growing complexity and globalization of financial markets.

Even if any crisis might be understood as an occasion to revisit an outdated system, it appears that the current framework is locked in a self-perpetuating mechanism, in which every solution taken is shaped around specific regulatory culture.

In general terms, when a system is in distress a “menu of options” is considered by policymakers in order to respond to such a crisis. All reforms occurred after a crisis followed a pre-cast ideology. In this sense, the menu of possible choices was locked in by a dogma built over a set of principles rooted in market fundamentalism. Accordingly, because of this menu-dependence, and because situations of distress in financial markets are often perceived to be the result of supervisory failure, the international architecture – every time a crisis occurred – was enriched by a new organization, whose aim was not to deal with instability (because deemed as physiological), and whose scope of action was not involving free movements of capital (because such regulation is burdensome for international business).

When a legal system has to cope with a crisis, a change in the original structure might be required to provide an escape from the distressing situation. In financial markets, when scandals or crises emerge, an immediate answer is often needed to limit the impact on the real economy of such events or simply to improve state’s credibility. Thus, in order to block eventual systemic effects and to recover from the crisis, an immediate institutional response was instinctively provided, with the aim of instilling new trust in the supervisory structure. However, in urgency situations like financial distress, the dependence on existing

cultural beliefs might impede the creation of new, more effective institutional frameworks.

In other words, if on the one hand an institutional response was expected, on the other hand the ideological background stifled any new attempt in providing a consistent and general revision of financial architecture. This approach determined the adoption of legal arrangements not coping with the growing interconnection and sophistication of capital markets. Considering the current situation, it is necessary to implement a genuinely new structural framework dealing with the externalities directly generated by excessive speculation. In this sense, only once the classical common beliefs are overruled can a reliable architectural framework for financial markets supervision be put in place.

3.3 All previous reforms were constructed around harmful dogmas, according to which: (i) crises are inevitable; (ii) markets are self-healing; (iii) crises are a domestic matter. Only by overriding such cultural grid of references a genuinely new approach can be designed.

It is commonly recognized that after a crisis or a shock, governments – even the most reluctant – strengthen their regulatory tights. As just explained, however, every new legal arrangement adopted in the aftermath of a crisis was determined by a narrow cultural grid of references, according to which: (i) crises are inevitable; (ii) markets are self-healing; (iii) crises are a domestic matter.

Are crises inevitable? It is often alleged that human beings are selfish, rent-seekers, and profit-maximizers; greed and self-indulgence is unavoidable behavior of our species. In this sense, crises cannot be really avoided and a certain amount of instability is required to get rid of "unhealthy" institutions, promote competition and create sound financial system (which eventually never occurred). Consequently, following this belief, the strategy to cope with crises could be well represented by the "let the fire burn" slogan.

Several studies have already explained the phases of every crisis. In accordance with the Financial Instability Hypothesis (FIH), over periods of protracted wealth, capitalist economies tend to move from a financial structure dominated by "hedge finance" (i.e. stable) to a structure that increasingly emphasizes "speculative" and "Ponzi finance" (i.e. unstable). It is clear that in this historical time we are in the so-called "Minsky moment", in which the income-debt relation led us to a "Ponzi finance". The systemic consequences are evident even if not yet fully assessed.

Nevertheless, the fact that there is cyclical movement in the way financial markets (without a calibrated governmental intervention) generate instability has provided the ground for "wait and see" approach to financial crises. Although

rescue packages are generally enacted as immediate response to the crises, the normative application of the "physiological argument" has contributed to block any attempt to redraw a consistent architectural framework.

Are markets self-healing? This question might appear odd in such an historical moment, in which is under everyone's eyes the daily governmental activity in attempting to heal the current economic meltdown. Nevertheless, the logical consequence of considering crises as physiological occurrences implies to believe that markets have the natural power to overcome instability; in other words, markets are auto-regulating. Exogenous regulatory actions (in a broader sense) are, thus, considered an inhibition to growth and competition. Even after recent scandals, it was said that market would respond without needing the implementation of new legislations. As a result, the Enron scandal became an example of market functioning and not a market failure.

Even if it is in the long run, the market's invisible hand may solve failures by its own endogenous mechanisms; nevertheless, it is obvious – as proven by historical evidence – that losses caused by market failures, may be unpredictable and disastrous in the short run. This makes public intervention necessary. The evolution of financial markets shows that countries are oriented towards regulatory solutions instead of deregulating, while free banking remains confined to some limited historical examples.

Furthermore, stronger waves of liberalization (which does not necessarily coincide with deregulation) of financial systems have occurred throughout financial history. Countries have sometimes lowered compulsory reserve requirements and entry barriers in the banking sector, governmental interference in credit allocation has been reduced, insurance companies and banks have been privatized, and several countries promoted the development of local stock markets encouraging the entry of foreign financial intermediaries. Nevertheless, several studies conducted by the WB have verified that an excessive financial liberalization, once it leads to deregulation, exerts an independent adverse effect on financial stability.

In the case of the current crisis, it appears that deficiencies in the regulatory and supervisory systems contributed in determining the current severe situation. The *shadow banking* system provides clear evidence. Non-bank mortgage lenders (such as hedge funds, investment vehicles, brokers, etc.) were operating like credit institutions: they borrowed very short-term and in liquid ways and they carried the risk, but unlike banks they were not subject to banking regulation and supervision, which implies they were more leveraged without a deposit insurance coverage and they were not protected by systemic risk by central banks' lender-of-last-resort liquidity. The growing expansion of such a *de facto* unregulated system has aggravated the subprime mortgage crisis and contributed to transform the credit crunch into a global meltdown.

Are crises a domestic matter? This common belief is also addressed as the "house-in approach". This assumes that shocks are domestically originated and no internationally coordinated response is required if all countries enhance optimal policies. The *ex ante* consequences of such wisdom leads to prescribe general recipes for uninflationary policies to avoid global systemic imbalances. The *ex post* reaction (when a crisis still occurs) is the enactment of a series of measures to "isolate the contagion".

Although good domestic policies are an essential piece for the stability of the international system, this approach has often compromised any attempt to shape international arrangements in order to deal with what is deemed a mere domestic problem. In this sense the "reform of the international financial architecture" proposed by the G7 countries, and highly debated after the Asian-Russian crisis of the 1990s, was mainly conceived as an effort to strengthen financial systems in emerging market countries by adopting standards and codes.

There are at least two economic reasons that make any domestic-oriented approach to cope with crises a limited and potentially harmful device. Scholars have pointed out that since the 1973 crisis frequency has been double that of the Bretton Woods and classical gold standard periods, and matched only by the crisis-ridden 1920s and 1930s.

Precisely, the indicator that financial crises are not anymore a domestic matter only is the increased frequency in financial turmoil. Conventional thinking holds that risks are mainly local and routine, and they can be dealt with through a risk-based approach shaped upon previous experiences.

The first argument deals with the globalization process. The growing interconnection of markets and people characterizing this age emphazise the impact of any financial turbulence, thus making impossible to forecast any consequences. In this sense, the impact of a crisis tends to be unpredictably spreading out easily around the globe, like a pandemic infection. Moreover, the financial products' complexity (misunderstood by supervisors, banks, rate agencies and practitioners) makes it hard to predict consequences and losses. In this sense, previous experiences only provide a small hint to the future consequences. For this reason, a structural arrangement that is aimed at filling a gap is a solution born already outdated. The only certainty is that nowadays every spark might light a fire. Thus, a global net ensuring a reliable supervisory scheme has to be urgently put in place.

The second reason is more subtle. It is clear (and easily verifiable nowadays) that a failure of a bank in the US might indeed easily cause the failure of other healthy institutions in Europe and elsewhere, by activating a subsequent chain reaction that will dramatically affect the real economy. However, there is another channel of contagion in crises: information. Financial instability generate negative externalities that my affect other markets not directly touched by the

crises. In other words, after a crisis occurs, a second generation of crises (defined as "self-fulfilling"), might occur. Self-fulfilling crises on a fixed exchange rate occur when markets come to expect that a crisis will force the authorities to adopt new policies, or when a country simply fears some negative consequence might touch its market.

In these days (again leaving aside any ethical consideration about the different approaches), "isolating the fire" is simply nonsense, considering the scale and the severity of current crises.

3.4 Reframing the international architecture implies both the creation of a single, reliable and transparent framework for international bodies, and the establishment of a more consistent domestic architecture for national financial supervisors.

Both avoiding inconsistency among regulations set up by different bodies operating at the domestic level (but in different sectors) and at the international level is important. In this sense, the domestic architecture for financial markets supervision is a fundamental brick in the overall stability of financial markets.

The institutional design for financial supervision has become a major policy issue (especially after scandals or crises), and in some cases ending in structural reforms and animating public debate in a number of countries (just to mention some instances in the last decade of a new architectural regime: Belgium, France, Germany, Hungary, Netherlands, Singapore, United Kingdom). Increasing emphasis, even before the present crisis, was given to the architectural shape as a medium to implement the efficiency of regulation and supervision - although the literature in this field is poorly developed and it is merely relying on identifying the optimal number of authorities.

The need of a national consistent system has been stressed in several occasions. It appears that a bank operating in different European countries with cross-border and cross-sector operations (mainly between insurance and banking products) has to deal with 57 different authorities, which all have similar, but not identical, standards and procedures. Even more, the recent Basel 2 agreement in Europe allows for more than 300 differences among EU member states. The creation of a European Security Exchange Commission might be, accordingly, a project to be carefully analysed, though perhaps such an authority - to be at all effective - should be imagined at the global level, and funded very generously to learn from the failures of the US model.

The highly fragmented system has also played a crucial role in the subprime crisis in the US and in the spread of toxic assets around Europe. Such institutional framework, in fact, might induce hazardous behaviours. Firms may invest substantial resources to avoid a specific country's regulation, which would leave consumers no better-off and provoke social disadvantage. The shadow-

banking phenomenon that emerged in the US is a clear example of avoiding bank regulations through the implementation of new derivative devices. Such practice falls into the broader definition of regulatory arbitrage. This typically could lead to "forum shopping", if companies choose the weakest regulatory regime in order to operate without strong transparency requirements or rigid supervisory standards, to the detriment of investors.

3.5 Every new authority should fully embrace the conceptual distinction between regulatory powers and supervisory tasks. Such distinction lies at the core of a system based on accountability and transparency principles.

