UK CORPORATE GOVERNANCE AND BANKING REGULATION: THE REGULATOR'S ROLE AS STAKEHOLDER

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The role of financial regulation in influencing the development of corporate governance principles in the United Kingdom (UK) and throughout Europe has become an important policy issue that has received little attention in the literature. To date, most research on corporate governance has addressed issues affecting companies and firms in the nonfinancial sector. Corporate governance regulation in the financial sector traditionally has been regarded as a specialty area with standards and rules fashioned to achieve the overriding objectives of financial regulation—safety and soundness of the financial system, and consumer and investor protection. In the case of banking regulation, the traditional principal–agent model used to analyze the relationship between shareholders, directors, and managers has given way to broader policy concerns to maintain financial stability and to ensure that banks operate in a way that promotes broader economic growth and enhances shareholder value.

Recent research suggests that corporate governance reforms in the nonfinancial sector may not be appropriate for banks and other financial sector firms.[1] This is based on the view that no

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I would like to thank Dr. Rahul Dhumale and Professor John Eatwell for their comments and insights. Special thanks to the *Stetson Law Review* and, in particular, to Cheryl L. Smith and Meredith A. Phipps for their careful editorial attention. Many thanks also to the participants of the Annual Meeting of the American Society of Comparative Law and to the organizers of the Comparative Corporate Governance Symposium. Much of the research and writing took place at the Cambridge Endowment for Research in Finance and the ESRC Centre for Business Research, Cambridge University. All errors remain mine.

1. *See e.g.* Renée Adams & Hamid Mehran, *Is Corporate Governance Different for Bank Holding Companies?* 9 Fed. Reserve Bank of N.Y. Econ. Policy Rev. 123 (2003) (explaining why governance may differ for bank holding companies).

single corporate governance structure is appropriate for all industry sectors and that the application of governance models to particular industry sectors should take account of the institutional dynamics of the specific industry. Corporate governance in the banking and financial sector differs from that in the nonfinancial sectors because of the broader risk that banks and financial firms pose to the economy.[2] As a result, the regulator plays a more active role in establishing standards and rules to make banking management practices more accountable and efficient.

Unlike firms in the nonfinancial sector, a mismanaged bank may lead to a bank run or a collapse. This can cause the bank to fail on its various counterparty obligations to other financial institutions and to fail to provide liquidity to other sectors of the economy.[3] The role of the board of directors therefore becomes crucial in balancing the interests of shareholders and other stakeholders, such as creditors and depositors. Consequently, bank regulators place additional responsibilities on bank boards that often result in detailed regulations regarding the boards' decision-making practices and strategic aims. These additional regulatory responsibilities for management have led some experts to observe that banking regulation is a substitute for corporate governance.[4] According to this view, the regulator represents the public interest, including stakeholders' interests, and can act more efficiently than most stakeholder groups to ensure the bank's adherence to regulatory and legal responsibilities.

By contrast, other scholars argue that private remedies should be strengthened to enforce corporate governance standards at banks.[5] Many propose improving banks' accountability and efficiency of operations by increasing the legal duties that bank directors and senior management owe to depositors and

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2. *See* John Eatwell & Lance Taylor, *Global Finance at Risk: The Case for International Regulation* 21–27 (The New Press 2000) (discussing the pricing of risk by banks and how systemic risk can arise and undermine financial stability).

3. The mispricing of risk by banks creates the negative externality of systemic risk. *See id*. at 40–43 (discussing systemic risk and risk management techniques in the financial sector). For a discussion of how the negative effects of bank insolvency can be transmitted through the economy, see E. Philip Davis, *Debt, Financial Fragility, and Systemic Risk* 109–116 (Clarendon Press Oxford 1995).

4. Adams & Mehran, *supra* n. 1, at 124.

5. *See e.g.* Jonathan R. Macey & Maureen O'Hara, *The Corporate Governance of Banks*, 9 Fed. Reserve Bank of N.Y. Econ. Policy Rev. 91, 103 (2003) (proposing expanded fiduciary duties for bank directors).

other creditors.[6] This would involve expanding the scope of fiduciary duties beyond shareholders to include depositors and creditors. Under this approach, depositors and other creditors could sue the board of directors for breach of fiduciary duties and the standard of care, in addition to whatever contractual claims they may have. This would increase bank managers' and directors' incentive to pay more regard to solvency risk and would thereby protect the broader economy from excessive risk-taking.

The traditional approach of corporate governance in the financial sector often involved the regulator or bank supervisor relying on statutory authority to devise governance standards promoting the interests of shareholders, depositors, and other stakeholders. In the UK, banking regulation has traditionally involved government regulators adopting standards and rules that applied externally to regulated financial institutions.[7] Regulatory powers were derived, in part, from the informal customary practices of the Bank of England and other bodies that exercised discretionary authority in their oversight of the UK banking industry.[8] Bank regulation involved, *inter alia*, capital requirements, ownership limitations, and restrictions on connected lending.[9] These regulatory standards and rules composed the core elements of corporate governance for banking and credit institutions.

As deregulation and liberalization led to the emergence of global financial markets, banks expanded their international operations and moved into multiple lines of financial business. They developed complex risk-management strategies that allow them to price financial products and hedge their risk exposures in a manner that improves expected profits, but which may generate more risk and increase liquidity problems in certain circumstances.[10] The limited liability structure of most banks and financial firms, combined with the premium placed on shareholder profits, provides incentives for bank officers to undertake increas-

6. *E.g. id*. at 92.

7. *See* Maximilian J.B. Hall, *Handbook of Banking Regulation and Supervision in the United Kingdom* 205 (3d ed., Edward Elgar 1999) (discussing the flexible supervisory approach of regulation in the UK).

8. *Id*.

9. *Id*.

10. Avinash Persaud, *Liquidity Black Holes: And Why Modern Financial Regulation in Developed Countries Is Making Short-Term Capital Flows to Developing Countries Even More Volatile* 1 (UNU/WIDER 2002).

ingly risky behavior to achieve higher profits without a corresponding concern for the downside losses of risk. Regulators and supervisors find it increasingly difficult to monitor the complicated, internal operating systems of banks and financial firms. This has made the external model of regulation less effective as a supervisory technique in addressing the increasing problems that financial firms' excessive risk-taking poses to the broader economy.

Increasingly, regulators are devising frameworks that require financial firms to adopt internal, self-monitoring systems and processes to comply with statutory and regulatory standards. This Article analyzes the new financial regulatory framework under the UK Financial Services and Markets Act of 2000[11] (FSMA), which requires banks and other authorized financial firms to establish internal systems of control, compliance, and reporting for senior management and other key personnel.[12]

Under FSMA, the Financial Services Authority (FSA) has the power to review and sanction banks and financial firms regarding the types of internal control and compliance systems they adopt.[13] These systems must be based on recognized principles and standards of good governance in the financial sector. These regulatory standards place responsibility on the senior management of firms to establish and to maintain proper systems and controls, to oversee effectively the different aspects of the business, and to show that they have done so.[14] The FSA will take disciplinary action if an approved person—director, senior manager, or key personnel—deliberately violates regulatory standards or if his or her behavior falls below a standard that the FSA could reasonably expect him or her to observe.[15]

The broader objective of the FSA's regulatory approach is to balance the competing interests of shareholder wealth maximization and the interests of other stakeholders.[16] The FSA's balancing

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11. 2000, c. 8 (Eng.).
12. *Id*.
13. *Id*. at § 66.
14. *Id*. at § 1.
15. Fin. Servs. Auth., *Consultation Paper 17: Financial Services Regulation: Enforcing the New Regime* 33, http://www.fsa.gov.uk/pubs/cp/cp17.pdf (Dec. 1998).
16. *See id*. at 5 (explaining that the FSA seeks to "[maintain] confidence in the financial system, promot[e] public awareness of the financial system, [and] secur[e] the appropriate degree of protection for consumers").

exercise relies less on the strict application of external statutory codes and regulatory standards, and more on the design of flexible, internal compliance programs that fit the particular risk level and nature of the bank's business. To accomplish this, the FSA plays an active role with bank management in designing internal control systems and risk-management practices that seek to achieve an optimal level of protection for shareholders, creditors, customers, and the broader economy.[17] The regulator essentially steps into the shoes of these various stakeholder groups to assert stakeholder interests while ensuring that the bank's governance practices do not undermine the broader goals of macroeconomic growth and financial stability. The proactive role of the regulator is considered necessary because of the special risk that banks and financial firms pose to the broader economy. This Article raises the broader question, for future research, of whether regulation should play as proactive a role in the governance practices of other large companies in the nonfinancial sector.[18]

Part I of this Article reviews recent developments in UK corporate governance and discusses the relevant aspects of UK company law. Unlike United States corporation law, company law in the UK has traditionally provided that directors owe a duty to the company, not to the shareholders.[19] This legal principle provides a point of departure for analyzing the regulator's role in devising corporate governance standards that seek to balance the various interests of shareholders, creditors, and stakeholders. Part II considers "governance" within the context of the principal–agent framework and how this would apply to financial-sector firms. Part III reviews some of the major international standards of corporate governance as they relate to banking and financial firms. This involves a general discussion of the international norms of corporate governance for banking and financial institutions, as set forth by the Organisation for Economic Cooperation and Development and the Basel Committee on Banking Supervision.

Part IV analyzes the FSMA regulatory regime for banking regulation and suggests that its requirements for banks and fi-

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17. *See infra* nn. 166–176 and accompany text (discussing senior management arrangements, systems, and controls).

18. However, this Article does not specifically address the question.

19. *See infra* nn. 57–89 and accompanying text (discussing directors' duties under English company law).

nancial firms to establish internal systems of control and compliance programs represent a significant change in UK banking supervisory techniques and establishes a new corporate governance framework for UK banks and financial firms. This new regulatory framework departs from traditional UK company law by establishing an objective reasonable person standard to assess whether senior managers and directors have complied with regulatory requirements, with the threat of substantial civil and criminal sanctions for breach.[20] Part V argues that this new regulatory framework for the corporate governance of banks promotes some of the core values in the corporate governance debate over transparency in governance structure and information flow, and the supervisor's external, monitoring function. This Section also suggests that the governance framework of UK banking regulation might serve as a model for corporate governance reform for companies in the nonfinancial sector.

I. UK CORPORATE GOVERNANCE AND COMPANY LAW: RECENT DEVELOPMENTS

A. The Combined Code of Corporate Governance

The boards of directors of UK companies traditionally have had two functions—to lead and to control the company. Shareholders, directors, and auditors have had a role to play in ensuring good corporate governance. In the 1990s, corporate governance reform in UK companies became a major issue of concern for shareholders as well as policymakers. This was precipitated by a number of serious financial scandals involving major UK banks and financial institutions.[21]

In May 1991, a committee chaired by Sir Adrian Cadbury was established to make recommendations to improve corporate control mechanisms not only for banks, but also for all UK compa-

20. *See infra* nn. 165–175 and accompanying text (discussing the reasonable person standard applicable to directors and corporate officers under the FSA's regulatory regime).

