Chapter 5

Carrots for Good Governance

Good Governance Requires Proper Incentives

There is no doubt that compensation incentives for managers that are unduly focused on contemporaneous results create inherent conflict and a potential for corporate misgovernance. This is especially true when boards fail to exercise skillful discipline of management, particularly with regard to risks undertaken by corporate managers. Under these conditions, shareholder property can be placed at risk without the knowledge of shareholders. Corporate governance can also be undermined by capital market servicers whose personal interests compromise the stewardship that their institutions should display. As their key personnel strive for increased fees and rapid promotion motivated by their own performance pay systems, capital market servicers can be negligent with regard to the risks of their clients. Account officers of these capital market servicers, therefore, also are in a position to create "agency" problems for their own companies. Negligent acquiescence of client financial results can confer a misleading seal of approval by the underwriter that is in turn transmitted to the public market. The ultimate chain of a financial tragedy is made up of many such links.

One might hope that prudent credit analysis and steadfast adherence to sound accounting principles would prevail, but frequently prudence does not prevail. A boom in security markets, underpinned by lavishly supplied credit, can create an irresistible surge in agency issues as envy replaces common sense. Surely, it must be upsetting to see one’s fellow employees get rich while more sober and dutiful capital market service employees insist on careful analysis! Fellow employees are neighbors, too! It is unreasonable to suppose that all key personnel of capital market service firms will obey Lord Nelson’s flag signal to the fleet at Trafalgar.

B.E. Munk, *Disorganized Crimes*

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**The Wave**

The wave (or the speculative wave as it is often termed) that is frequently identified as the observed surge characteristic of a boom has been explored for years as a source of trouble in speculative markets. The late Professor Charles Kindleberger of MIT, an eminent student of past financial crises and scandals, posited the beginning of the speculative phase of financial markets in the displacement of more conventional notions of value.³

Some event increases confidence. Optimism sets in. Confident expectations of a steady stream of prosperity and gross profits make portfolio plunging more appealing. Financial institutions accept liability structures that decrease liquidity that in a more sober climate they would have rejected.⁴

Professor Kindleberger identified the vast structural shock that displaced prior beliefs and allows financial fantasies to grow without limit as the essential precondition of a speculative wave. The boom of the 1990s had such characteristics. The sources of that boom were said to be the personal computer revolution, the introduction and rapid development of the internet and the spread of mobile communications. Each pointed to a seeming future of dizzying profits.

These technology shifts also coincided with a watershed historical moment in contemporary geopolitical affairs: the collapse of the Soviet Union and the end of the cold war. As the cold war ended, the emergence of China (and later India) followed, becoming significant engines of world economic growth and generating additional sources of investor enthusiasm in security markets. Equity markets boomed, reflecting these seemingly unparalleled historical and technological opportunities. This boom was also a period of rapidly expanding participation in equity markets by newcomers who visualized growing wealth through investment in common stocks. Indeed, many grew rich on paper. It was only later, in the bust of 2000–01, that these new investors felt serious pain as their newly won wealth evaporated.

Some of these new shareholders had gotten into the market via the rapidly expanded capabilities of “online brokers.” Online trading represented a financial innovation that dramatically reduced the transaction costs of buying and selling shares. It also deprived many investment banks of a source of significant commission income that already had been declining since the end of fixed commissions.⁵ That lost commission income in turn provided incentives to create new sources of income from proprietary trading.⁶ One cannot be sure, but the continual mention of the profits from day trading by some (and unmentioned losses by others) did suggest a growing participation in the public equity market by many first-time shareholders. In a