Independent authorities (both at the national and international level) are not only entrusted with the power to enact specific rules: many of the above-mentioned international bodies do issue soft laws that might take the form of best practices and codes. Together with this rulemaking power, they have also the power to control the compliance of market participants with those rules. It is evident that a regulatory action will not be complete (nor credible) without an effective oversight mechanism, nor without adequate enforcement procedures. Considering the high volume of transactions, the number of participants and the involvement of end-consumers, the surveillance activity is a fundamental tool to ensure the transparency and the soundness of financial markets.

Two distinct but interconnected activities are performed by independent agencies: *regulation* and *supervision*. Generally, the terms are confused and the word "regulation" absorbs the concept of supervision. The conceptual distinction between regulatory activity and supervisory duty, even if both embedded in the same body, represents a fundamental logical step in defining a transparent, accountable, and reliable system. Regulation, therefore, consists of a legislative delegation allowing the specialized bodies to produce more detailed provisions. The very concept of delegation implies that the legislative power is performing an a-priori policy choice, which is enacted in its detail by other bodies. However, supervisory activities are related to the oversight performed by independent bodies once they are controlling the application of the relevant laws and regulations. Conceptually, therefore, this implies monitoring and enforcement activities.

In this sense, the administrative agencies' role, in which supervision and regulation converge, is a form of bureaucratic lawmaking that does not follow the democratic decision-making process, though it has a strong impact on the regulated sectors. Accordingly, accountability is a manner to inject some democracy into such an important decision-making process. Thus, in line with the legal theory, accountability becomes a way to ensure a democratic mechanism of rule making.

By emphasizing and institutionally enforcing the conceptual distinction between regulation and supervision, it becomes clear that accountability can be both a way to ensure a democratic mechanism of rule making, and a means to ensure the fairness in supervisory activities. Accountability is precisely what legitimates quasi-legislative action that falls outside the parliamentary activity, and quasi-judiciary activity performed by administrative agencies.

Accordingly, accountability should be ensured at the *structural* level by establishing appointment and removal procedures for the head officials, assessment and evaluation mechanisms, and coordination procedures with other national and international bodies. Moreover, every new authority should clearly set up accountability mechanisms to cope with the *regulatory* dimension of its activity. Regulatory accountability consists of all those mechanisms directly devoted to counterbalancing the discretionary rulemaking powers. In this sense, the limits established by international laws and legal systems should be fully taken into account together with mechanisms fostering transparency and the right of participating, through public consultations in the rulemaking activity. Finally, the *supervisory* dimension should be addressed by a set of accountability mechanisms devoted to counterbalancing the individual decision making activity, i.e. the discretionary action that might affect individual rights or interests.

Having in mind a clear allocation of powers, the implementation of specific mechanisms to counterbalance such powers will immediately lead to a transparent and legitimate regulatory action in which procedures in the decision making actions are fully disclosed.

3.6 To shape a consistent framework for financial market supervision and regulation, financial instability should be directly addressed by setting up regional monitoring agencies and by taxing speculative capital flows.

Financial instability might be seen as a "public bad" (like pollution) generating non-pecuniary externalities. Though a certain degree of volatility can be accepted, an excessive volatility causes wide spread damages through an undefined number of people.

Such costs should be internalized, by shaping a system directly coping with a core characteristic of financial markets, i.e. the free movement of capital. Free movement of capital is advocated in terms of efficiency, welfare spread, and even a higher flexibility in case of shocks. However, it is true that a liberal approach to capital circulation generates instability. More precisely, the externalities generated by instability are flying with capital and they circulate around the globe.

The analysis of capital flows usually discerns between long-term (e.g. foreign direct investments or long-term loans) and short-term flows (short-terms

loans or speculative investment). In the neoclassical approach, both flows are supposed to generate positive effects equilibrating the internal production (and consumption), and evening out the risk.

However, this view hardly explains those crises (e.g. Asian crisis) which are associated with the excessive liberalization of short-term capital flows. Moreover, the actual crisis proves that the liberalization of capital flows around the globe has amplified the externalities of financial instability. To internalize such costs, in a long-term perspective, two main actions can be adopted. At first, the architectural framework should include regional monitoring agencies, entrusted with the power to track capital flows; then, a tax policy to internalize short-term speculative flows should be adopted.

One of the main problems is to track flows and assets (toxic or healthy) circulating within a given geographic area. Accordingly, new regional authorities whose primary task is to track information over capital, cross-border operations and assets might be the first step towards a reliable network of international bodies constantly monitoring capital flows. Such bodies, which should not have sanctioning or rulemaking powers, might become the point of reference for national authorities, which indeed are carrying out the supervisory activity. In this sense, capital and financial products should be monitored and tracked not by a scattered system of rating agencies, but by an independent public body that might provide information to national or international authorities.

A similar system is, for instance, set up to fight money laundering and financial fraud. International mutual cooperation is crucial to combating the fraud globally. In this field, national agencies are acquiring the power to share information with their overseas partners enabling prosecution in multiple jurisdictions. This system is supported by a series of Financial Intelligent Units located around the world, whose primary task is to provide assistance to the national authorities. A similar solution might be adopted to track and assess capital flows circulating around the world.

Independent regional bodies, entrusted with the power to gather information, analyzing assets and practices have the positive effect to directly cope with what has turned out to be one of the main disadvantages of free movements of capital. In addition, capital flows can be restrained selectively by using Tobin taxes as successfully operating in different countries. Such tools discourage speculative short-term flows without harming efficient long-term capital flows.

The Tobin Tax has heated several debates since 1974, when James Tobin first formulated his proposal to tax currency transaction. However, this proposal – vividly discussed in several occasions and presented again by James Tobin as a contribution to the UNDP Human Development Report in 1994 – was blocked by

the regulatory culture inspiring the lassez-faire approach that claimed to have weaker governmental intervention in the economy.

The rationale is to regulate short-term round trips, affecting negatively long-term investments, by adopting a uniform fixed tax for each transaction. As a result, short-term repeated operations will be heavily taxed and strongly discouraged.

By adopting a systemic approach necessary to cope with such a global crisis, a Tobin taxation mechanism could have beneficial consequences to the global financial stability by establishing a correct set of incentives that leads towards less speculative finance. While Tobin taxes were mainly considered as a tool to cope with the exploitation of emerging economies, in the actual situation they may become a general policy tool to internalize the externality generated by financial instability.

3.7 Decision-making depends on the institutional structure within which the decision is taken as a concrete exercise of power. Yet, since questioning economic policy as currently produced by the IMF and the WB goes beyond the purpose of this Report, the focus will only be on the IMF and the WB as producers of global law.

It would be pointless to add here yet another voice to the chorus that blames the IMF and the WB for the current global inequitable state of affairs. More important is to approach them as institutional producers of global law by fully emphasizing that most policy decisions are determined by the institutional structure in which they are taken. Both the WB and the IMF display the hierarchical structure of a corporation. Both of them were thought as agencies of economic policy and not of law-making. While the hierarchical structure has remained unchanged until today, the economic policy has been dramatically transformed, especially in the aftermath of the fall of the Soviet Union, when geo-political powers stopped to work as counter-forces to preclude legal intervention in contested political settings. The outcome of this altered context makes an institutional reform process of the WB and the IMF an unavoidable precondition for maintaining or expanding their function. Until such deep structural reform allows them to operate as systems of democratic governance subject to global checks and balances, their role should be marginalized since bad, self-serving, short-sighted policy will be the structurally unavoidable result.

In theory, the WB assists the governments of developing countries in implementing their own customized economic policies and developmental strategies, under what is now called the Comprehensive Development Framework (CDF), set in 1999, which includes the ideas of long-term development strategies, local stakeholder "ownership", and ongoing supervision and evaluation. In

practice the most important vehicle through which the WB exercises a law-making activity is the so called "Structural Adjustment". These "adjustments" to the internal legal systems of assisted countries are necessary (so called conditionality) if they wish to access new loans or decrease interest rates on existing ones. Since the "end of history", Structural Adjustment Programs (SAP) in a regime of conditionality have been used to apply free market policies, such as privatization, deregulation, reduction of trade and capital barriers as well as opening up developing countries to exploitive foreign investment.

Structural Adjustment policies applied by the WB have affected negatively the fight against poverty in developing countries. Although the total number of conditions may have decreased because of sustained critique since the end of the last century, only non-legally binding conditions were dropped, while those legally binding remained unchanged. More than 71% of all grants and loans of the International Development Association (IDA) contained some sort of legally sensitive condition, such as price liberalization, privatization, public enterprise restructuring, abolition of commodity price regulation and subsidies, trade reforms and tariff reductions. Privatization has led to a shift in ownership from local governments to foreign investors in many cases, leading to employment cuts. Promotion of exports and trade liberalization are both trade policies of SAP that have led to ignoring domestic needs in favor of foreign markets (thus producing more unemployment). The imposition of user fees and the downsizing of government spending have reduced the main services available such as health and education services.

Hence, the pedigree of the WB in regard to the new necessary policies at the end of the end of history is very poor. For instance, the WB has played a role in several of the financial and economic crisis of the past - beginning as far back as the debt crisis in 1982. While forcing countries to remove any control over capital or exchange movements, the WB increased the phenomenon of capital flight, tax evasion and corruption. Throughout its lifetime, the WB has financed projects with severe negative effects on the environment especially in the areas of forestry, water and mining. The building of dams has displaced millions, many of them without sufficient compensation and resettlement steps, while forests have been opened up for commercial logging because of road projects.

Nor does it seem wise, considering its past performance, to rely on the IMF. The International Monetary Fund (IMF) was created at the Bretton Woods Conference in 1944 as a public entity whose unique scope was to maintain global economic stability. Originally, the IMF was created as an international institution - "democratic" in some sense, even if only the representatives of the winners of World War II gathered in Bretton Woods (1944). The IMF was based on the theory of the lack of aggregate demand formulated by Lord Keynes, and on the understanding that markets are flawed and that a depression is always behind the

corner. Therefore, it was born as an institution that formally belonged to the entire global community, and whose aim was to prevent unassisted global markets from falling apart. However, well-known circumstances, mostly based on political transformations that followed the abandoning of the gold standard, transformed the IMF into a supporter and guardian of the free and global market and of a laissez-faire approach of economic policy. Ironically, the IMF has been sponsoring economic and legal policies that are exactly the opposite of what it was originally conceived to sustain.

3.8 The IMF and the WB - albeit discrete institutions - are de facto highly integrated partners in the making and execution of the system of global financial deregulation that has severely limited the possibility of legitimized political actors to protect themselves against the spreading of the US crisis.