21. During this period, the three most important corporate governance scandals involved UK banks and financial firms: British and Commonwealth Bank in 1990; the Bank of Credit and Commerce International in 1992 to 1993; and the Barings Bank collapse in 1995. *See* George Matyjewicz & Sarah Blackburn, *The Need for Corporate Governance*, http://www.gapent.com/sox/corporate_governance.htm (May 2003) (discussing high-profile scandals in the UK).

nies.[22] The Cadbury Committee's main focus was on financial control mechanisms and the responsibilities of the board of directors, auditor, and shareholders.[23] The Committee published a final report in 1992, which concluded that the cause of these problems was not the need for improved auditing and accounting standards, but widespread defects in the internal control systems of large UK companies.[24] In the report, the Committee defined corporate governance as "the system by which companies are directed and controlled."[25] Moreover, the Committee recommended that the boards of all listed companies registered in the UK comply with the Committee's recommended Code of Best Practice immediately or explain why they have not complied.[26]

A major concern of the Cadbury Committee was to address the problem of a company's management being dominated by a single, over-powerful managing director or chief executive officer (CEO).[27] The Committee took the view that compliance with the Code would provide a more transparent approach to information disclosure and would contribute to the efficient operation of the economy, while encouraging boards to allow more shareholder scrutiny of company affairs.[28] The report's most controversial proposals concerned reforms of the board structure and its functioning in large UK companies. The report emphasized that the effectiveness of the board would be tested in terms of how well the members, as a whole, worked together.[29] The contributions of the executive and nonexecutive directors were viewed as complementary.[30] While reaffirming the principle of the "unitary nature" of the board, the report emphasized the need to review the perform-

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22. *Id*.

23. Comm. on Fin. Aspects of Corp. Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* § 1.2, 1.6 (Gee & Co., Ltd. 1992) [hereinafter *The Cadbury Report*].

24. *Id*. at § 1.6–1.9.

25. *Id*. at § 2.5.

26. *Id*. at § 3.7.

27. *Id*. at § 4.9. The Committee recommended a clear "division of responsibilities at the head of a company . . . [to] ensure a balance of power and authority, such that no one individual has unfettered powers of decision." *Id*. For an example of a dominating, overpowerful CEO, see BBC News, *Robert Maxwell: A Profile*, http://www.news.bbc.co.uk/1/hi/business/1249739.stm (Mar. 2001).

28. *The Cadbury Report*, *supra* n. 23, at § 3.2, 3.5.

29. *Id*. at § 4.2.

30. *Id*. at § 4.3–4.4.

ance of the board and executives, and to intervene to prevent potential conflicts of interest.[31]

Although the Committee recognized the importance of a company's financial audit, no specific reform proposals were made.[32] Moreover, the extent of auditor liability was not addressed and continues to be a subject of government concern.[33] Similarly, the report did little to address the role of private, individual shareholders, focusing most of its attention on institutional shareholders' potential to exert leverage over the company to comply with the Code.[34]

The Cadbury Committee's recommendations attracted much criticism because of their voluntary nature and because of their reliance on nonexecutive directors to hold executive directors accountable to the company. It has been argued that the report's reliance on nonexecutive directors could lead to a type of two-tiered board, with different directors fulfilling different functions, which might undermine the traditional governance principle of a "unitary board."[35]

In 1998, the Hampel Report[36] combined the Cadbury Committee's recommendations and those of the Greenbury Report[37] on disclosure of directors' remuneration with its own principles on governance into what became known as "the Combined Code."[38] While the Cadbury Committee concerned itself with the financial aspects of corporate governance, the Hampel Committee was called simply a "Committee on Corporate Governance" and con-

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31. *Id*. at § 4.4.–4.6.

32. *See id*. at §§ 5.36–5.37 (noting that "[t]he accounting profession has done much recently to improve its standards and procedures" and simply stating, "[i]t is essential that this effort should continue").

33. *See id*. at § 5.35 (stating that, "[a]t present there is no consensus on a satisfactory way of reconciling the conflicting interests of all those involved" and that, "[a]s the debate on the nature and extent of auditors' liability continues . . . the Committee will keep watch on developments").

34. *Id*. at § 6.16.

35. Paul L. Davies, *Gower and Davies' Principles of Modern Company Law* 325–326 (7th ed., Sweet & Maxwell 2003).

36. Comm. on Corp. Governance, *Committee on Corporate Governance: Final Report* (Gee Publg. Ltd. 1998) [hereinafter *The Hampel Report*].

37. Study Group on Directors' Remuneration, *Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury* (Gee Publg. Ltd. 1995) [hereinafter *The Greenbury Report*]. The Study Group on Directors' Remuneration formed in January 1995, on the initiative of the Confederation of British Industry (CBI). *Id*. at § 1.1.

38. CPA Audit, *Corporate Governance*, http://www.cpaaudit.co.uk/pages/corpgovernance.html (accessed Feb. 14, 2004).

cerned itself with wider issues.[39] Following the Hampel Committee, the London Stock Exchange began implementing a "Combined Code,"[40] which amalgamated the various UK corporate governance committee recommendations into one code to be applied to all listed UK companies.[41] A major requirement of the Combined Code is that a company maintain a "sound system of internal control" to manage significant risks to shareholder investments and company assets.[42]

In recent years, UK corporate governance has been greatly influenced by the corporate and financial scandals in the United States, and by the broader framework of reforms being undertaken in the European Community.[43] As a result, a revised Combined Code came into effect on November 1, 2003, based on proposals of the Financial Reporting Council.[44] The revision incorporated proposals of the Higgs Review[45] regarding the role and effectiveness of nonexecutive directors and the proposals of Sir Robert Smith's report[46] on audit committees.[47] The Code was amended to

39. *See The Hampel Report*, *supra* n. 36, at § 1.20 (explaining that the Committee's recommended principles were directed "largely at the process of corporate governance").

40. Comm. on Corp. Governance, *The Combined Code: Principles of Good Governance and Code of Best Practice*, http://www.football-research.org/combinedcode.pdf (May 2000).

41. *Id*. at §§ 1–3.

42. *Id*. at § D.2.

43. *See High-Level Debate on Corporate Governance and Financial Market Reform*, 8 Richmond L. & Tax (newsletter of the Europ. Fin. Servs. Reg.) 1, 1–2 (Nov. 2003) (discussing reforms in the European Community).

44. Fin. Reporting Council, *The Combined Code on Corporate Governance* 1, http://www.frc.org.uk/documents/pdf/combinedcodefinal.pdf (July 2003) [hereinafter *The Combined Code*]. Higgs proposed a number of reforms, including a requirement that at least one-half of the board be nonexecutives and that one-half of that total should be independent. *Id*. at § A.3.2. The Combined Code also provides a more precise definition of "independence" for directors that excludes former employees employed within the last five years and anyone who has had a "material business relationship with the company" within the previous three years. *Id*. at § A.3.1. The board chairperson should also meet an independence test. *Id*. at § A.2.2.

45. The Higgs Review, *Review of the Role and Effectiveness of Non-Executive Directors*, http://www.dti.gov.uk/cld/non_exec_review/pdfs/morifulldata.pdf (Jan. 2003) [hereinafter *The Higgs Review*]. The Higgs Review was intended to be descriptive, rather than prescriptive, and sets forth three "propositions for a well-functioning board": (1) "developing [company] . . . structures and processes;" (2) "appointing the right people to the board;" and (3) encouraging a boardroom atmosphere that leads to accountable decision-making. *The Role and Effectiveness of Non-Executive Directors*, 14 Cambridge Alumni Mgt. (CAiM) 1, 1 (2003).

46. Fin. Reporting Council, *Audit Committees Combined Code Guidance*, http://www.asb.org.uk/documents/pdf/acreport.pdf (Jan. 2003).

47. *The Higgs Review*, *supra* n. 45, at 1, § 1.

reflect proposals in the Higgs Review that a change in board structure should be based on two principles: (1) enhancing the role of nonexecutive directors, and (2) splitting the role of the CEO and chair of the board.[48] Another important proposal of the Higgs Review was that independent, nonexecutive directors should be used more to transmit shareholder views to the board.[49] In this way, nonexecutives would have more responsibility to monitor the performance of the company's executive directors.

The FSA now considers compliance with the Code to be an important issue for investor consideration.[50] Although the Combined Code is technically voluntary in a legal sense, public companies listed on the London Stock Exchange and other regulated exchanges are required to state in their annual reports whether they comply with the Code and must provide an explanation if they do not comply.[51] This is known as the "comply or explain principle."[52] The requirement to comply or explain does not apply to nonlisted companies.[53]

Most recently, the FSA undertook a review of corporate governance and the regulation of capital markets that seeks to examine the following issues: the interaction of the Combined Code

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48. *See The Combined Code*, *supra* n. 44, at 5–7 (describing the roles of nonexecutive directors, CEO, and board chairman). The Higgs Report proposes that at least one-half of the board's members should be independent, nonexecutive directors. Derek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* 82, http://www.dti.gov.uk/cld/non_exec_review/pdfs/higgsreport.pdf (Jan. 2003). The Report also proposes that nonexecutives serve as a majority on the audit, remuneration, and appointment committees. *Id*. at 82, 87, 90. Additionally, the CEO and chairman should not be the same person. *Id.* at 80.

49. S*ee* Ian Jones & Michael Pollitt, *Understanding How Issues in Corporate Governance Develop: Cadbury Report to Higgs Review* 15 (U. of Cambridge, ESRC Ctr. for Bus. Research, Working Paper No. 277, 2003) (explaining that "the major recommendation of the Higgs Review is the strengthening of the channels of communication between shareholders and the board via the senior independent director").

50. *The Combined Code*, *supra* n. 44, at 1.

51. Fin. Servs. Auth., *The Listing Rules* § 12.43A, http://www.fsa.gov.uk/pubs/ukla/chapt12-3.pdf (accessed Feb. 12, 2004).

52. *The Combined Code*, *supra* n. 44, at 2.

53. *See* Fin. Reporting Council, *The Combined Code: Requirements of Auditors under the Listing Rules of the London Stock Exchange* ¶ 26, http://www.frc.org.uk/images/uploaded/documents/Bull_99-05.pdf (Nov. 1999) (explaining that the Stock Exchange requires compliance by all *listed* companies). It should be noted that the Cadbury Report intended the requirement to apply to all large companies, public and nonpublic. *The Cadbury Report*, *supra* n. 23, at § 3.1. But the Company Law Review recommended, and the UK government accepted, that the Code apply to all quoted companies. Co. L. Rev. Steering Group, *Modern Company Law for a Competitive Economy: Final Report* vol. 1, 53, http://www.dti.gov.uk/cld/review/htm; *select* Company Law Review (June 2001).

with the listing rules; the conflicts of interests that can arise when directors serve on several different boards; and the value of applying the FSA's Model Code on financial regulation to the corporate governance practices of publicly-listed companies. Moreover, regarding financial institutions, the FSA recognizes that corporate governance standards and practices must be devised with broader systemic issues in mind, requiring the regulator to take a more proactive role balancing shareholder and other stakeholder interests.

As mentioned above, the Combined Code is not a legal requirement under UK financial regulation. For example, it is not part of the FSA's banking regulation or its listing rules. Therefore, it has not been subject to FSA investigations and enforcement.[54] It should be recalled that the Cadbury Report recommended that the Combined Code be applicable to all companies—listed and unlisted.[55] The UK Government has taken this a step further by proposing that the Combined Code be legally obligatory and enforced by a new standards board.[56]

B. English Company Law and Directors' Duties

The UK Companies Act of 1985[57] provides the legal mechanism to ensure that UK companies are managed and operated in the interests of shareholders. The board of directors has sole responsibility for setting and controlling the company's internal governance system, while the main external governance system is the market for corporate control.[58] As discussed above, most provisions of the Combined Code are not legally binding and form a type of soft law in the regulation of companies. Nevertheless, the Companies Act and the Combined Code together form a comprehensive framework for ensuring that private and public UK companies are managed for the benefit of shareholders.

Although the traditional model of UK corporate governance focuses on shareholder wealth maximization, it should be noted

54. *See* UK Dept. of Trade and Indus., *Modernising Company Law* § 5.11 (July 2002) (proposing that a new body, the Standards Board, be established to enforce the Combined Code on Corporate Governance) [hereinafter *White Paper*].

55. *The Cadbury Report*, *supra* n. 23, at § 3.1.

56. *White Paper*, *supra* n. 54, at § 5.11, 5.14.

57. 1985, c. 6 (Eng.).

58. Davies, *supra* n. 35, at 294–295.

that English company law has traditionally stated that directors owe a duty to the company, not to individual shareholders.[59] This position has been interpreted as meaning that directors owe duties of care and fiduciary duties directly to the shareholders collectively, in the form of the company, and not to the shareholders individually.[60]

The starting point of analysis for this area of the law is the case of *Percival v. Wright*,[61] in which the court held that a company's directors are not trustees for individual shareholders and may purchase their shares without disclosing pending negotiations for the sale of the company.[62] In essence, a director owes duties to the company and not to individual shareholders.[63] However, a director who does disclose certain information to shareholders has a duty not to mislead the shareholders with respect to that information.[64] The rule in *Percival* has been subject to substantial criticism by various UK government committees, including the Cohen Committee and the Jenkins Committee.[65] The law has now evolved to a point where the courts recognize that directors may owe a fiduciary duty to individual shareholders in spe-

59. *See Re Chez Nico Ltd.*, [1992] BCLC 192 (1991) (stating that, "in general directors do not owe fiduciary duties to shareholders but owe them to the company"). This principle applies only to those duties that directors owe to the company because of their appointment as company directors. It would not apply, for instance, to directors' duties that arose from a special relationship between directors and shareholders based on particular facts. *See* Davies, *supra* n. 35, at 374–375 (discussing directors' duties to the company).

60. Davies, *supra* n. 35, at 374.

61. [1902] 2 Ch. 421, 425–426 (1902) (rejecting shareholders' demand that share sales be set aside on grounds that company chairman and directors breached duty owed to shareholders).

62. *Id*. It should be noted that a general principle of English contract law holds that, in the absence of a specific duty to make disclosure of material facts, there is no general duty to disclose material information. *Id*.; *see also Chase Manhattan Equities Ltd. v. Goodman*, [1991] BCLC 897 (1990) (stating that silence did not constitute a misrepresentation).

63. *Percival v. Wright* has been actively criticized in New Zealand and Australia. The New South Wales Court of Appeal, in *Brunninghausen v. Glavanics*, (1999) 32 ACSR 294, 1999 NSW LEXIS 998, **59–60, recently refused to follow the decision, thus following the lead taken by the New Zealand Court of Appeal in *Coleman v. Myers*, [1976] 2 N.Z.L.R. 225, 280.

64. This duty derives from the law of deceit. *See Prudential Assurance Co. Ltd. v. Newman Indus. Ltd.*, [1980] 2 All E.R. 841, 853 (1980) (stating that, "in advising the shareholders . . . [the directors] owed them a duty to give such advice in good faith and not to do so in a tricky and misleading way"); Anthony L. Boyle, Robin Qc Potts & Leonard S. Sealy, *Gore-Browne on Companies* § 12.17 (44th ed., Jordan Pblg. Ltd. 1986).

65. *Re Chez Nico*, [1992] BCLC 192.

cial circumstances, such as where the company is a family-run business.[66]

Therefore, under English law, barring special circumstances or regulatory intervention, company directors owe their duty to the legal person—the "company"—rather than to shareholders or to potential shareholders.[67] Although the UK company law model is based on the notion of the shareholder "city state,"[68] the directors owe their fiduciary duties directly to the company and only indirectly to the shareholders.[69] However, it is difficult to separate the interests of the company from those of the shareholders. Indeed, the interests of the company are, in an economic and a legal sense, the interests of the shareholders, which can be divided further into the interests of the *present* and *future* shareholders, including a balance between the interests of the various shareholder classes. Therefore, discretionary exercise of the directors' duties must be directed toward the maximization of those shareholder interests—that is, to maximize profits. The technical legal duty, however, is to the *company*, not the *shareholders*.

The principle that the director's duty is owed to the company raises important issues regarding how the interests of the company should be defined. Is the company merely an aggregate of the interests of the shareholders? Or does the company itself encompass a broader measure of interests that includes not only the shareholders' interests, but also the interests of other so-called "stakeholders"? The general view of the English courts in inter-

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66. *E.g. Peskin v. Anderson*, [2000] 2 BCLC 1, 14 (1999); *Peskin v. Anderson*, [2001] 1 BCLC 372, ¶ 35 (C.A. 2000). In *Peskin*, the claimants failed to establish special circumstances sufficient to resist an application to strike out the claim. *Peskin*, [2001] 1 BCLC at ¶¶ 58–59. The judgments, both at first instance and in the Court of Appeal, agreed that special circumstances must be established, particularly in "the specially strong context of the familial relationships of the directors and shareholders and their relative personal positions of influence in the company concerned." *Id*. at ¶ 35.

67. Section 459 of the Companies Act 1985, however, provides specific statutory duties. 1985, c. 6 at § 459.

68. Lord Wedderburn of Charlton, *The Legal Development of Corporate Responsibility: For Whom Will Corporate Managers Be Trustees?* in *Corporate Governance and Directors' Liabilities: Legal, Economic and Sociological Analyses on Corporate Social Responsibility* 3, 5 (Klaus J. Hopt & Gunther Teubner eds., Walter de Gruyter 1985).

69. This principle means that the enforcement of the directors' duties requires the company, not the shareholders, to sue the directors. This principle becomes especially difficult to apply when a group of companies is involved. Typically, a single company is seen as the "parent" company and will hold a majority of the shares of the subsidiary companies. For a thoughtful analysis, see Janet Dine, *The Governance of Corporate Groups* (Cambridge U. Press 2000).

preting the Companies Act of 1985 is that a director's legal duties are owed to the company and that the company's interests are defined primarily in terms of what benefits the shareholders. UK corporate governance standards, as set forth in the Combined Code, reinforce this position by holding that shareholder wealth maximization is the main criterion for determining the successful stewardship of a company.[70]

In the case of bank directors, English courts have addressed senior management's and directors' duties and responsibilities over the affairs of a bank. The classic statement of directors' duties regarding a bank was in the *Marquis of Bute's Case*,[71] which involved the Marquis of Bute, who had inherited the office of president of the Cardiff Savings Bank when he was six months old.[72] Over the next thirty-eight years, he attended only one board meeting of the bank before he was sued for negligence in failing to keep himself informed about the bank's reckless lending activities.[73] The judge rejected the liability claim on the grounds that, as a director, the Marquis knew nothing about the affairs of the bank, and furthermore, had no duty to keep himself informed of the bank's affairs.[74] In reaching its decision, the court did not apply a reasonable person standard to determine whether the Marquis should have kept himself informed about the bank's activities.

This case appeared to stand for the proposition that a "reasonable person" test would not be applied to the acts or omissions of a director or senior manager who failed to keep himself informed of the bank or the company's activities. In subsequent cases, the courts were reluctant to release directors from liability so easily. For instance, in *Dovey v. Cory*,[75] a third party brought an action in negligence against a company director for malpractice, and the court applied a reasonable person standard in finding the director not liable.[76] The court found that the director had not acted negligently in receiving suspicious information from

70. *The Combined Code*, *supra* n. 44, at §§ 1, 4.
71. *In re Cardiff Sav. Bank* (*Marquis of Bute's Case*), [1892] 2 Ch. 100 (1892).
72. *Id*. at 105.
73. *Id*.
74. *Id*. at 109–100.
75. [1901] A.C. 477 (1901).
76. *Id*. at 492–493.

other company officers and in failing to investigate further any irregularities in company practice.[77] However, the significance of the case was that the court recognized that a reasonable person test should be applied to determine whether a director breached his or her duty of care and skill. But the reasonable person test would not be that of a "reasonable professional director"—rather, it would be that of a reasonable man who possessed the particular ability and skills of the actual defendant in the case.[78] In *Marquis of Bute's Case*, it would not be hard to show that the defendant lacked the requisite skills at hand to make an informed judgment.[79] On the other hand, it would be easier to do so regarding an experienced and skilled senior manager who failed to act on information that was of direct relevance to the company's operations.

The courts have developed this reasonable person standard in several cases.[80] The most recent case is *Dorchester Finance Co., Ltd. v. Stebbing*,[81] where the court found that the reasonable person test should apply equally to both executive and nonexecutive directors.[82] More generally, modern English company law set forth three important standards regarding the duty of care and skill for directors. First, a director is not required to demonstrate a degree of skill that would exceed what would normally be expected of a person with the director's actual level of skill and knowledge.[83] Second, a director is not required to concern himself or herself on a continuous basis with the affairs of the company, as his or her involvement will be periodic and will be focused mainly at board meetings and other meetings at which he or she is in attendance, and he or she is not required to attend all meetings, nor to be liable for decisions that are made in his or her absence.[84] Third, a director may properly rely on company officers to perform any day-to-day affairs of the business, while not being liable for any

77. *Id*.