Born as two separate entities - even if created during the same Conference - the two institutions began working more closely with each other starting from the 1980s. The World Bank for the Reconstruction and Development, which until that moment had been exclusively involved in low-interest rate loans necessary to the realization of international projects, both public and private, became the operational arm of the IMF and the Washington Consensus policies.

The two headquarters, not far from one another, agreed on a new form of cooperative action, according to which the WB would have granted its loans only to those countries that had committed to implement a series of economic, financial and political reforms suggested by the IMF. This determined the birth of the tragically famous structural adjustment loans, and their legislative reforms generally based on the three watchwords of austerity, privatization and liberalization, and on the so-called cross-conditionality.

Given the current situation and its repercussions over the developing countries, the IMF-imposed conditionality concerning the liberalization of the banking system and of the financial markets, should be the object of some second guessing. In fact, one of the typical IMF conditions aims to create a unique and global financial market where capital and securities can flow from one country to another (or to an offshore heavens), without any barrier. Unfortunately, fast and widely unregulated liberalization of the banking system and of the financial markets without an appropriate set of rules and limits also makes the contagious effect of a financial crisis very difficult to limit. This “no rules no limits” policy prevailed because of its ability to increase the profit made by the big financial institutions and speculators. Regrettably, it had a very negative impact over the involved countries. It has been long generally known that, without going too far in the past, the 1994 Tequila crisis in Mexico, the 2001 crisis of Argentina, and the

1997 Asian crisis, were all mainly determined by the possibility for foreign capital to enter and exit without any difficulty. First, the free flow of financial capital makes it a fundamental part of the national economies; then, its sudden withdrawal determines an immediate turmoil of the real economy with all the consequent suffering.

Confronted with this scenario, it is necessary to create institutional conditions that preclude the IMF from imposing the traditional and draconian conditions to its loans, especially to those provided in order to plug the effects of the global meltdown. Furthermore, the privatization and liberalization of the banking and financial sectors, which on average account for almost half of all privatization and liberalization conditions, are at the basis of the spreading of the current crisis so that once again a turning point is needed. Again, institutional conditions should be produced for a change. It is never too late to intervene responsibly. The last twenty years represent only a fraction of modern history, and the faster we act, the easier it will be to stop the ongoing process of self-destruction. Unfortunately, using the Fund outside of a thorough revision of its institutional decision making not only makes the same old policies inevitable, but also produces more self-serving double standards between rich and not-sufficiently-represented poor countries. The only foreseeable consequence of such fundamental continuity is the broadening of the gap that separates poor and rich countries, a scenario that could only lead to stronger global instability.

3.9 The organization of Special Drawing Rights is a short-term response. A more structured long-term institutional reform is necessary now.

One of the six pledges announced by the recent G-20 London summit is to give the IMF an extra $750 billion to distribute special drawing rights (SDRs). While some commentators have described this plan as a strong commitment to help countries whose economies run into trouble, a close look to the history and structure of this financial instrument suggests a certain amount of skepticism. Briefly speaking, SDRs are an international reserve asset whose value depends on a basket of currencies - a sort of credit line that can be allocated to member countries in proportion to their IMF quotas. The IMF created these quotas in 1969 to support the Bretton Woods fixed exchange-rate system, as a reserve that countries could use to buy their own currency in order to pop up its value when downward fluctuation so requires. Soon, as the fixed exchange-rate system collapsed, and all the countries started looking at the US dollar as a trustworthy currency that could be used to build up national reserves, SDRs were abandoned, and the US acquired the central role they have had during the last decades (see *supra* Part II). The scope of SDRs is, in any case, to reinforce national reserves: in

fact, they are interest-free if untouched, while countries pay interest whenever SDRs are converted into hard currencies.

This reserve asset is not a new tool to fight back crises: SDRs were distributed in 1970-1972; again in 1979-1981; and proposed in September 1997, but in this last case the US, with their 16.75% of total votes in the IMF, imposed their veto. Now, the choice of SDRs undoubtedly has geopolitical consequences, but unless something changes in the way they are managed and distributed, a change in the economic perspective will be extremely unlikely.

3.10 The international financial institutions should be reformed in a long-term perspective. Their current role shows the need of a degree of separation of power in any system of global representative government.

There is no doubt that through the "end of history" the role of the international financial institutions has been transformed into a role of unaccountable global economic legislator endowed with tremendous executive power through the leverage of economic conditionality, and outside of any possibility of judicial challenge. This institutional stance explains much of their policy in fostering the interests of the strongest (mostly US-based) transnational corporate power. Consequently, rethinking the role of the international financial institutions today requires a focus on their internal governance to foster representation and to limit the concentration of power.

The description of their voting quota and of their representativeness (or lack of it) shows that it is necessary to redistribute the number of votes that every member country has, because otherwise these institutions will continue to be undemocratic and unrepresentative bodies where corporate interests are imposed throughout the world.

It is structurally impossible for an institution that assigns the voting rights on the basis of the economic power of the member countries to create a new, fair, and widely accepted global system. Because of this impossibility many countries, like Venezuela, have already withdrawn from the institution, but that kind of decision is not what we need right now. To reshape world governance, we need to at least improve the existing institutional system into a new globalized and fair framework where there is an actual possibility for all countries to exercise political discretion rather than simply having to forcefully implement policy imposed from the top down.

To do so, the specific weight of the countries must be increased up to a level that should force the IMF and WB to take into full consideration all proposals and alternative visions - the requests and the needs of all the people of the world. While the first step should be to give a higher level of importance to the BRIC Countries (Brazil, Russia, India and China), the eventual goal is to

establish a public international body that helps the poorest on the basis of their needs, independently and autonomously from the money deployed by the wealthier. The logic of the stronger cannot ground any legal system. Rather, what we need is a public international body that helps all countries on the basis of their needs. In this new logic, among the various proposals that have appeared in recent years is, for instance, the suggestion of a system which, like today, starts from a minimum amount of votes equal for each country (currently in the IMF, each country has 250 basic votes); then, another share of votes could be given on the basis of the population and its life conditions, attributing more votes where life conditions are lower and an external support is needed more; a third share of votes could be finally attributed on the basis of the size of the state economy in the global market. Such a combination, negotiated within the global economic constitution process, would annul the present US power of veto, reshuffling the current priorities and substituting the needs for the power, which is the first step toward a fairer and more equal world.

Moreover, from the legal perspective, one should also observe that the international financial institutions display another very strong structural problem, so that a change in the voting ratio while necessary would not be a sufficient precondition. Based on a hierarchical structure of governance shaped after the structure of a private corporation, and exercising a strong indirect de-facto global law-making power through the mechanism of conditionality, both the IMF and the WB display a severely counter-democratic posture. In a sense, they concentrate legislative (drafting of policies to be implemented through internal legal transformations of member states), executive (monitoring on the effectiveness of the implementation of the policy through tremendously powerful conditional means), and even judicial power (countries can challenge the execution of the policies only through mediation panels *internal* to the very same institutions).

Working out an effort of constitutional creativity aimed at making good of the shortcomings that we have briefly described would be a major aspect of the development of a global economic constitutional framework under the umbrella of the UN.

3.11 Before market liberalization, the Western financial system was based on the strict institutional partition between "banking" and "securities". Socio-economic evolution and technological innovation have favored the legal breaking up of market segregation and the creation of financial conglomerates and giant financial institutions.

The financial systems of most Western countries – starting from the 1930s and for almost six decades – were based on the strict institutional partition between

"banking" and "securities" (*viz* between traditional banking activities on the one hand, and financial activities connected with the sell and purchase of negotiable financial instruments on the other). In the US, segregation was established by the well-known Glass Steagall Act and any country which adopted *de jure* or *de facto* a similar regulatory regime was denominated a "Glass-Steagall Country".

The rationales for segregation were the followings: (1) Banks and securities firms deal with risks which are structurally different requiring different know-how: the former manage credit and interest risks bearing instruments, the latter deal mostly with market risks. (2) Consequently, the balance sheets of banks and securities firms are structurally different: banks' balance sheets have assets and liabilities which are not only illiquid, but also quite heterogeneous - mid-long term assets (credits) *versus* short-term liabilities (deposits). On the contrary, on balance sheets of securities firms we find assets and liabilities which are both liquid and, therefore, basically homogeneous. (3) Customers of the two types of institutions are socially different: banks sell their "products" (deposits on bank accounts) to lower income and less sophisticated customers (account holders); securities firms usually sell their "products" (financial instruments) to wealthier and more sophisticated investors.

The strict partition between banking and securities was mirrored (and it is partially still mirrored today) by a corresponding partition within the regulatory schemes adopted: the main objectives standing behind banking regulation were financial stability and prudential supervision, whereas, as far as securities firms are concerned, the main regulatory objectives were transparency and investors' protection. As a result, banking regulation was a body of imperative rules aimed at ensuring capital adequacy, effective public control and supervision (central banks or other public authorities were in charge of prudential supervision) and protection of the holders of banking accounts. To the contrary, securities regulation was based on the imposition of mandatory disclosure requirements in accordance with the logic of investors' self-protection.

In the last two/three decades, the traditional partition between banking and securities has been eroded. Behind this trend there are both technological and socio-economic reasons.

First, assets securitization has had an unprecedented growth in the last few years: the traditional households' financial savings in advanced economies until the end of the 1970s were still mostly held in the form of bank deposits, whereas nowadays financial sophisticated products are not only held by higher income classes of investors, but also by a growing number of much less informed individuals. Furthermore, technological innovation (development and management of complex data banks) has made it possible to convert traditionally illiquid bank assets into negotiable financial instruments to such an extent that also credits of modest entity (e.g. land credits, consumption credits etc.) are

pooled and repackaged into financial instruments and then sold (the so called credit securitization). Hence, if up to ten years ago small business and households were mainly financed by banks, whilst long-term funding to big business was provided by securities firms, today we can state that this traditional compartmentalization has lost its accuracy.

In the 1990s, the original segmentation was gradually dismantled. In 1999, in the US the *Gramm-Leach-Bliley Act* abrogated the *Glass Steagall Act*; similarly in Europe, EC directives have followed the German model of "universal banks" (i.e. banks whose principal functions are not only to receive demand deposits and provide short-term loans to families or mid-long-term loans to firms, but also to trade in securities, investment funds, private equity funds etc.).