78. *See In re City Eq. Fire Ins. Co., Ltd.*, [1925] 1 Ch. 407, 408 (1924) (stating that a director "need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience").

79. The Marquis became president of the bank when he was six months old. *In re Cardiff Sav. Bank*, [1892] 2 Ch. at 105.

80. *E.g. In re City Eq. Fire Ins. Co.*, *Ltd.*, [1925] 1 Ch. 407.

81. [1989] BCLC 498 (1977).

82. *Id*.

83. *In re City Eq. Fire Ins. Co., Ltd.*, [1925] 1 Ch. at 408.

84. *Id*.

wrongdoing of those officers in the absence of grounds for suspicion.[85] Notwithstanding the courts' efforts to define further the reasonable person standard for company directors, the standard can be criticized on the grounds that it may create a disincentive, in the absence of regulatory standards, for skilled persons to serve as directors, especially for financial companies that often require more technical supervisory skills in the boardroom.

Regarding fiduciary duties, English company directors have the paramount duty of acting bona fide in the interest of the company. Specifically, this means that the director individually owes a duty of good faith to the company, which means that the director is a fiduciary of the company's interest. Although the director's fiduciary duties resemble the duties of a trustee, they are not the same.[86] The fiduciary duties of directors have been set forth in the Companies Act and fall into the following categories: the directors may act only within the course and scope of duties conferred upon them by the company memorandum or articles,[87] and they must act in good faith with respect to the best interests of the company, while not allowing their discretion to be limited in the decisions they make for the company.[88] Moreover, a director who finds himself or herself in the position of having a conflict of interest will be required to take corrective measures.[89]

II. CORPORATE GOVERNANCE AND BANKING REGULATION

A. Why Banks Are Special

The role of banks is integral to any economy. They provide financing for commercial enterprises, access to payment systems, and a variety of retail financial services for the economy at large. Some banks have a broader impact on the macro-sector of the economy, facilitating the transmission of monetary policy by making credit and liquidity available in difficult market conditions.[90] The integral role that banks play in the national economy is dem-

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85. *Id*.

86. *See* Davies, *supra* n. 35, at 381 (discussing directors' fiduciary duties).

87. 1985, c. 6 at § 35(3).

88. *Id*. at § 309(2).

89. *See id*. at § 317 (stating director's duty to disclose interest).

90. John Hawkins & Philip Turner, *Managing Foreign Debt and Liquidity Risks in Emerging Economies: An Overview* 8–9, http://www.bis.org/publ/plcy08.pdf (Sept. 2000).

onstrated by the states' almost-universal practice of regulating the banking industry and providing, in many cases, a government safety net to compensate depositors when banks fail. Financial regulation is necessary because of the multiplier effect that banking activities have on the rest of the economy. The large number of stakeholders, such as employees, customers, suppliers, etc., whose economic well-being depends on the health of the banking industry, depend on appropriate regulatory practices and supervision. Indeed, in a healthy banking system, the supervisors and regulators themselves are stakeholders acting on behalf of society at large. Their primary function is to develop substantive standards and other risk-management procedures for financial institutions in which regulatory risk measures correspond to the overall economic and operational risk faced by a bank. Accordingly, it is imperative that financial regulators ensure that banking and other financial institutions have strong governance structures, especially in light of the pervasive changes in the nature and structure of both the banking industry and the regulations that govern its activities.

B. The Principal–Agent Problem

The main characteristics of any governance problem are the opportunity for some managers to improve their economic payoffs by engaging in unobserved, socially-costly behavior or "abuse," and the information set of the outside monitors, which is inferior to the firm's information set.[91] These characteristics are related because abuse would not be unobserved if the monitor had complete information. The basic idea—that managers have an information advantage and that this gives them the opportunity to take self-interested actions—is the standard principal–agent problem.[92] The more interesting issue is how this information asymmetry and the resulting inefficiencies affect governance within financial institutions. Does the manager have better information? Perhaps the best evidence that monitors possess infe-

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91. *See* Franklin Allen & Douglas Gale, *Comparing Financial Systems* 93–97 (MIT Press 2000) (discussing governance mechanisms that allow shareholders to ensure that management acts in their interests).

92. Joseph E. Stiglitz, *Principal and Agent*, in *The New Palgrave: Allocation, Information, and Markets* 241, 241 (John Eatwell, Murray Milgate & Peter Newman eds., Macmillan Press Ltd. 1989).

rior information relative to managers lies in the fact that monitors often employ incentive mechanisms rather than relying completely on explicit directives alone.[93]

Moreover, the principal–agent problem may also manifest itself within the context of the bank playing the role of external monitor over the activities of third parties to whom it grants loans. In fact, when making loans, banks are concerned with two issues: (1) the interest rate that they receive on the loan, and (2) the risk level of the loan. However, the interest rate charged has two effects. First, it sorts between potential borrowers ("adverse selection").[94] And second, it affects the actions of borrowers ("moral hazard").[95] These effects derive from the informational asymmetries present in the loan markets, and hence, the interest rate may not be the market-clearing price.[96]

Adverse selection arises from different borrowers having different probabilities of repayment. Therefore, to maximize expected return, the bank would like to lend only to borrowers with a high probability of repayment. To determine who the good borrowers are, the bank can use the interest rate as a screening device. Unfortunately, those who are willing to pay high interest rates may be bad borrowers because they perceive their probability of repayment to be low. Therefore, as interest rates rise, the average "riskiness" of borrowers increases and, hence, expected profits are lower. The behavior of the borrower often is a function of the interest rate. Higher interest rates induce firms to undertake projects with higher payoffs but, adversely for the bank, lower probabilities of success. Moreover, an excess supply of credit could also be a problem. If competitor banks use lower interest rates to try to tempt customers away from other banks, they may succeed in attracting only bad borrowers—hence, they will not bother to do so.

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93. For example, such incentive mechanisms may take the form of tying a portion of a manager's compensation to the company performance in the stock market through the use of stock options.

94. Joseph E. Stiglitz, *The Causes and Consequences of the Dependence of Quality on Price*, 25 J. Econ. Literature 1, 6 (1987).

95. *Id*. at 3, 18. Overall, the presence of asymmetric information can prevent certain equilibrium outcomes from being achieved, and the market equilibria that often result fail to be Pareto optimal, showing the importance of perfect information for the efficient operation of financial markets and efficient management of financial firms. *Id*. at 29.

96. Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 Am. Econ. Rev. 393, 393–394, 409 (1981).

To avoid credit rationing, banks use other methods to screen potential borrowers.[97] For example, banks can use extensive and comprehensive covenants on loans to mitigate agency costs. As new information arrives, covenants can be renegotiated. Covenants may also require collateral or personal guarantees from firms about their future activities and business practices to maximize the probability of repayment. The bank's lending history produces valuable information that evolves over time. Therefore, a bank serves as a depository of information, which, in itself, becomes a valuable asset that allows the bank to ascertain good borrowers from bad borrowers and to price risk more efficiently by attracting good borrowers with lower interest rates and reducing the number of riskier borrowers.

C. Regulatory Intervention

The foregoing illustrates the wide range of potential agency problems in financial institutions involving several major stakeholder groups including, but not limited to, shareholders, creditors/owners, depositors, management, and supervisory bodies. Agency problems arise because responsibility for decision-making is directly or indirectly delegated from one stakeholder group to another in situations where objectives between stakeholder groups differ and where complete information that would allow further control to be exerted over the decision-maker is not readily available. One of the most studied agency problems in the case of financial institutions involves depositors and shareholders, or supervisors and shareholders. While that perspective underpins the major features of the design of regulatory structures—capital adequacy requirements, deposit insurance, etc.—incentive problems that arise because of conflicts between management and owners have become a focus of recent attention.[98]

The resulting view, that financial markets can be subject to inherent instability, induces governments to intervene to provide depositor protection in some form or another. Explicit deposit in-

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97. For a discussion of methods used to screen potential borrowers, see Stiglitz, *supra* n. 94.

98. *See e.g.* Arnoud W.A. Boot & Anjan V. Thakor, *Banking Scope and Financial Innovation*, in *New Research in Corporate Finance and Banking* 190–202 (Bruno Biais & Marco Pagano eds., Oxford U. Press 2002) (exploring the various implications of financial system designs).

surance is one approach, while an explicit or implicit deposit guarantee is another. In either case, general prudential supervision also occurs to limit the risk incurred by insurers or guarantors. To control the incentives of bank owners who rely too heavily on government-funded deposit insurance, governments typically enforce some control over bank owners. This can involve limiting the range of activities, linking deposit insurance premiums to risk, and aligning capital adequacy requirements with business risk.[99]

While such controls may overcome the agency problem between government and bank owners, one must ask how significant this problem is in reality. A cursory review of recent banking crises would suggest that many causes for concern relate to management decisions that reflect agency problems involving management. Management may have different risk preferences from those of other stakeholders, including the government, owners, creditors, etc., or limited competence in assessing the risks involved in its decisions, and yet have significant freedom of action because of the absence of adequate control systems able to resolve agency problems.

Adequate corporate governance structures for banking institutions require internal control systems within banks to address the inherent asymmetries of information and the potential market failure that may result. This form of market failure suggests a role for government intervention. If a central authority could know all agents' private information and engage in lump-sum transfers between agents, then it could achieve a Pareto[100] improvement. However, because a government cannot, in practice, observe agents' private information, it can achieve only a constrained or second-best Pareto optimum. Reducing the costs associated with the principal–agent problem, and thereby achieving a second-best solution, depends, to a large extent, on the corporate

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99. For details on attempts to align regulatory capital with economic risk, see Basel Committee on Banking Supervision, *Consultative Document: The New Basel Capital Accord*, http://www.bis.org/publ/bcbsca03.pdf (Jan. 2001) [hereinafter *Second Consultative Paper*].