In the last decade, also due to the liberalization of financial activities, we have witnessed: (i) the rise of "financial conglomerates", i.e. financial institutions supplying a range of financial services in the three traditional fields of finance (banking, securities, insurance; the so-called conglomeration process); (ii) the support of the European and American Antitrust Authorities to the consolidation of economic power in the hands of few large complex financial institutions (the so-called concentration process).

3.12 Unrestrained liberalization and market-friendly controls have contributed to the current financial crisis fostering and exacerbating conflicts of interests and pricing opacity.

The mere fact that currently financial conglomerates, in their quasi-oligopolistic position, can combine banking and securities activities exposes the financial system to several structural risks. One of the major risks is undoubtedly the conflict of interests. If, prior to liberalization, banks (to which trade in securities was forbidden) could only purchase financial instruments from third-party financial intermediaries, in the new liberalized regime, the same banks (which now are allowed to trade in securities directly or via other branches of the same financial conglomerate) can freely purchase, on behalf of their customers, their own financial instruments. In other words: prior to liberalization, banks could be considered as impartial disinterested third parties in contracts between securities firms and investors, and so they could act in the interests of weak parties; on the contrary, after deregulation, banks can sell and purchase their own financial products: it follows that they are more likely to act in a self-interested way instead of giving impartial information.

Western legislators have advocated a shift from the old paternalistic and imperative regulatory arrangements (i.e. the original segmentation of financial activities) to a modern, "market-friendly" technique of managing conflicts of interests (e.g. the *Markets in Financial Instruments Directive* - Mifid). Three general principles and tendencies emerged: (i) rules of conduct aimed at

preventing conflicts of interests are to be developed “within” rather than “outside” the market; (ii) there is a duty to disclose an actual or potential conflict of interest; (iii) several activities that would normally create conflicts of interest are deemed permissible if authorized by customers who have been previously informed. We can see that regulators have leaned toward a *self-regulatory* model that could work some decades ago, when mainly qualified investors purchased financial instruments, but it is inadequate to face the current situation whereby financial instruments are widespread amongst common retail customers.

The breaking up of market segmentation and the adoption of a self-regulatory model based on disclosure requirements represent a dangerous attack to the functional pricing of financial activities. The mere fact that banks may act with a simple authorization of customers simultaneously as sellers on one side and as a buyers’ intermediaries on the other implies that the pricing of financial instruments is someway distorted: it is not the result of arm’s length transactions (i.e. transactions whereby the parties act independently and have equal information), and therefore it is easily maneuverable.

This happens especially for unlisted financial instruments that do not have an “official price”. If the financial instrument involved in a conflict of interest transaction is a listed instrument, there is less room left for price manipulation. On the contrary, unlisted financial instruments that do not have an official price are to the highest degree at risk of price manipulation because financial institutions, acting at the same time as sellers (on their own behalf or as intermediaries) and as buyers, can freely set (*rectius* can freely manipulate) prices without any concern about the correspondence between the set price and the real market value - at least up to the moment when the veil of financial illusion will be lifted and the real value of those operation will be brought to light.

It is no accident that the majority of financial instruments that are closely involved in the ongoing financial crisis are the unlisted ones (e.g. securitized sub-primes and derivatives – especially credit derivatives – whose value is significantly above the GDP of Western countries). Mainly with reference to the unlisted financial instruments, the end of segregation between banking and securities has contributed to their uncontrolled introduction into the financial system without any real market price mechanism in place.

The lack of an effective market discipline, together with the “license to manipulate prices” given to financial intermediaries, produced adverse effects throughout the whole financial system. To the price manipulation of the financial instruments sold to customers, the parallel price manipulation corresponds of the same financial instruments on financial institutions balance sheets. A plausible objection might be that while price manipulation of financial products for circulation and to be sold to customers may have a logic (i.e. it is a fraudulent operation at the expense of consumers and to firms’ advantage), to the contrary

the manipulation of financial products that are placed on financial institutions balance sheets is a quite illogic and self-destructive behavior - such operations "make up" the balance sheets, but are easily detectable and very likely, at some point, to come to light. Actually, this would be true if those behaviors were rare and adopted by a single firm, but if the bad conduct is generalized, as it is, for a sort of "herding effect", no financial institution has incentives to abstain from such conducts for fear of facing the unfair competition of misbehaving competitors.

3.13 Mandatory disclosure remedies make information more extensively accessible and affordable to consumers, but they are not alone sufficient to address conflicts of interest and price manipulation.

The typical contract relation between firms/issuers and consumers/savers is characterized by an information asymmetry that market forces alone cannot address properly. The usual remedy adopted to address such market failures is to impose a mandatory disclosure regime (mandatory prospectuses, accounting disclosure etc.) so that the information is freely accessible to consumers/investors. If we consider that financial institutions often act in the face of conflicts of interest and that the only assets given as a guarantee for the fulfillment of the disclosure requirements are the same financial products sold to the public, it follows that they do not have incentives to provide all the relevant information. Hence, if we wish the mandatory disclosure remedy to be functional, the law must provide an adequate sanction in case of breach of the duty to inform, and mandatory disclosure of information must be imposed not only on issuers, but also on other parties that are supposed to act to guarantee a well-functioning financial environment (accounting auditors, intermediary institutions etc.).

The extension of the disclosure requirements to other subjects (e.g. auditors) would transform them into sort of investment advisors, providing investors with all the necessary information, thus leading to a progressive solution of the information asymmetry problem and to a more efficient pricing of financial products. A regulatory reform based on a pure mandatory disclosure regime with reference to listed financial instruments and on the legal prohibition of conflict of interests transactions with reference to unlisted ones would be a less intrusive kind of regulation - if compared to a new segmentation of the financial markets - and would undoubtedly represent a leap forward in the right direction. Nevertheless, disclosure rules are necessary, but not sufficient to address the problems in a correct and optimal way.

Disclosure regulation makes information more extensively accessible and affordable to investors - thus addressing the problem of accessibility of

information - but the information provided might not be sufficient because the many small investors/savers often lack the expertise required to process the data properly. In other words: investors need not only professionals who provide information, but above all professionals who translate the provided information into prices in order to enable them to make good informed choices. To address the problem of the full understanding of information an "institutional buyer" of financial instruments is required who must be free from any form of conflict of interest.

3.14 In order to overcome role confusion, re-establishing market segmentation is a necessary step to effective reform.

Legal reform must have a new segregation of financial markets *à la Glass Steagall*: a reform that is willing to optimally address the problems deriving from conflicts of interest and price manipulation must look to a rigorous segmentation of financial activities, and therefore to a sharp distinction between sellers (firms and firms' intermediaries) on one hand and buyers (investors and investors' intermediaries) on the other.

Such legal reform, in order to be successful, should aim at, and end up with a tripartite compartmentalization of financial services industry into:

(i) traditional banking activities;
(ii) financial intermediation activities in the interests of firms (sellers);
(iii) financial intermediation activities in the interests of investors/savers (buyers).

Accordingly:

i. Traditional banks shall be allowed to combine their traditional "monetary functions" (i.e. collecting deposits and providing loans) with other financial activities (i.e. the management of individual investment portfolios) if and only if, in so doing, they do not risk any conflicts of interest (banks shall not be allowed to trade securities directly, but only on behalf of individual clients). As a result, we would have banks that could effectively address information asymmetry problems, not only by providing customers with all the necessary information, but also by helping them to process the given data;

ii. Securities firms that operate only in the interest of firms (i.e. merchant banks and private investment funds) shall act as professional issuers of financial instruments and shall be prevented from managing individual or collective portfolios (in order to avoid any form of conflict of interests). As a result, we would have those securities firms officially and legally recognized as buyers' counterparts or better as sellers' side intermediaries.

iii. Securities firms that operate only in the interest of investors/savers - collective investments undertakings, like pension funds, investment funds, etc. - shall act as professional buyers of financial instruments, and shall be legally

banned from consulting sellers as well as from issuing their own financial products. As a result, we would have those securities firms officially and legally recognized as buyers' side intermediaries.

Such a reform is unquestionably ambitious, but not completely utopian, if we consider that in the current global crisis the role of regulators is crucial and market segmentation could indisputably contribute to a more efficient and fair pricing of financial instruments, and to the general equilibrium of the global financial system.

3.15 The law should monitor the originate-to-distribute business model. Ex-ante legal control should be provided to guarantee the full understanding of the relationship.

The so-called originate-to-distribute model introduces a notable structural change in the relationship between the bank and the contractor of a loan. Such a model is based on a scheme according to which banks do not hold the credit assets they originate until maturity, but they distribute them to different types of investors through the issuance of structured finance products. The originate-to-distribute model was thought to have made the financial system more resilient by dispersing credit risk to a broad range of investors. Yet, it became itself perhaps a principal source of financial instability. Monitoring such transactions which produce a basic principal-agent problem, and determining in which cases they should and should not be acceptable is a crucial role of the law. Such transactions are fundamentally vulnerable to certain adverse behavior, since agents seek to maximize their benefits, while principals cannot fully observe and control the agents' actions. Thereby, without a legal framework forcing a different distribution of costs and benefits, the incentive for market participants to maximize their revenues may have the following effects: originators reduce their efforts in screening and/or monitoring borrowers and select originated assets in the event of their being sold to intermediaries; intermediaries' interests conflict with investors' objectives of balancing the risk/return trade-off; credit rating agencies (CRAs) are less willing to effect timely downgrades; and servicers are not inclined to adopt the most efficient measures with respect to non-performing loans. Moreover, investors may not have the proper incentives or the technical equipment to conduct their own risk assessment of structured finance products, thus relying excessively on external ratings and failing to play an effective disciplining role with respect to the other actors in the originate-to-distribute model.

3.16 Reviving securitization and its benefits requires deep structural change. However, the reform process does not need to start from scratch. It could draw on from safe and steady financial techniques, such as 'Pfandbriefe' and covered bonds.

Legal reform should address a variety of issues such as: the setting of the threshold of risk and ownership retaining by the originators (with no retention there are no appropriate incentives to screen and/or monitor borrowers and to select assets to be sold to the intermediaries); setting standard contracts for the securitization transactions; enhancing "environmental" transparency of the transactions themselves (i.e. reducing conflicts of interest between originators, intermediaries, and credit rating agencies), determining the appropriate information to be disclosed, and establishing the centralization and timely dissemination of aggregated data.