100. "An economic outcome is said to be Pareto optimal if it is impossible to make some individuals better off without making some other individuals worse off." Andreu Mas-Colell, Michael D. Whinston & Jerry R. Green, *Microeconomic Theory* 307 (Oxford U. Press 1995).

governance structures of financial firms and institutions and the way information is disseminated in the capital markets.[101]

The principal–agent problem, outlined above, poses a systemic threat to financial systems when the incentives of management for banking or securities firms are not aligned with those of the owners of the firm. This may result in different risk preferences for management as compared to the firm's owners, as well as other stakeholders, including creditors, employees, and the public. The financial regulator represents the public's interest in seeing that banks and securities firms are regulated efficiently so as to reduce systemic risk. Many experts recognize the threat that market intermediaries and some investment firms pose to the systemic stability of financial systems. In its report, the International Organization of Securities Commissions (IOSCO) adopts internal corporate governance standards for investment firms to conduct themselves in a manner that protects their clients and the integrity and stability of financial markets.[102] IOSCO places primary responsibility for the management and operation of securities firms on senior management.[103]

III. INTERNATIONAL STANDARDS OF CORPORATE GOVERNANCE FOR BANKS AND FINANCIAL INSTITUTIONS

A. Organisation for Economic Co-operation and Development

The liberalization and deregulation of global financial markets led to efforts to devise international standards of financial regulation to govern the activities of international banks and financial institutions. An important part of this emerging international regulatory framework has been the development of international corporate-governance standards. The Organisation for Economic Co-operation and Development (OECD) has been at the forefront, establishing international norms of corporate governance that apply to both multinational firms and banking institutions. In 1999, the OECD issued a set of corporate governance standards and guidelines to assist governments in their efforts to

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101. *See id*. at 368–374 (discussing private information and second-best solutions).
102. Intl. Org. of Secs. Commns., *Objectives and Principles of Securities Regulation*, http://www.iosco.org/pubdocs/pdf/IOSCOPD82-English.pdf (Sept. 1998).
103. *Id*. at 36.

evaluate and improve the legal, institutional, and regulatory framework for corporate governance in their countries.[104] The OECD guidelines also provide standards and suggestions for "stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance."[105] Such corporate-governance standards and structures are especially important for banking institutions that operate on a global basis. To this extent, the OECD principles may serve as a model for the governance structure of multinational financial institutions.

In its most recent corporate governance report, the OECD emphasized the important role that banking and financial supervision plays in developing corporate-governance standards for financial institutions.[106] Consequently, banking supervisors have a strong interest in ensuring effective corporate governance at every banking organization. Supervisory experience underscores the necessity of having appropriate levels of accountability and managerial competence within each bank. Essentially, the effective supervision of the international banking system requires sound governance structures within each bank, especially with respect to multifunctional banks that operate on a transnational basis. A sound governance system can contribute to a collaborative working relationship between bank supervisors and bank management.

The Basel Committee on Banking Supervision (Basel Committee) has also addressed the issue of corporate governance of banks and multinational financial conglomerates, and has issued several reports addressing specific topics on corporate governance and banking activities.[107] These reports set forth the essential

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104. Org. for Econ. Co-operation & Dev., *OECD Principles of Corporate Governance*, http://www.oecd.org/dataoecd/47/50/4347646.pdf (1999).

105. *Id*. at 11.

106. *See* Org. for Econ. Co-operation & Dev., *Survey of Corporate Governance Developments in OECD Countries* 12, http://www.oecd.org/dataoecd/58/27/21755678.pdf (accessed Feb. 19, 2004) (noting that banks "[i]n several countries . . . have had an important place in the overall corporate governance system, serving both a monitoring and a financial role").

107. The most important of these reports are Basel Comm. on Banking Supervision, *Principles for the Management of Credit Risk*, http://www.bis.org/publ/bcbs54.pdf (July 1999); Basel Comm. on Banking Supervision, *Framework for Internal Control Systems in Banking Organisations*, http://www.bis.org/publ/bcbs40.pdf (Sept. 1998); Basel Comm. on Banking Supervision, *Enhancing Bank Transparency: Public Disclosure and Supervisory*

strategies and techniques for the sound corporate governance of financial institutions, which can be summarized as follows:

a. "Establishing strategic objectives and a set of corporate values that are communicated throughout the banking organi[z]ation;"[108]
b. "Setting and enforcing clear lines of responsibility and accountability throughout the organi[z]ation;"[109]
c. "Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns;"[110]
d. "Ensuring that there is appropriate oversight by senior management;"[111]
e. "Effectively utili[z]ing the work conducted by internal and external auditors, in recognition of the important control function they provide;"[112]
f. "Ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment;"[113] and
g. "Conducting corporate governance in a transparent manner."[114]

These standards recognize that senior management is an integral component of the corporate-governance process, while the board of directors provides checks and balances to senior managers, and that senior managers should assume the oversight role with respect to line managers in specific business areas and activities. The effectiveness of the audit process can be enhanced by recognizing the importance and independence of the auditors and requiring management's timely correction of problems identified by auditors. The organizational structure of the board and man-

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Information that Promote Safety and Soundness in Banking Systems, http://www.bis.org/publ/bcbs41.pdf (Sept. 1998); and Basel Comm. on Banking Supervision, *Principles for the Management of Interest Rate Risk*, http://www.bis.org/publ/bcbs29a.pdf (Sept. 1997).

108. Basel Comm. on Banking Supervision, *Enhancing Corporate Governance for Banking Organisations* 5, http://www.bis.org/publ./bcbs56.pdf (Sept. 1999).

109. *Id*.

110. *Id*. at 6.

111. *Id*. at 7.

112. *Id*.

113. *Id*. at 8.

114. *Id*.

agement should be transparent, with clearly identifiable lines of communication and responsibility for decision-making and business areas. Moreover, there should be itemization of the nature and the extent of transactions with affiliates and related parties.[115]

B. Basel II

The Basel Committee adopted the Capital Accord in 1988 as a legally nonbinding international agreement among the world's leading central banks and bank regulators to uphold minimum levels of capital adequacy for internationally-active banks.[116] The New Basel Capital Accord (Basel II)[117] contains the first detailed framework of rules and standards that supervisors can apply to the practices of senior management and the board for banking groups. Bank supervisors will now have the discretion to approve a variety of corporate-governance and risk-management activities for internal processes and decision-making, as well as substantive requirements for estimating capital adequacy and a disclosure framework for investors. For example, under Pillar One, the board and senior management have responsibility for overseeing and approving the capital rating and estimation processes.[118] Senior management is expected to have a thorough understanding of the design and operation of the bank's capital rating system and

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115. The International Accounting Standards Committee defines "related parties" as parties who are able to exercise "control" or "significant influence." David Cairns & Christopher Nobes, *The Convergence Handbook: A Comparison Between International Accounting Standards and UK Financial Reporting Requirements* 101 (ICAEW 2000). Such controlled relationships include (1) parent–subsidiary; (2) entities under common control; (3) associates; (4) individuals who, through ownership, have significant influence over the enterprise, and close members of their families; and (5) key management personnel. *Id*.

116. For an in-depth discussion of the Basel Capital Accord by a former regulator, see Jonathan Ward, *The Supervisory Approach: A Critique* (Working Paper No. 02, 2002) and Jonathan Ward, *The New Basel Accord and Developing Countries: Problems and Alternatives* (Working Paper No. 04, 2002). *See also* George A. Walker, *International Banking Regulation* Law, Policy & Practice (Kluwer Law Intl. 2001) (discussing the Basel Capital Accord).

117. Basel Comm. on Banking Supervision, *The New Basel Capital Accord* (Consultative Document), http://www.bis.org/bcbs/cp3full.pdf (Apr. 2003) [hereinafter *Basel II*].

118. *Id*. at ¶ 400. Pillar One states, in relevant part, as follows:

> All material aspects of the rating and estimation processes must be approved by the bank's board of directors or a designated committee thereof and senior management. These parties must possess a general understanding of the bank's risk rating system and detailed comprehension of its associated management reports.

Id.

its evaluation of credit, market, and operational risks.[119] Members of senior management will be expected to oversee any testing processes that evaluate the bank's compliance with capital adequacy requirements and its overall control environment. Senior management and executive members of the board should be in a position to justify any material differences between established procedures set by regulation and actual practice.[120] Moreover, the reporting process to senior management should provide a detailed account of the bank's internal ratings-based approach for determining capital adequacy.[121]

Pillar One has been criticized as allowing large, sophisticated banks to use their own internal ratings methodologies for assessing credit and market risk to calculate their capital requirements.[122] This approach relies primarily on historical data that may be subject to sophisticated applications that might not accurately reflect the bank's true risk exposure, and it may also fail to take account of events that could not be foreseen by past data. Moreover, by allowing banks to use their own calculations to obtain regulatory capital levels, the capital can be criticized as being potentially incentive incompatible.

Pillar Two seeks to address this problem by providing for both internal and external monitoring of the bank's corporate governance and risk-management practices.[123] Banks are required to monitor their assessments of financial risks and to apply capital charges in a way that most closely approximates the bank's business-risk exposure.[124] Significantly, the supervisor is now expected to play a proactive role in this process by reviewing and assessing the bank's ability to monitor and comply with regulatory capital requirements. Supervisors and bank management are expected to engage in an ongoing dialogue regarding the most appropriate internal control processes and risk-assessment systems, which may vary between banks depending on their organizational structure, business practices, and domestic regulatory framework.

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119. *Id*.

120. *Id*. at ¶ 401.

121. *Id*. at ¶ 402.

122. *See e.g.* Ward, *supra* n. 116 (Working Paper No. 04), at 11 (describing Basel II's reliance on banks' own risk estimates as a "fundamental weakness").

123. *See Basel II*, *supra* n. 117, at ¶¶ 677–756 (discussing the supervisory-review process).

124. *Id*. at ¶ 680.

Pillar Three also addresses corporate governance concerns by focusing on transparency and market-discipline mechanisms to improve the flow of information between bank management and investors.[125] The goal is to align regulatory objectives with the bank's incentives to make profits for its shareholders. Pillar Three seeks to do this by improving reporting requirements for bank capital adequacy. This covers both quantitative and qualitative disclosure requirements for both overall capital adequacy and capital allocation based on credit risk, market risk, operational risk, and interest rate risks.[126]

Pillar Three sets forth important proposals to improve transparency by linking regulatory capital levels with the quality of disclosure.[127] This means that banks will have incentives to improve their internal controls, systems operations, and overall risk-management practices if they improve the quality of the information regarding the bank's risk exposure and management practices. Under this approach, shareholders would possess more and better information with which to make decisions about well-managed and poorly-managed banks. The downside of this approach is that, in countries with undeveloped accounting and corporate-governance frameworks, the disclosure of such information might lead to volatilities that might undermine financial stability by causing a bank run or failure that might not have otherwise occurred had the information been disclosed in a more sensitive manner. Pillar Three has not yet provided a useful framework for regulators and bank management to coordinate their efforts in the release of information that might create a volatile response in the market.

Although the Basel Committee has recognized that "primary responsibility for good corporate governance rests with boards of directors and senior management of banks,"[128] its 1999 report on corporate governance suggested other ways to promote corporate governance, including laws and regulations; disclosure and listing requirements by securities regulators and stock exchanges; sound

125. *Id*. at ¶¶ 758–759; Ward, *supra* n. 116 (Working Paper No. 04), at 9.

126. *See Basel II*, *supra* n. 117, at 156–168 (detailing both quantitative and qualitative disclosure requirements).

127. *See id.* at ¶ 758 (explaining that "[t]he purpose of Pillar [Three] . . . is to complement the minimum capital requirements [of Pillar One] . . .").

128. *Enhancing Corporate Governance for Banking Organisations*, *supra* n. 108, at 10.

accounting and auditing standards as a basis for communicating to the board and senior management; and voluntary adoption of industry principles by banking associations that agree on the publication of sound practices.[129]

In this respect, the role of legal issues is crucial for determining ways to improve corporate governance for financial institutions. There are several ways to help promote strong businesses and legal environments that support corporate governance and related supervisory activities. These include enforcing contracts, including those with service providers; clarifying supervisors' and senior management's governance roles; ensuring that corporations operate in an environment free from corruption and bribery; and aligning laws, regulations, and other measures with the interests of managers, employees, and shareholders.

These principles of corporate governance for financial institutions, as set forth by the OECD and the Basel Committee, have been influential in determining the shape and evolution of corporate-governance standards in many advanced economies and developing countries and, in particular, have been influential in establishing internal control systems and risk-management frameworks for banks and financial institutions. These standards of corporate governance are likely to become international in scope and to be implemented into the regulatory practices of the leading industrial states.

The globalization of financial markets necessitates minimum international standards of corporate governance for financial institutions that can be transmitted into financial systems in a way that will reduce systemic risk and enhance the integrity of financial markets. However, it should be noted that international standards of corporate governance may result in different types and levels of systemic risk for different jurisdictions due to differences in business customs and practices and the differences in institutional and legal structures of national markets. Therefore, the adoption of international standards and principles of corporate governance should be accompanied by domestic regulations that prescribe specific rules and procedures for the governance of financial institutions, which address the national differences in political, economic, and legal systems.

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129. *Id.*

Although international standards of corporate governance should respect diverse economic and legal systems, the overriding objective for all financial regulators is to encourage banks to devise regulatory controls and compliance programs that require senior bank management and directors to adopt good regulatory practices approximating the economic risk exposure of the financial institution. Because different national markets must protect against different types of economic risk, there are no universally correct answers accounting for differences in financial markets, and laws need not be uniform from country to country. Recognizing this, sound governance practices for banking organizations can take place according to different forms that suit the economic and legal structure of a particular jurisdiction.

Nevertheless, the organizational structure of any bank or securities firm should include four forms of oversight: (1) oversight by the board of directors or supervisory board; (2) oversight by nonexecutive individuals who are not involved in the day-to-day management of the business; (3) oversight by direct line supervision of different business areas; and (4) oversight by independent risk management and audit functions. Regulators should also utilize approximate criteria to ensure that key personnel meet fit and proper standards. These principles should also apply to government-owned banks, but with the recognition that government ownership may often mean different strategies and objectives for the bank.

IV. UK FINANCIAL REGULATION AND CORPORATE GOVERNANCE: THE STATUTORY FRAMEWORK

A. Statutory Framework

The Financial Services and Markets Act of 2000 (FSMA)[130] and its accompanying regulations create a regime founded on a risk-based approach to the regulation of all financial business. FSMA's stated statutory objectives are to maintain confidence in the financial system, to promote public awareness, to provide

130. 2000, c. 8 (Eng.) The FSMA received Royal Assent on June 14, 2000. *Id*. The FSMA repealed existing financial services legislation, including the Banking Act of 1987, the Financial Services Act of 1986, and the Insurance Companies Act of 1982. Clive Briault, *The Rationale for a Single National Financial Services Regulator* 7 n. 3, Fin. Servs. Auth., *Occasional Paper Series 2* (May 1999).

"appropriate" consumer protection, and to reduce financial crime.[131] FSMA incorporates and simplifies the various regulatory approaches utilized under the Financial Services Act of 1986, in which self-regulatory organizations were delegated authority to regulate and to supervise the financial services industry.[132] FSMA created the FSA as a single regulator of the financial services industry with responsibility, inter alia, for banking supervision and regulation of the investment services and insurance industries.[133]

To achieve these objectives, the FSA has been delegated legislative authority to adopt rules and standards to ensure that the statutory objectives are implemented and enforced.[134] In doing so, the FSA must have regard to seven principles, which include "the desirability of facilitating innovation in connection with regulated activities;" "the need to minimi[z]e the adverse effects on competition that may arise from anything done in the discharge of those functions;" and "the desirability of facilitating competition be-

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131. 2000 c. 8 at § 2. The UK Parliament adopted FSMA, in part, as a response to major financial scandals, occurring in the 1990s, that resulted in the collapse of the Bank of Credit and Commerce International, and Barings. *See generally* Matyjewicz & Blackburn, *supra* n. 21 (discussing high-profile scandals in the UK).

132. *See* Briault, *supra* n. 130, at 6 (quoting the Treasury and explaining that "[t]he existing arrangements for financial regulation involve a large number of regulators, each responsible for different parts of the industry"). The FSA replaced the Securities and Investment Board, and consolidated nine regulatory organizations, including the Personal Investment Authority, Securities and Futures Authority, and Investment Management Regulatory Organisation. *Id*. at 6 n. 1. The FSA also assumed responsibility for banking supervision from the Bank of England's Supervision and Surveillance Division. *Id*. at 7. In addition, the FSA has assumed regulatory oversight for the Lloyds insurance market and has exercised its reserve powers to regulate the sale of mortgages and general insurance. *See generally* Fin. Servs. Auth., *Consultation Paper 66: Prudential Requirements for Lloyd's Insurance Business*, http://www.fsa.gov.uk/pubs/cp/cp66.pdf (Aug. 2000) (discussing the FSA's supervision of Lloyd's insurance business). The FSA now regulates various professionals, including solicitors, accountants, and actuaries, to the extent that their activities involve investment business and other financial services. Fin. Servs. Auth., *Consultation Paper 69: The Exempt Professional Firms Sourcebook* § 1.3, http://www.fsa.gov.uk/pubs/cp/cp69.pdf (Oct. 2000).

133. Briault, *supra* n. 130, at 5. The FSA has been described as a "super-regulator" and as one of the largest and most powerful regulatory bodies in the world. *E.g. id*. The FSA has been chartered by Parliament as a company limited by guarantee, which is accountable to the Treasury and funded by industry levies. 2000, c. 8 at § 12.

134. 2000, c. 8 at § 2.4. The idea of creating a single regulator was "one of the big ideas to emerge from the . . . stable" of the Chancellor of the Exchequer, Gordon Brown. Alex Brummer, *Pound Could Be down and out*, The Guardian (Dec. 31, 1998) (available at http://www.guardian.co.uk/business/story/0,3604,320144.html).

tween those who are subject to any form of regulation by the Authority."[135]

The FSA has established a regulatory regime that emphasizes ex ante preventative strategies, including front-end intervention when market participants are suspected of not complying with their obligations. Under the FSMA framework, regulatory resources are redirected away from reactive, post-event intervention towards a more proactive stance emphasizing the use of regulatory investigations and enforcement actions, which have the overall objective of achieving market confidence and investor and consumer protection. In devising regulations, the FSA is required to conduct a cost-benefit analysis of the regulations' impact on financial markets.[136] Although many leading economists have criticized the use of cost-benefit analysis,[137] the FSA has adopted a comprehensive framework for such assessments. It has published its internal guidance, which allows market participants and the investing public to gain a better understanding of the basis on which regulations are adopted. In addition, FSMA provides for a single authorization process and a new market abuse offense[138] that imposes civil liability, fines, and penalties for the misuse of inside information and market manipulation.[139]

The FSMA sets out a framework to protect the integrity of nine of the UK's recognized investment exchanges, including the London Stock Exchange, London Metal Exchange, and London International Financial Futures Exchange.[140] The FSA has the power to scrutinize the rules and practices of firms and exchanges for anticompetitive effects. Moreover, the FSA has exercised its statutory authority to create an ombudsman and compensation scheme for consumers and investors who have complaints against financial services providers for misconduct in the sale of financial products.[141]

135. 2000, c. 8 at § 2.3.

136. *Id*. at § 155(2)(a).

137. *E.g.* Charles A.E. Goodhart, *Regulating the Regulators: Accountability and Control for Central Banks and Supervisors* 7–9 (Fin. Mkts. Group, London Sch. of Econs. 2001).

138. 2000 c. 8 at § 118.

139. *See* Barry Rider, Kern Alexander & Lisa Linklater, *Market Abuse and Insider Dealing* chs. 6–8 (Butterworths 2002) (discussing market abuse offenses).

140. *Id*.

141. The FSMA's objective to protect and educate consumers is not new. It derives, in part, from previous regulations of the Financial Services Act of 1986 to provide "investors protection at least equivalent to that afforded in respect of investment business . . . ." 1986,

The FSA's main functions will be forming policy and setting regulation standards and rules (including the authorization of firms); approval and registration of senior management and key personnel; investigation, enforcement and discipline; consumer relations; and banking and financial supervision. The FSMA requires the FSA to adopt a flexible and differentiated risk-based approach to setting standards and supervising banks and financial firms. The FSA has authority to enter into negotiations with foreign regulators and governments regarding a host of issues, including agreements for the exchange of information, coordinating implementation of EU and international standards, and cross-border enforcement and surveillance of transnational financial institutions.

In pursuit of these aims, the FSA has signed a number of memoranda of understanding (MOU) and mutual assistance treaties with foreign authorities that provide for cooperation and information sharing.[142] The FSA, UK Treasury, and Bank of England signed a domestic MOU providing a general division of responsibilities in which the Treasury maintains overall responsibility for policy and the adoption of statutory instruments, while the FSA has primary responsibility for the supervision and regulation of all financial business, and the Bank of England conducts monetary policy and surveillance of international financial markets.[143]

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c. 60 (Eng.).

142. *E.g.* Comm. of European Securities Regulators, *Multilateral Memorandum of Understanding on the Exchange of Information and Surveillance of Securities Activities*, http://www.europefesco.org/DOCUMENTS/FESCOPOL/KEYDOC/Fescopol_MOV.pdf (Jan. 26, 1999).

143. *Memorandum of Understanding between HM Treasury, the Bank of England and the FSA*, http://www.bankofengland.co.uk/legislation/mou.pdf (Oct. 28, 1997). The FSA is to regulate firms and markets, while the Bank has responsibility for monetary stability and, in exceptional circumstances, is to undertake official financial rescue operations to prevent problems affecting one particular financial institution from spreading to the whole financial system. *Id*. at §§ 2, 3. The Treasury is to be responsible for the "overall institutional structure of regulation," supervising the Bank and the FSA, but having no operational involvement in their activities. *Id*. at § 4. The FSA and the Bank will both be represented on the Basel Supervisors' Committee, the EMI Banking Supervisors' Sub-Committee, and "on other international committees where necessary." *Id*. at § 15.