The reform process does not need to start from scratch. It could draw on from safe and steady financial techniques, such as "Pfandbriefe" and covered bonds. As is well-known, "Pfandbrief" is a German-born securitization technique, whose first appearances date back to the late 18th century. The technique offers Pfandbrief investors a tight-knit safety net. Financial institutions must satisfy stringent requirements in order to receive a license to issue Pfandbriefe. Only a percentage (in German law: 60%) of the originators' mortgage lending value is eligible to be securitized and refinanceable through the Pfandbriefe. The outstanding Pfandbrief is covered by mortgages (or by public-sector loans) of at least an equal amount. These assets are entered into separate registers. In the event of an issuer's insolvency, the claims of the Pfandbrief creditors are privileged by a preferential right in respect to the assets entered into the registers. An obligation (statutorily imposed in Germany) to disclose the key data of the pools on a quarterly basis makes their composition transparent and comparable over time, thereby making it difficult for inferior quality loans to find their way into the Pfandbrief issuers' pools.

Before, and aside from the rise of the lucrative US model(s) of securitization, Pfandbriefe have provided banks (esp. German Banks) with cost-efficient secured financing for over 200 years. The same holds true for the younger covered bonds techniques.

Covered bonds have been developed in many European countries on the Pfandbrief model since the 1990s. They are characterized by the following common essential features which are achieved under special domestic legislations: (i) The bond is issued by – or bondholders otherwise have full recourse to – a credit institution which is subject to public supervision and regulation. (ii) The credit institution has the ongoing obligation to maintain sufficient assets in the cover pool to satisfy the claims of covered bondholders at

all times. (iii) The obligations of the credit institution in respect to that of the cover pool are supervised by public or other independent bodies.

Covered bonds and Pfandbriefe are backed by identifiable and legally "ring-fenced" pools of loans. They remain on the balance sheet, so that the bank retains the ultimate credit risk and is encouraged to maintain loan quality. During the market turmoil, in particular until mid-September 2008, the relative resilience of covered bonds was demonstrated by the European Central Bank, especially once compared with other forms of asset-based finance – such as the US model of securitization – associated with the "originate-to-distribute" model. Moreover, the market for covered bond and Pfandbriefe is known for its comparatively high transparency standards (as originators' organizations frequently calculate indices for the whole market and sub-indices), and does provide a less complex alternative to outright securitization.

When US authorities launched an initiative to encourage the use of the above European techniques by US banks, it was already too late.

3.17 In recent times, the growing complexity and interrelation of financial markets' segments has induced firms operating in various jurisdictions to establish financial conglomerates, in which the insurance business is conducted within the same group, alongside other financial activities, such as banking or financial intermediation.

Significant challenges have to be faced by prudential insurance regulation and supervision worldwide. For instance, in order to avoid double gearing of capital or the risk of contagion, a close collaboration and mutual understanding between different authorities (or different divisions within the same authority) in charge of the regulation and/or supervision of different financial markets' segments is required.

When financial conglomerates are also multinational groups, such difficulties are further exacerbated. The cross-sectoral and trans-national nature of modern financial-market players, in fact, greatly increases the risk of regulatory gaps and regulatory arbitrage. The case of the American International Group (AIG) tells us a lot, since the core insurance activities duly performed worldwide were "poisoned" by the catastrophic results of the US "financial arm" of the Group which issued - taking advantage of the fact that derivatives markets, unlike insurance markets, are mostly unregulated in the US - a high volume of credit default swaps (CDS) to European banks and other protection buyers without setting aside sufficient reserves to cover the undertaken credit risks.

On top of that, the core insurance function of risk pooling, diversification and spreading is greatly enhanced by the use of reinsurance and retrocession. Risk

securitization, moreover, is yet another means to further spread the risks, and to increase the available financial capacity, especially with respect to the coverage of peak risks (e.g. catastrophic risks). Since the reinsurance, retrocession and risk securitization markets are global in nature, it is more and more often the case that risks are transferred across jurisdictional borders. The resulting complexity and interdependencies generate the need for a coordinated international and cross-sectoral regulatory and supervisory approach.

Key questions include:

- How best to achieve an effective global cross-sector coordination and information exchange between regulatory and supervisory authorities?
- To what extent are insurance companies still taking up risks from other segments of the financial markets (such as credit and/or liquidity risks from banks)? How are they managing such risks?
- To what extent are insurance companies taking into account the potential impact on their portfolio of global emerging risks, such as those posed by climate change and by the interdependence of critical networks?
- Will insurance companies that currently offer retirement products (such as annuities) be able to cope effectively with longevity risk worldwide and finally meet their obligations?

Furthermore, the transfer of insurance risks to capital markets via risk-linked securities poses additional regulatory and policy questions such as:

- Under what conditions and to what extent should insurance-sponsored SPVs be exempted from prudential regulation?
- Under what conditions and to what extent should insurance/reinsurance companies be allowed to take credit for risks ceded to investors via (on-shore and off-shore) securitized deals? Is there a risk or regulatory arbitrage?
- Under what conditions and to what extent should the development of a secondary market for risk-linked securities be encouraged? Are we comfortable with the idea that such risk-linked securities (covering e.g. catastrophic risks posed by natural hazards) could end up in the investment portfolio of households and individuals?

The relationship between the regulatory/supervisory authorities and the regulated/supervised entities is another key issue in this field. While it is certainly very important to establish a direct and close relationship with top management based on mutual understanding and trust, the risk of capture must be controlled. In this respect, the new wave of risk-based solvency standards (e.g. Solvency II in Europe), placing a high degree of reliance on internal risk models may pose additional questions such as:

- Are insurance regulators and supervisors in all relevant jurisdictions in a position to fully evaluate and appreciate the reliability of internal risk models?

- Are there significant information asymmetries that may undermine the effectiveness of supervisory activities?
- Is the risk of capture sufficiently controlled?

Insurance regulation, however, is not the only prudential regulation. There are a number of other areas in which the legal, regulatory and supervisory frameworks for insurance will play an increasingly important role to ensure the proper functioning of the market and to enhance market confidence.

Monitoring claims management practices, for instance, is a fundamental step: the fair, efficient and speedy adjustment of claims is essential to the protection of the interests of policy holders and insured parties, especially where the private insurance sector is taking up roles that should be played by the public sector (e.g. in the fields of health insurance, natural hazards insurance, retirement products).

3.18 Ensuring transparency of insurance contracts is another key objective of an effective legal and regulatory framework. However, one should be aware of the ideology according to which in every domain of life uncertainty private insurances are good substitute for public institutions.

As regards the retail insurance market is concerned, culture widely varies across jurisdictions and decisions made under uncertainty by prospective policy holders are very often affected by cognitive biases. While education and awareness campaigns in this field to introduce or strengthen a risk management culture are advisable, they certainly cannot allow the creeping reproduction of the caveat emptor principle. Potentially tricky insurance products should be banned by hard law.

Too often in the past, "sensible" risks were progressively shifted from the public budget to that of households and individuals on the assumption that private sector solutions, such as insurance, are available to cover such risks. While the availability of the private sector should never be a reason for the public sector to shrink, it is particularly important that at least the following measures aimed at limiting abusive profit-seeking private behavior are taken:

- explicit coordination schemes between the public sector and the private insurance sector (such as private-public partnerships) to ensure consistency with policy objectives, enhance the degree of reliability and trust, and achieve a clearer allocation of the respective duties and responsibilities;
- behavioral bias and systematic deviation from the rational-choice paradigm in the policy holders' decision-making process must be fully assessed by policymakers (the decision to purchase protection for their assets against natural hazards, for instance, is rarely made by individuals according to rational

criteria). In this perspective, behavioral bias should be incorporated into policy analysis when setting up explicit coordination schemes.

3.19 With the financial crisis, rating agencies have come under repeated criticism, either for poor responsiveness and delays in modifying ratings in view of market developments, or for the abruptness of unexpected downgrades. Their role should be limited and their activity monitored.

Rating agencies function as private soft-law makers. Lack of legal instruments left such agencies free to compromise the quality of their processes in order to grab or defend market share in a booming environment, with the volumes and complexity of securitizations sharply on the rise in the years to 2007. Conflicts of interest in their relationships with their clients aggravated the situation.

In the US, a regulatory framework for credit rating agencies' activity exists since 1975, reinforced by the 2006 Credit Rating Agency Reform Act. The 2006 Act aimed to foster increased transparency, accountability, and competition in the credit rating agency industry for the benefit of investors. It enhanced the SEC's regulatory authority over rating agencies in several areas, requiring the SEC: to establish a registration process for credit rating agencies; to impose disclosure and filing requirements on credit rating agencies seeking registration; to prohibit certain activities of registered credit rating agencies; to censure, deny, suspend or revoke the NRSRO registration. Although this regulatory framework has not prevented the agencies from ill-performing their role, in 2008 the European Commission followed the US model through a proposal for a European regulation on credit rating agencies.

The point is that both the US and EU regulatory approaches content themselves with focusing on the lack of competition in the rating market, on the absence of transparency in rating processes, and on the conflicts of interest inherent in the rating process. Their implied assumption is that market discipline, in the form of fear of loss of reputation, does (or at least should) provide the right incentives for high-quality ratings. According to this school of thought – to which, to nobody's surprise, credit rating agencies fully adhere – investors and issuers can only accept reliable and serious agencies' conduct in the long run. Once again, the creed is that the market can always regulate itself.

3.20 The highly favorable legal regime shielding rating agencies from liability should be radically transformed. The possibility to establish an international not-for-profit public or quasi-public institution to carry on reliable rating should be explored.

The mere existence of many competitors does not guarantee quality unless there is something causing high-quality producers to benefit and low-quality producers to suffer. Despite this obvious point, so far regulatory authorities have focused on measures to improve rating agencies' incentives and to adjust investors' degree of reliance on agency ratings, and showed no interest in considering appropriate disincentives or constraints to rating agencies' misbehavior, and in devising or enhancing remedies providing direct relief for low-quality ratings.

Striking! Rating agencies are everywhere almost immune from any form of liability. In Europe there is no case law in point, while US courts have failed to recognize the *de facto* regulatory power of rating agencies within the market, equating their ratings to mere opinions, thereby imposing liability on the agencies only when they were found to cause the intentional harm.

Rating agencies should bear significant liability for their misconduct, where "significant" means that liability should be dependant on the negligent breach of a pre-determined (and revisable in the course of time) set of duties. Beyond stay or stop of the activity, agencies should be liable for compensation, disgorgement, and penalties, whose amount should be linked to a fixed multiple, and imposed not to benefit plaintiffs but to feed an international fund to be set up with the aim to compensate victims of financial entities that become insolvent and leave investors holding an empty bag. Third-party insurance coverage should be imposed upon the agencies, also to set a market user- friendly threshold for the agencies' choice to leave, or to keep playing into the market.

Finally, for the activities carried on by the rating agencies, which have a sweeping and truly global impact on the whole of the economies of states and inhabitants of the planet (and this should apply to any financial activity), there might be the case for contemplating a global public system either in the form of ex-ante sweeping controls or in the form of of independent organs made up of independent experts representing all the areas of the world where the activity at stake has had a harmful effect.

3.21 In the last couple of decades, the shareholder's model of corporate governance has gradually become the dominant mode of organizing listed corporations in the world. This structure is responsible for distorted incentives and weak regulation favoring shortsighted and often predatory corporate choices. This supremacy of optional contract-based law over regulation should be stopped and radically inverted.

Since the beginning of this century, there has been a movement of competitive convergence of corporate governance systems throughout the Western industrialized world. In our vision, such convergence must be understood as a rush to the bottom. It has displaced and marginalized other models of corporate governance structurally more effective in taming opportunistic and predatory corporate behavior.

The path of convergence was based on the common concept of a public corporation, which despite the apparent divergence had achieved a high degree of conceptual uniformity in all jurisdictions. However, institutional differences in governance, share ownership, capital markets, and business culture have been, and still are, quite significant. Four models have been competing with each other: (1) the manager-oriented model (US in the 1950s and 1960s); (2) the bank and labor-oriented model (Germany and Austria); (3) the State and family oriented model (Italy, France, Spain and Asia); (4) the shareholder-model (US and UK since the 1980s and gradually Continental Europe since the 1990s).

In the last decade, there has been an open debate on the shareholder model as corporate law's end of history. Some authors cited among the reasons for the supremacy of the shareholder model the followings: the weakness of all the alternative models; the competitive success of contemporary British and American firms; the growing influence worldwide of the academic disciplines of economics and finance; the diffusion of share ownership in developed countries, and the emergence of active shareholder representatives and interest groups in major jurisdictions; a superiority, as yet unproved, of diffused shareholder's structures over concentrated ones as far as cost of capital and value creation are concerned. We add to these considerations a number of factors which are fostering shareholder-style capitalism in European markets, such as: the homogenization of large firms' behavior (in accounting standards, corporate finance and strategic planning) due to influence of international investment houses, consulting firms and rating agencies (discussed supra) and to the de-listing of large European corporations on the New York and London Stock Exchanges; the growing number of strategic alliances, mergers and acquisitions among firms of different nationalities, including trans-national equity agreements, which are mostly based on international standards, where Anglo-American modes

are dominant; privatization which greatly increased the number of European firms listed on national and international markets, including former state-owned companies with very large market capitalization; a large participation of Anglo-American investors on the pan-European equity markets; last, but not least, the equity shift of private portfolios from governments bonds into equity investments, which has gradually introduced an Anglo-American-style equity culture among European investors.

Disagreement continues among scholars on the timing and modalities of the global process of Americanization of corporate structure and governance through the periphery and semi-periphery. Clearly, the current crisis should lead to *very serious* questioning on the soundness of the dominant model of corporate governance, which has been behind much of the unrestrained predatory activity, including the trend to over-compensate the managers. Naturally, a whole academic industry mostly active in top US research institutions has provided mainstream scholarly legitimacy for this rush to the bottom, exporting its vision to weaker geo-political contexts through World Bank's development reports.

As well known, Anglo-American globalized corporate governance puts the maximization of the shareholder's value at the centre of the stage. This model is "light" and contractual in its form. It has been described as a mere "nexus of contracts" – which conceives efficiency primarily as the maximization of value of the firms' shares. "The firm" must be preferred to "the market" as a place of production only on efficiency grounds.

Such a model is characterized generally by a total absence of social responsibility. The management is contractually linked only to the shareholders and not to the workers and the social context of the activity. The firm is abstract, its playground is the world - its efficient strategy is to mimic a zero transaction-cost market. All of this is incompatible with a social reality made of real people in real settings, to whom you might owe a long-term commitment. The only counterpart is the consumer - another abstract reduction of the human experience into a one-shot deal of selling and buying. The "shortermism" that has characterized the managers' behavior in the last few years naturally follows from this conception.

The managers of the firm are "winners" if they maximize the value of the shares, which is directly related to their huge bonuses and stock options. Labor is a mere input in the process of maximizing the value for the shareholders. The firm is efficient if it minimizes the cost of labor (and other social or environmental costs) by discharging such cost directly on the community, and minimizes the cost of capital under the logic of share-value maximization.

For some scholars of the law and economics paradigm, such a model represents "the end of history in corporate law". Indeed, during the global process of privatization at the end of history the Anglo-American model of corporate

governance was transplanted in most European, Latin American and Asian settings. This light model turned out to be a failure, not only for the economy and society as a whole, but also for the long-term value of the firms themselves. We therefore need to rethink the very foundations of such a conceptual apparatus ultimately based on the dominance of incentives over regulation.

3.22 Short from obeying the logic of economic democracy, the public company structure actually encourages the concentration of irresponsible power. The system of "public companies" in the UK is run by a group of few major financial institutions; individuals and households have no direct role in the governance of the system.

At the end of history, within the massive effort to privatize global economies the "public company" was represented as the best of all possible worlds. Its destiny would be to achieve the so-called "shareholders' society", where millions of citizens played an active part in the strategic choices of the firms, through a democratic mechanism of votes in the general assemblies and by nominating their representatives to the boards of directors. In this "dream", an aggregate of selfish individuals would actually work for the public good (represented by economic growth) because of their direct holding of shares and of quotes of investment funds, insurance companies, and pension funds. Shareholders were then supposed to be part of the life of the firms via two possible actions: either by "voice" (representation in the governance of firms), or by "exit" (by selling the shares of firms which were "badly" run).

Why did this "dream" turned out to be a nightmare? First, the shareholders are not "citizens" of the firm. They do not have any real interest, let alone competence, to have a voice in the managerial and strategic choices of the firms. Their only real interest is in the value of their investments (or pensions). Second, even where there is a genuinely diffused shareholding structure, through systems of collection of voting rights, the decisions on the governance of the listed companies in the US-UK are in the hands of the few - no more than 10-15 very large financial institutions, which are related to each others through a system of cross-holdings. The system works in a way very close to the typical logic of British clubs. Power always tends to be concentrated at the top. Whenever a firm is going through a major strategic choice, or is not run according to a given vision, this group of financial institutions enters into the shareholding base of the firm to take control for a limited time span, until the "change" (of management or of strategic direction) is made. The following step is obviously to cash in the capital gains by selling the controlling stakes. Recent empirical studies on the temporal evolutions of shareholdings' structures on the London FTSE have confirmed the workings of such a mechanism, showing how a much increased institutional

ownership of UK equities has come mainly at the expense of the direct holdings of individuals.

3.23 Very different models of ownership structure of the systems of large corporations characterized the rise and decline of 20th-century State-owned enterprises in Europe. Basic structural elements of that experience, dismantled in the privatization frenzy at the end of history, should be used in the new public intervention required to overcome the negative effects of the crisis.

The end of history was characterized by major privatization programs. A large part of the industry and banks belonging to States was transferred to capital markets. A profound transformation in the role of the State in the economy occurred in most industrialized countries.

Mixed-economy systems began to emerge in Europe in the 1920s and 1930s, mainly in France, Italy, Spain and Great Britain to save some major firms from bankruptcy after the 1929 international financial crisis. Afterwards, however, their role gained importance and eventually became an essential mechanism of 20th-century European economy. The underlying common belief was that the State should take responsibility for national industrial growth. One of the main arguments was that infant industries in major sectors (steel and iron, telecommunications, energy, infrastructures, aerospace, defense and, in general, high technology) needed greater investments and managerial capacity than private capitalists and capital markets alone could provide. It was also widely believed that a certain amount of protection of new industries had to be provided by the State before exposing them to international competition, and some infringement of the liberal rules of international economy was necessary if structural conditions for the "take-off" were to arise. Accordingly, in his *National Self-Sufficiency* (1933), John Maynard Keynes declared his personal, moral and intellectual disassociation from 19th-century theories on free trade, and helped mercantilist logic regain a new dignity.

After the Second World War, a second wave of nationalization of the main European economies occurred, with added social goals such as full employment. So, the tendency of modern capitalism to introduce planning elements in the running of the economy offered updated instruments for economic post-war nationalism. At this point, however, interventionism also aimed at making national monopolists competitive on the international markets, since they were thought to be ready for it. As well as using macroeconomic instruments to protect the economy (control on prices, on foreign exchange, and on the discount rate), major European governments established a panoply of industrial/political tools to bolster growth, such as subsidies, public job orders, mergers of various national

firms working in areas of national interest, control of foreign investments, a reduction of export fees, and so on, in order to favour reconstruction and new industrial growth.

In many European countries, state holdings included industries of basic and strategic importance, such as energy and transport services. Moreover, public ownership was not confined to the State. Lower public authorities also owned (and still do) enterprises. Examples are the Länder of Austria and Germany, the Regions in Italy, and local authorities virtually everywhere.

The Public Enterprise system in Europe was a very successful model until the end of the 1970s. Its dismantling was less the product of a wise evaluation of pros and cons, than of an ideological turning point. From the mid-1980s on, privatization became mainstream all over Europe. The European Union played a crucial role in fostering privatization, with its free-trade politics at the basis of the formation of a single European market that supplied all the countries with a common conceptual picture and neo-liberal theoretical paradigm. While the Rome's Treaty left each country free to decide on whether companies should be publicly or privately owned, the principal economic reasons for the choice of public ownership were successfully challenged. This conceptual picture - borrowed from the experience of the US and the UK, and strengthened by the European Commission's increasing role in anti-trust policy - caused the transformation of ownership systems and financial markets in all European countries. Since the State was variously prevented from helping companies, companies turned to private capital markets. Moreover, public ownership was thought to render the international alliances games more difficult and contribute to the under-valuation of state-owned companies' stocks. A number of other factors had paved the way for privatization: the excessive costs of social security that weighed heavily on a public financial balance already in deficit; the internal crisis of the public enterprise; the enforcement of European competition policy; the wide belief that the private insurance business could provide social welfare.

3.24 The case of self-management schemes in former Yougoslavia - overstretched for ideological reasons - shows that even desirable ideologies need to be appreciated in practice. Like neo-liberal orthodoxy in Western Europe, self management was put above critique and consequently produced paradoxical results.