B. The FSA's Corporate Governance Regime

A major consequence of FSMA is its direct impact on corporate-governance standards for UK financial firms through its requirement of high standards of conduct for senior managers and key personnel of regulated financial institutions. The main idea is based on the belief that transparency of information is integrally related to accountability in that it can provide government supervisors, bank owners, creditors, and other market participants sufficient information and incentive to assess a bank's management. To this end, the FSA has adopted comprehensive regulations that create civil liability for senior managers and directors for breaches by their firms, even if they had no direct knowledge or involvement in the breach or violation itself. For example, if the regulator finds that a firm has breached rules because of the actions of a rogue employee who has conducted unauthorized trades or stolen client money, the regulator may take action against senior management for failing to have adequate procedures in place to prevent this from happening.

1. High-Level Principles

The FSA has incorporated the eleven high-level principles of business that were part of previous UK financial services legislation.[144] They applied to all persons and firms in the UK financial services industry. These principles also apply to senior management and directors of UK financial firms. The most widely invoked of these principles are integrity; skill, care, and diligence; management and control; financial prudence; market conduct; conflicts of interests; and relations with regulators. FSA regulations often cite these principles as a policy basis justifying new regulatory rules and standards for the financial sector. These principles are also used as a basis to evaluate the suitability of applicants to become approved persons to carry on financial business in the UK.

Principle Two states that "[a] firm must conduct its business with due skill, care and diligence."[145] The FSA interprets this principle as setting forth an objective, reasonable person standard

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144. Fin. Servs. Auth., Press Release, *The FSA Publishes Response Paper on Principles for Business*, http://www.fsa.gov.uk/pubs/press/1999/099.html (Oct. 12, 1999).
145. *Id*.

for all persons involved in the management and direction of authorized financial firms.[146] The reasonable person standard also applies to Principle Nine, which provides a basic framework for internal standards of corporate governance by requiring that a financial firm "organi[z]e and control its internal affairs in a responsible manner."[147] Regarding employees or agents, the firm "should have adequate arrangements to ensure that they are suitable, adequately trained and properly supervised and that it has well-defined compliance procedures."[148]

In addition, the FSA has adopted its own statement of principles for all approved persons, which includes integrity in carrying out functions,[149] acting with due skill and care in carrying out a controlled function,[150] observing proper standards of market conduct,[151] and dealing with the regulator in an open and honest way.[152] The FSA has also adopted additional principles that apply directly to senior managers and require them to take reasonable steps to ensure that the regulated business of their firm is organized so that it can be controlled effectively.[153] The objective, reasonable person test is reinforced in Principle Six with the requirement that senior managers "exercise due skill, care and diligence in managing the [regulated] business" of their firm.[154] Addi-

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146. Fin. Servs. Auth., *Statement of Principle and Code of Practice for Approved Persons* § 4.2, http://www.fsa.gov.uk/handbook/legal_instruments/2001/nov15_aper.pdf (Dec. 01, 2001) [hereinafter *FSA Code of Practice*].

147. Fin. Servs. Auth., Press Release, *Paine Webber International (UK) Limited Fined £ 350,000*, http://www.fsa.gov.uk/pubs/additional/sfa009-01.pdf (Aug. 22, 2001).

148. *Id*.

149. *FSA Code of Practice*, *supra* n. 146, at § 4.1.1. Principle One states, "An *approved person* must act with integrity in carrying out his *controlled function*." *Id*. (emphasis in original).

150. *Id*. at § 4.2.1. Principle Two states, "An *approved person* must act with due skill, care and diligence in carrying out his *controlled function*." *Id*. (emphasis in original).

151. *Id*. at § 4.3.1. Principle Three states, "An *approved person* must observe proper standards of market conduct in carrying out his *controlled function*." *Id*. (emphasis in original).

152. *Id*. at § 4.4.1. Principle Four states, "An *approved person* must deal with the *FSA* and with other regulators in an open and cooperative way and must disclose appropriately any information of which the *FSA* would reasonably expect notice." *Id*. (emphasis in original).

153. *Id*. at § 4.5.1. Principle Five states, "An *approved person* performing a *significant influence function* must take reasonable steps to ensure that the business of the *firm* for which he is responsible in his *controlled function* is organi[z]ed so that it can be controlled effectively." *Id*. (emphasis in original).

154. *Id*. at § 4.6.1. Principle Six states, "An *approved person* performing a *significant influence* function must exercise due skill, care and diligence in managing the business of

tionally, senior managers must take reasonable steps to ensure that the regulated business of their firm complies with all applicable requirements.[155] These high-level principles demonstrate that an objective regulatory standard of care exists to govern the actions of senior managers and directors in their supervision and oversight of the banking firm.

2. Authorization

FSMA Section 56 provides the legal basis for authorizing financial firms and individuals.[156] Based on this authority, the FSA provides a single authorization regime for all firms and approved individuals who exercise controlled functions in the financial services industry. The FSA can impose a single prohibition on anyone who is not an authorized or exempt person from carrying on regulated activities.[157] Any person who does so can be subject to civil fines and may be adjudicated guilty of a criminal offense.[158] The FSA takes the view that its authorization process is a fundamental part of its risk-based approach to regulation.

The FSA discharges its function by scrutinizing, at entry level, firms and individuals who satisfy the necessary criteria (including honesty, competence, and financial soundness) to engage in regulated activity. The authorization process of the FSA regulations seeks to prevent most regulatory problems by maintaining a thorough vetting system for those seeking licenses to operate or work in the financial sector.[159] The FSA has discretionary authority to exercise its powers in any way that it "considers most appropriate for the purpose of meeting [its regulatory] objectives."[160]

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the *firm* for which he is responsible in his *controlled function*." *Id*. (emphasis in original).

155. *Id*. at § 4.7.1. Principle Seven states, "An *approved person* performing a *significant influence function* must take reasonable steps to ensure that the business of the *firm* for which he is responsible in his *controlled function* complies with the relevant requirements and standards of the *regulatory system*." *Id*. (emphasis in original).

156. Section 56 states, in relevant part, as follows:

> [I]f it appears to the [Financial Services] Authority that an individual is not a fit and proper person to perform functions in relation to a regulated activity carried on by an authori[z]ed person . . . [t]he Authority may make an order ("a prohibition order") prohibiting the individual from performing a specified function, any function falling within a specified description or any function.

2000, c. 8 at § 56.

157. *Id*. at § 56(2).

158. *Id*. at § 56(4).

159. *See id*. at §§ 51–54 (setting forth provisions governing the authorization process).

160. *Id*. at § 2(1)(b).

The FSA will take three factors into account when determining fitness and propriety in the authorization process. First, it must make a determination that the applicant is honest in its dealings with consumers, professional market participants, and regulators.[161] This is known as the "honesty, integrity, and reputation" requirement. Second, the FSA requires the applicant to have competence and capability—that is, the necessary skills to fulfill the functions that are assigned or expected.[162] Third, an applicant must be able to demonstrate financial soundness.[163] These are objective standards that must be fulfilled to engage in the banking or financial business.

In addition, a firm or an individual applying for authorization must submit a business plan detailing its intended activities, with a level of detail appropriate for the level of risks.[164] The FSA will determine whether employees, the company board, and the firm itself meet the minimum requirements set out in the Act. It is a core function of the FSA authorization process that the regulator satisfy itself that the applicants and their employees are capable of identifying, managing, and controlling various financial risks and can perform effectively the risk-management functions.

3. Senior Management Arrangements, Systems, and Controls

The FSMA aims to regulate the activities of individuals who exert significant influence on the conduct of a firm's affairs in relation to its regulated activities. Pursuant to this authority, the FSA has divided these individuals into two groups: (1) members of governing bodies of firms, such as directors, members of managing groups of partners, and management committees, who have responsibility for setting the firm's business strategy, regulatory climate, and ethical standards; and (2) members of senior management to whom the firm's governing body has made significant delegation of controlled functions.[165] Controlled functions include, inter alia, internal audits, risk management, leadership of signifi-

161. Fin. Servs. Auth., *FSA Handbook: Enforcement* § 8.5.2(1)(a), http://www.fsa.gov.uk/handbook/BL3ENFPP/ENF/Chapter_8.pdf (Jan. 2004).

162. *Id*. at § 8.5.2(1)(b).

163. *Id*. at § 8.5.2(1)(c).

164. Fin. Servs. Auth., *FSA Handbook: Threshold Conditions* § 2.4.6, http://www.fsa.gov.uk/handbook/BL1CONDpp/COND/Chapter_2.pdf (Jan. 2004).

165. Fin. Servs. Auth., *Consultation Paper 26: The Regulation of Approved Persons* 4, http://www.fsa.gov.uk/pubs/cp/cp26.pdf (July 1999).

cant business units, and compliance responsibilities.[166] The delegation of controlled functions likely would occur in a number of contexts, but would occur particularly in companies that are part of complex financial groups.

The FSA is required to regulate in a way that recognizes senior managements' responsibility to manage firms and to ensure the firms' compliance with regulatory requirements. FSA regulations are designed to reinforce effective senior management and internal systems of control. At a fundamental level, firms are required to "take reasonable care to establish and maintain such systems and controls as are appropriate to [their] business."[167] The FSA requires senior management to play the main role in ensuring that effective governance structures are in place, overseeing the operation of systems and controls, and maintaining strong standards of accountability.[168]

More specifically, the FSA requires firms to take reasonable care to establish and maintain an appropriate apportionment of responsibilities among directors and senior managers in a way that makes their responsibilities clear.[169] They also are required to take reasonable care to ensure that internal governance systems are appropriate to the scale, nature, and complexity of the firm's business.[170] This reasonable care standard also applies to the board of directors and corporate officers who must exercise the necessary skill and care to ensure that effective systems and controls for compliance are in place. Unlike the reasonable care standard at common law, the reasonable care standard in the FSA regulations is an objective standard that expects corporate officers and board members to comply with a certain skill level when exercising their functions. It will not be a defense for them merely

166. Fin. Servs. Auth., *FSA Handbook: Supervision* § 10.4.5, http://www.fsa.gov.uk/handbook/BL3SUPppb/SUP/Chapter_10.pdf (Jan. 2004).

167. Fin. Servs. Auth., *FSA Handbook: Senior Management Arrangements, Systems and Controls* § 3.1.1, http://www.fsa.gov.uk/handbook/BL1SYSCpp/SYSC/Chapter_3.pdf (Jan. 2004).

168. *Id*. at § 1.2.1 (available at http://www.fsa.gov.uk/handbook/BL1SYSCpp/SYSC/Chapter_1.pdf).

169. *Id*. at § 2.1.1 (available at http://www.fsa.gov.uk/handbook/BL1SYSCpp/SYSC/Chapter_2.pdf).