We now know, "at the end of the end of history", that many sectors that were hastily privatized – especially in the public utilities, in the large strategic corporations and in the banking systems – did not deliver the promises emphatically claimed by the neo-liberal supporters of the privatization process. The time certainly is now to rethink the role of the public sector in the large and

medium industrial and financial corporations, and to introduce some structural factors that might avoid the waste of the massive amount of public money that is currently introduced into the system.

Creative legal structures must be conceived of only after acquiring full knowledge of the large menu of options available to create a system of corporate governance capable of reflecting the needs of stability and long-term quality-based sustainable development. To do so, the menu should be wide open and include experiences that, in the decade of market fundamentalism, were transformed into taboos. From such an exercise of humble reflection on a too hastily condemned past, we can learn something important for a long-term future.

Of course, every institutional experience must be appraised in its own context. Let us look briefly to a governance model which comes from the examples of Tito's Yugoslavia. For decades, it was possible to experience a rather fervent response to the Soviet type political system and economy. Labor's self determination was put at the center of the scene. Labeling the Soviet system as "State capitalism", Tito and his followers put on their flag "self-management", and the idea that decisions should always be crafted by those who are directly concerned. Hence, there were worker's self-management and "organizations of associated labor" instead of corporations or State enterprises. Participation as an indispensable element of human dignity was also stressed: people who participate in decision-makings will not be reduced into robots, incapable of facing unexpected circumstances requiring flexibility and creativity.

The experience of a law student might show how self management, a subject regularly thought in law school would work in practice. Teachers decided about the curriculum, teaching load, appointments, deans; teachers – together with staff, including janitors and cleaners – decided about salaries, reconstruction of the building, and many other things. Materials were prepared for meetings, and students were supposed to read them. Had they participated at all meetings – and had they read all materials – this would have taken not much less than a third of their working time. But students, as any other social group, were also a part of the self-management structure of the building where they lived, and they were supposed to attend meetings at which it was decided on most efficient ways of handling garbage collection, repairs, installation of TV antennas, and on many other emerging problems. Students were also a part of a self-management structure deciding on research priorities and channeling of funds. There were such "self-management communities of interest for scientific research" at provincial level (e.g. Vojvodina), at regional level (e.g. Serbia), and at State level (Yugoslavia). Everybody was also a part of the self-management structure in the part of the town where they lived, part of the self-management structure of the school of their children – and part of many other self-management structures. According to certain calculations, each citizen would have needed between 23 to

28 hours per day just to observe all self-management rights and duties. But it was hardly possible to raise such a question. You had to believe in self-management (rather than to analyze it seriously).

It is difficult to know whether it would have been possible to organize self-management in an efficient way while remaining within the realm of rational time. The question had to be raised in order to be addressed, which did not happen at the time. As structural problems were not spelled out and faced, self-management was to a large extent hijacked. Rights that in principle belonged to the "self-managers" (the owners) were mostly exercised by the managers and the party.

Quite paradoxically, the same happened to the ideology of market fundamentalism until the current crisis. People believe in it – instead of analyzing it seriously. People believe in the rationality of a mechanism (particularly when it is juxtaposed to Soviet type communism after the fall of the Berlin Wall), without even trying to comprehend its actual structure. We needed a disaster in order to give some room for doubt. In addition to disasters, we need dissidents. (This is also something we all learned under communism.)

It has been obvious for some time that present day capitalism displays severe structural irrationalities. Also obvious is that it is impossible to get any improvement if one continues to be in denial of such irrationalities. (Just as under communism, where "taking away from the kulaks" was the paradigm of rationalization – even when there were no more kulaks, and when bureaucracy presented a rampant irrationality.) Let's briefly look into the paradigmatic case of Bob Nardelli, the former CEO of Home Depot based in Atlanta. He took over in 2000, and since the first year yielded some difficulties, he resorted to the pattern of rationalization that was dominant (in Yugoslavia, they would have said "which was on the party line"), and turned to "downsizing". This meant the firing of about 200 employees (including many cashiers). The yearly salary of these employees was between $20,000 and 25,000. Hence, his rationalizations saved about 5 millions. This may make some sense, until compared with his CEO salary, which was $156 million per year - equivalent to about 6,000 Home Depot workplaces. Had his salary been reduced to a still outrageous 150 million, there would have been no need to fire anyone. (Also, Nardelli was probably more responsible for the bad year than the cashiers.) But downsizing CEO salaries (rather than jobs) would not have been in accordance with the "party line", hence was not an option – just as reducing bureaucracy for the sake of rationalization was not an option under Stalin. When Nardelli was fired in 2006, he received a severance payment of 210 million. He later wound up in the automobile industry, as a top manager of Chrysler.

Since last year the irrationalities are less hidden, and it seems that the "party line" is not as unimpeachable as it used to be. What has become an issue is

that Wall Street distributed $18 billion in bonuses in 2008. This is actually the equivalent of more than half a million jobs. Furthermore, this was not a one-year event (in 2007 Wall Street distributed bonuses for $32.7 billion). In the experience with self-management, corrections and rationalizations were hardly possible, because this would have presumed spelling out and facing irrationalities. We hope this will be possible this time around. Our knowledge is limited (probably even more limited than with regard to self-management), but let us try to contribute by way of spelling out some ideas.

3.25 A significant number of irrationalities affecting the current corporate governance structure are located in property theory - especially in the paradigm of individuals' rationality when following their self interests. To this, it is usually added that the interests of the owners are in line with the interests of the consumers.

Let us mention a few stumbling blocks that make the functioning of the dominant model of corporate governance difficult in present times: Can the owners do what they want? Not really. A key issue closely linked with (the chances of) rationalization is the balance of rights and duties between owners and managers. Increasing shareholder's power is one of the proposals already on the table, and it deserves attention. While it is not entirely clear whether the interests of the owners are necessarily in line with rationality, it has become clear that the interests of the managers are often not – at least not within the present regulatory framework. In his lecture to the Columbia Law School Federalist Society on November 24, 2008, Judge Posner stated that boards of directors are hardly reliable agents of shareholders, and pointed out that managers were actually acting rationally (in line with their own interests) while leading corporations towards disaster. It is obvious that these premises have to be changed. If incentives are misaligned, this should be perceived as a systemic irrationality rather than an expression of freedom.

It is also important to observe that in those (not many) cases in which outraged shareholders tried to obtain some legal remedy against managers, the existing legal framework made this often impossible. In the (in)famous Walt Disney company Derivate Litigation case, the shareholders sued the managers for breach of fiduciary duty by way of choosing a most unsuccessful CEO – and for giving him after 14 months a $140 million severance payment. The Delaware Court found that there was no remedy under the existing rules. An interesting (although not really persuasive) thought in this judgment was that one cannot and should not measure corporate behavior *ex post* with those more demanding standards that were shaped after the ENRON and World Com scandals. In his

statement of reasons, Judge Chandler was quite apologetic, but this did not change his position. His judgment was confirmed by the Supreme Court of Delaware.

The truth of the matter is that owners are neither informed nor qualified enough to make decisions within the corporate structure. Corporate structures and ways of dealing are getting more and more complicated, and less and less transparent. One of the essential findings of the Powers Committee which analyzed the circumstances of the ENRON scandal was that ENRON did not make its activities transparent and understandable for those who read financial reports. In sum, owners simply did not understand what was going on. Hence, even if they had power to make decisions, they were not in a position to do so. What is even more important is that this was not just a bizarre idiosyncratic situation. Lack of transparency and lack of preconditions for comprehension is quite typical. This leads to a situation in which the majority of decisions are guided by fashion, or belief (or "party line"), by "heard mentality", rather than by rational choice. It is difficult to see how capitalism can be rational if the owners are deprived of the opportunity of making rational choices. Making corporate dealings fully transparent and understandable is probably not possible. A considerable improvement of the present situation by way of legal norms is probably possible.

Today, a huge number of owners are simply unaware of their ownership. People have portfolios, which tend to be diversified, and which are handled by agents and banks. Shares in these portfolios are, of course, proofs of ownership, and the owners will gain or loose money as a consequence of their ownership. But typically they do not really know what is exactly in their portfolio – and even less do they feel entitled or obliged to act as "real" owners. This type of ownership covers a considerable territory of the economy. It is clear that the mythology of ownership-based rationality has no soundness in this territory.

This circumstance puts again into focus the power of managers, and the issue of control over managers, when a significant part of the owners does not even have a voice (because they are not even aware of ownership). A recent article in the Washington Post claims that many companies (including Google) allowed executives to exchange sharply depreciated stock options for new awards with more generous terms. The article mentions that "the companies argue" that this is "necessary to retain and motivate personnel". The question is: Who actually articulated this concern? Who are "the companies"? The owners?

One could link to this question another one. Has the number of fired unsuccessful executives come anywhere near to being proportionate to the disastrous results accomplished by them? Again, who are the companies?

We would also like to raise a different (though not unrelated) issue. Two years ago, a new course at the International Business Law Program of the Central European University in Budapest was introduced. The title of the course was

"Human Rights in Corporations". It has been a very positive experience, and we would like to suggest that such a course should be an element of law school curriculum. Corporations have obviously become important and powerful enough to determine one's life and human rights. Contemporary human rights problems cannot be fully analyzed if they are only perceived in juxtaposition with States. And, as we have already mentioned many times in this report, education is the key element in any long term endeavor.

In fact, one of the main shortcomings of the shareholder's value model of capitalism is its short-term horizon. It is important to introduce a long-term view of bank/industry relationship and corporate governance. To do so, it is essential to restructure the best of all historically tested models, be it the European social model of capitalism or the self management model of the former socialist world. Sustained investment in a global social capital may produce the kind of mix that is desirable for the challenges of this century.

3.26 The process of labor commodification, reflected in its legal organization, was exacerbated at the end of history. There is a global urgency to reverse this process.

The weaker the legal system, the less capable it is to tame the process of commodification of human beings. Globalization has exacerbated this process. Cheap labor stuck in poor countries by the artificially produced barriers of immigration law is today one of the most important inputs of the global productive process. Not only powerful economic forces but also many different legal strategies have facilitated this process, whose result is to transform a large portion of the global society into objects of production rather than subjects and human beings.

3.27 The separation of labor law from commercial law institutionalizes a division of the cooperative surplus that is unfair and unsustainable. Any benefits of financial capital mobility must always be synergized with the realities of social capital mobility.

From the economic perspective the productive process within a firm is a cooperative effort. Its hierarchical organization and the always increasing tendency to outsourcing of the activity into very competitive markets which require quick decision-making have produced an almost watertight distinction between decision makers (the management and the corporate organs) and subordinates, which as any other productive factors are the object of the decision. Commercial law and labor law have consequently reflected this separation, the former being devoted mostly to the process of corporate decision making, while the latter dealing mostly with the issue of "protecting" these human factors of

production while at the same time guaranteeing the "flexibility" of the labor market - striking a balance that should avoid class conflict to disrupt production.

What lawyers see as "labor law" today is generally confined to the regulatory structures that define and organize collective bargaining among various sub-groups of employees and employers. Some systems distinguish labor law from employment law as regulating the respective rights of individual employees and their employer. All capitalist legal systems reinforce the distinction between subjects and objects of the economic decision making by distinguishing labor law from corporate and commercial law, as regulating the organization of capital in various enterprises entities.

There are two structural principles that are needed to guide a forward-thinking integration of modern economic law, especially with regard to labor and corporate law. The first is that the benefits of financial capital mobility must always be synergized with the realities of social capital mobility. Even if, and this an empirical question, increases in financial capital mobility yield marginal increases in economic efficiency and growth, this has to be weighed against the distributive meaningfulness of such returns, but more importantly against the time-series specific impacts on quality of life that such mobility generates through economic instability. In short, Schumpeter's creative destruction taken to its extreme logic yields a life that is chaotic, uncertain, and ultimately undesirable. If the degree of financial capital mobility is used to define the regulatory logic of an economic system, it will invariably generate economic conditions that exceed the adaptive capacity of social capital, and consistently lead to the traumatic shocks people are facing around the world.

At the same time, the classic distinction between holders of labor and capital itself must be rejected as a structural principle that is again neither ontologically necessary nor socially desirable. The critical distinction between corporate and labor law is predicated on the incredible inequality in financial capital distribution during the 20th century. While certain institutional investors, most notably pension funds, represent accumulations of individual financial capital, they have neither acted nor invested with substantial deviation from any other economic actor. Because of the overall systemic logic, such actors have failed to promote conditions of economic justice and are not truly accountable to their individual constituents. A closer practical integration of labor and capital is the key to promote sustainable, community-driven wealth as well as a more effective internalization of enterprise externalities. Here, the two principles mutually reinforce each other: increasing integration between labor and capital in the wider sense serves to effectively and productively reconcile financial capital mobility and social capital mobility.

3.28 Alternatives aiming at the birth of a sustainable global economic law should be explored. Systems of co-decision, profit sharing and employees' ownership structurally facilitate long-term sustainable corporate decision making.

There are four extant regulatory alternatives that have been either marginalized in the mainstream labor/corporate law dichotomy, or de-emphasized in the last few decades of excessive transfers of regulatory power from public to private actors. Such alternatives have to be considered as better practices to be implemented by global labor law.

The first and least radical alternative is a shift away from the focus on collective bargaining on the individual corporate level (which is the global tendency given the trade unions' increased weakness) towards global industry-based bargaining units. While still problematic - given its perpetuation of the labor/corporate conceptual distinction - a large-scale social negotiation can in some way address real issues of long-term sustainability and quality of life for people. This represents in various shades the most successful traditional collective bargaining arrangements, including the effectively national-level bargaining in Scandinavia and the industry-level bargaining in pre-1996 Australia.

Moving progressively out of the traditional labor law paradigm is the proliferation of effective systems of corporate co-determination – giving workers or unions a real vote in corporate decision-making. For a long time an aspect of German corporate governance, co-determination has been fiercely resisted globally and not just as part of the recent trends in economic politics, but throughout the 20th century (the fate of the EC's Fifth Directive on Company Law illustrates this well). By diversifying the stakeholders in corporate decision-making, co-determination adds another powerful actor to monitor intra-firm management as well as alter the longitudinal-time horizons of corporate decision making. Both of these dynamics militate against exactly the type of insular, short-term cognitive fallacies that helped generate the current financial crisis, while underlining the necessity of strongly linking economic production to people's welfare instead of considering it an end in itself. This critically subverts the labor/corporate law distinction by creating a more holistic, and realistic, regulatory scheme that more broadly addresses the effects and justifications for enterprise activity.

The next two regulatory possibilities seek a more radical break from the traditional labor law paradigm. The first is the robust promotion or mandated provision of scheduled profit sharing and workplace reinvestment. A primary assumption of traditional labor law was that wages were the static outcome of the bargaining process grounded in the inherent antagonism between employee and employer. This grew out of assumptions in classic political economy related to bargaining power and static profit pools. Furthermore, it created the justificatory

illusion that wages defer all enterprise risk to capital, while in fact they contribute to systemic economic instability by removing employees from intra-firm monitoring and decision-making, and towards managerial agents with increasingly short-term time horizons. Coupled with limited liability for capital investment, a lack of profit-sharing moves most people into a context where they cyclically suffer the harshest practical consequences of economic downturns and the least benefit of economic upturns, witnessed by the growing rates of global and national inequality and wage stagnation in developed economies. Moreover, the advantages of profit sharing for enterprise activity are increased when at least some profit sharing is encouraged in workplace reinvestment. However, this also exposes the limitations of profit sharing when decoupled from direct governance mechanisms such as co-determination, as the diversification issues related to 401(k)'s have recently exposed in the US.

The final and more coherent expansion of the profit-sharing option is the promotion of systemic employee corporate ownership. This option largely vitiates the labor/capital distinction by creating an economic reality where capital itself it distributed equally enough, so that the labor/capital distinction is obviated on the individual level. Employee ownership itself has been an often-heated subject of analysis that joins in debate, though mostly in disagreement, contemporary labor law and corporate law scholars. A great deal of this debate concerns the theoretical intra-firm efficiency of employee-owned corporations – which at least for the time being has ended in an empirical stalemate over quite small marginal effects. In addition, most of the abstract or theoretical criticism of employee ownership generated in the debate, especially in regards to diversification, has either been empirically unsubstantiated or refuted in practice. However, on the political level employee ownership has often had a much less problematic fate. Employee Stock Ownership Plans or ESOP's in the US and abroad have attracted a great deal of attention largely because the idea of the citizen-owner cuts across traditional divisions in economic politics.

Yet, existing forms of employee ownership and ESOPs have been quite limited in their ability to represent a coherent alternative to the traditional labor/corporate law distinction. This is directly due to the fact that little in current labor or corporate law doctrine is tailored to regulate employee-owned corporations. The mainstream conclusion among most corporate law scholars is that the often heterogeneous interests in such firms are intractably inefficient. This conclusion is amiss because it holds up efficiency as the only value that enterprise activity serves, today that those heterogeneous interests in corporate decision making are increasingly desirable for sustainable, long-term growth, but also for preventing the type of unchecked groupthink that creates economic bubbles. Defenders of employee ownership are often caught up in old ideological debates over whether they are good or bad, and not what makes them good or better. It is

exactly the necessary process of research and experimentation in employee ownership that speaks to the need for mechanisms for agglomerating local economic successes and failures into a more global regulatory discussion.

The reduction of labor to a mere productive input (and of laborers to a commodity) is responsible for the growing global disparity, a problem whose solution is crucial to a stable and sustainable human future. Legal ideology - including that reflected in global organizations such as the ILO - institutionalized this view of the labor relationship by limiting itself to a reactive protection against the most outrageous abuses. This legal approach should be questioned. The more we can unshackle our law from the conceptual legacy of the 20th century the better off we will be for facing the new challenges of the 21st century and beyond.

3.29 Long-Term Investors should be the objects of much institutional attention, given their potentially stabilizing role. Such investors should find an adequate position in any new global financial architecture in order to support them with specific policy decisions and incentives.

From a purely financial point of view, a long-term investor can be defined as an investor who believes that markets will rise over a long period of time, and hopes that this long-term trend will offset short-term price volatility; the opposite of a long-term investor would be a short-term trader, who will hope to profit from market volatility by buying assets at a low price and selling them at a higher price within a short period of time.

There is a concrete institutional possibility to overcome the current prevalence of choices determined by short-term strategies in favor of more long-term oriented responsible forms of corporate investment. As is always the case, such a result can in principle be reached by working on the incentives, by introducing regulation, or by focusing on the institutional structure of the decision-maker. This last structural aspect should be modulated according to specific vocation and nature of the "Long-Term Investors", which requires some taxonomic scheme to handle potentially very different global institutional actors. We may have private, public and private/public Long-Term Investors, and each category may have different legal and structural constraints; different policy objectives; therefore different asset allocation models. For example, Long-Term Investors may hold controlling shares in strategic corporations for general national long-term interests; or for achieving specific policy goals related to sectors such as energy and climate change, infrastructure, transport, defense, R&D, education, cultural heritage, and the like.

From a legal perspective, a crucial topic is the desirability of particular corporate governance and general legal settings – as well as accounting standards

and techniques – for different types of Long-Term Investors like those that operate in the public sector, but also institutional investors such as Sovereign Wealth Funds, and Hedge Funds. New legal standards may require more segmentation (separation) of credit and financial institutions, which may pair with corporate governance, accounting and legal constraints on different classes of Long-Term Investors.

Long-term investors are, in fact, prepared to accept risks that short-term investors are unwilling to take - they are prepared, for example, to invest a large part of their wealth in equity portfolios and to finance infrastructures, the profitability of which can only be measured over a very long period, but which might be essential for a sustainable future; they stabilize markets and are prepared to smooth their gains and losses over time, and publish high quality long-term oriented information; they can adopt a counter-cyclical approach, as long as this is measured over the time horizon of their investments.

Long-term investors can be conceptualized as agents carrying on a long-term plan or vision of their principal. The relationship with the principal, shareholder or public authority, must be focused above all on preserving the long-term character of the investor, and particularly the permanence and stability of its liabilities. Special corporate governance rules, legal and accounting constraints and/or incentives may also be necessary.

In the case of a private-sector principal, the relationship should be expressed in the accounting and prudential framework, which must reflect the investor's desire to consider his investment as long-term in nature. If the principal is in the public sector, the State as a shareholder must undertake to guarantee the credibility of the investment through a legal framework, which clearly describes the medium-term contractual relationships. It may also maintain long-term control of corporations for strategic reasons of national interest, such as industrial policy, international cooperation, special needs of certain economically disadvantaged areas of the territory, and achievement of social and environmental goals.

Against the background of future discussions on the necessary changes to international financial regulations, we believe that it is both necessary and urgent to define a regulatory regime for long-term investors that is both stable and appropriate to their mission.