170. *Id*. at § 3.1.1. The original statement of this principle was set forth in the FSA's consultation on firms' senior management responsibilities. *See* Fin. Servs. Auth., *Consultation Paper 35: Senior Management Arrangements, Systems and Controls* 8, http://www.fsa.gov.uk/pubs/cp/cp35.pdf (Dec. 1999) [hereinafter *Consultation Paper 35*].

to claim ignorance or lack of expertise if they fail to live up to the objective standard of care that requires them to establish and to maintain systems and controls appropriate to the scale, nature, and complexity of the business.[171]

Furthermore, a company's most senior executives, alone or with other senior executives from different companies in the same corporate group, are required to apportion senior management responsibilities according to function and capability, and to oversee the establishment and maintenance of the firm's systems and controls.[172] Corporate officers' and directors' failure to act reasonably in apportioning responsibilities may result in substantial civil sanctions and, in some cases, restitution orders to shareholders for any losses arising from these breaches of duty.[173] In addition to shareholders' private remedies for restitution, the FSA may impose additional and unlimited civil sanctions and penalties on individuals who are officers or directors in an amount that the FSA deems appropriate, even though the individuals in question may not have been involved directly in the offense in question.[174] The decision to impose personal liability can arise from the senior manager's failure to comply with the objective standard of care.

The FSA regulations for internal systems and controls address the problem, which existed at common law and in the Companies Act, of requiring only a subjective, reasonable person test to determine whether a board member met his or her duty of care and skill. Firms and their senior managers and officers are now required to comply with a heightened objective standard set by the FSA through its authorization process or enforcement rules. For example, if a senior manager has exercised a controlled function in violation of the regulatory rules, and the FSA finds the manager to be in contravention of his or her legal obligations, the

171. The defense of ignorance put forth by the Marquis de Bute, discussed *supra* notes 68–71 and accompanying text, would not be available under these regulations.

172. *Consultation Paper 35*, *supra* n. 170, at 10.

173. *See* Financial Services and Markets Act 2000, c. 8 at § 66 (allowing the FSA to impose penalty for failure to comply with a statement of principle); *id*. at § 382 (authorizing use of restitution orders).

174. *See id*. at § 66(2)(b) (defining misconduct to include the indirect act of being "knowingly concerned" in an offense).

FSA may impose "a penalty, in respect of the contravention, of such amount as it considers appropriate."[175]

The regulations seek to ensure that the firm's system and control requirements will be proportionate to the size and nature of the firm's business. Moreover, corporate officers and directors of a bank or financial firm also have the responsibility to ensure that compliance with these systems and controls is linked in a meaningful way to the authorization process.

C. Corporate Governance and the UK Anti-Money Laundering Rules

FSMA's statutory objective to reduce financial crime has involved the FSA writing a comprehensive set of regulations for banks, financial services firms, and their advisors to undertake due diligence and know the customer reporting requirements, and to undertake other safeguards against financial crime in financial institutions.[176] Statutory anti-money-laundering requirements for financial firms were first adopted under the Money Laundering Regulations of 1993.[177] Section 146 of the FSMA authorizes the FSA to "make rules in relation to the prevention and detection of money laundering in connection with the carrying on of regulated activities by authori[z]ed persons."[178] Based on this power, the FSA has adopted specific rules to target money laundering and terrorist financing.[179]

The FSA Money Laundering Rules create an objective, reasonable person standard against which the activities of senior management and directors will be measured for the purpose of imposing civil and criminal sanctions for violations of the rules. For instance, the FSA rules require all UK financial institutions to,

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175. *Id*. at § 206(1).

176. *See* Financial Services and Markets Act 2000, c. 8 at § 146 (authorizing the FSA to make rules relating to money laundering).

177. (1993) SI 1993/1933. The Money Laundering Regulations of 1993 became effective April 1, 1994. *Id*. at § 1. The UK was required to adopt these regulations because of the European Community Money Laundering Directive. European Union, *Council Directive on Prevention of the Use of the Financial System for the Purpose of Money Laundering (91/308/EEC)* art. 2, http://www.imolin.org/eudireng.htm (accessed Feb. 18, 2004).

178. 2000, c. 8 at § 146.

179. *E.g.* Fin. Servs. Auth., *Money Laundering Sourcebook*, http://www.fsa.gov.uk/what/ml_terrorist.html; *select* Money Laundering Sourcebook (accessed Feb. 19, 2004).

> take reasonable care to establish and maintain effective systems and controls for compliance with applicable requirements and standards under the *regulatory system* and for countering the risk that the *firm* might be used to further *financial crime*.[180]

Moreover, an authorized firm must take reasonable steps to determine the identity of its client by obtaining sufficient evidence of the identity of any client who comes into contact with the firm.[181]

The FSA Money Laundering Rules require firms to have in place adequate anti-money-laundering controls and compliance programs. The FSA requires each authorized firm to have in place a self-certification program for anti-money-laundering compliance.[182] Senior management and directors are required to take responsibility for the firm's internal controls and compliance systems. Compliance monitoring and providing key information to the relevant compliance officer are major responsibilities of senior management.[183]

Regulated financial institutions are required to appoint a money laundering reporting officer (MLRO), who must be approved by the FSA.[184] The MLRO must issue a detailed annual report to assess whether the financial institution has complied with the FSA Money Laundering Rules.[185] Banks and financial institutions must also make and retain records, including evidence of identity, details of transactions, and details of internal and external reports.[186]

V. BANK REGULATION AND CORPORATE GOVERNANCE: ANALYSIS

The responsibility for the overall governance of a financial institution should lay with management, which should have re-

180. *FSA Handbook: Senior Management Arrangements, Systems and Controls*, *supra* n. 167, at § 3.2.6 (emphasis in original).

181. Fin. Servs. Auth., *FSA Handbook, Money Laundering* § 3.1.3(a), http://www.fsa.gov.uk/handbook/BL2MLpp/ML/Chapter_3.pdf (Feb. 2004).

182. *Id*. at § 7.2 (available at http://www.fsa.gov.uk/handbook/BL2MLpp/ML/Chapter_7.pdf).

183. *Id*. at § 7.2.2(1).

184. *Id*. at § 7.1.1.

185. *Id*. at § 7.1.11(6), 7.2.2(1)(a)(i).

186. *Id*. at § 7.3.2.(1).

sponsibility for compliance with appropriate standards of conduct and adherence to proper procedures. UK financial legislation provides the FSA with a mandate to establish these standards, rules, and procedures.[187] The nature of the risk posed by banks and financial firms necessitates regulatory intervention to balance the interests of the various stakeholder groups while ensuring a profitable business strategy that promotes economic growth but does not undermine safety and soundness concerns. Regulation, however, should not be responsible for removing risk from the marketplace, as such risk is inherent in the enterprise system. Rather, it should attempt to reduce asymmetries of information and other institutional barriers that cause market failure. It should seek to align the various incentives of shareholders, creditors, managers, and customers to create a more incentive-compatible framework for the pricing of financial risk. To do this, there must be periodic evaluation of risk-management processes within a regulated entity, and this must involve interaction with regulators and external auditors.

Another important objective of corporate governance in the financial sector is the control of operational risk. Operational risk is defined as "the risk of loss through a failure of systems or deliberate or negligent conduct of staff."[188] High levels of operational risk may have systemic implications when they involve large investment firms with global operations. This was clearly the case in the Barings and Daiwa collapses,[189] which resulted from senior management's failure to implement adequate internal control procedures for staff and broader issues of ensuring that various subsidiaries of the financial group were complying adequately with home and host state regulatory standards. What is clear from the Barings and Daiwa fiascos is that home and host country regulators must communicate more and coordinate their investigations along the lines of international standards for supervising multinational conglomerates. They must adhere to the generally

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187. Financial Services and Markets Act 2000, c. 8 at § 1.

188. Intl. Org. of Securities Commn., *Objectives and Principles of Securities Regulation* 36 n. 51, http://www.iosco.org/library/pubdocs/pdf/IOSCOPD82-English.pdf (Sept. 1998).

189. *See* Michael Power, *Discussion Paper No. 16: The Invention of Operational Risk* 2–12, http://www.lse.ac.uk/collections/CARR/pdf/Disspaper16.pdf (June 2003) (discussing the Barings and Daiwa collapses).

accepted standards of consolidated supervision based on home country control.

The FSA addresses operational risk by requiring banks and financial firms to be managed by internal procedures designed to prevent misconduct or negligence. Because the regulator cannot practically expend the resources to ensure that such internal procedures are adhered to on a day-to-day basis, senior management must take this responsibility. Members of senior management must make themselves aware of the nature of the firm's business, such as its internal control procedures and its policies regarding the allocation of risk for particular activities. They must also ensure that they can capably discharge their responsibilities. They must clearly set forth lines of responsibility in the management command structure and provide adequate access to communication for those involved at all levels of the firm's operations. All relevant information concerning the firm's risk must be made available in a timely manner to both management and the regulator.

The specific structure of the firm's internal organization should be different based on the following factors: the firm's size, the nature of its business, and the risks and activities it undertakes. Despite these differences, the regulation of market intermediaries and investment firms should do the following: (a) set high standards of fair dealing with customers to ensure market integrity; (b) have clear terms of engagement in contracts with customers; (c) obtain all relevant information on customers' backgrounds; (d) make adequate disclosure to customers to allow them to make a balanced and informed investment decision; (e) maintain high levels of staff training in the sale of products; (f) develop proper protection for customer assets; (g) comply with any relevant laws, codes, or standards as they apply to the firm, as well as with all internal policies and procedures; and (h) avoid any conflicts of interest to ensure fair treatment of customers and the public.

Moreover, the FSA rules emphasize that senior management must be directly responsible for all firm policies regarding proprietary trading.[190] The firm should make available to the regula-

190. *See FSA Handbook: Supervision*, *supra* n. 166, at § 10.9.13 (discussing proprietary trading).

tor information regarding the firm's own proprietary trading and determine that the firm's net capital is sufficient in relation to the firm's risk exposure. This information should provide an understanding of the firm's overall business and risk profile, including that of its subsidiaries and affiliates. Management should also have personal liability for overseeing the firm's compliance with regulations regarding margin trading and the detection of conflicts of interest or manipulative practices.

The FSMA statutory and regulatory framework, as it applies to senior management controls and internal governance procedures for banks, could serve as a possible model for reforming corporate-governance practices in the nonfinancial sector. The FSMA regulatory model emphasizes the regulator's role in representing stakeholder interests and in seeking to achieve the overall public interest of economic growth and a safe and sound banking system. The UK Combined Code or company law could be amended to allow the company regulator—the Department of Trade and Industry—to play a more active role in working with the senior management of nonfinancial companies to devise corporate-governance standards and practices that recognize broader stakeholder interests. The regulator could be given a more formal role to assist directors in devising internal control systems and accountability structures that allow them to fulfill fiduciary duties to the company. To achieve this objective, it would be necessary for the regulator to play a balancing role between the interests of shareholders and creditors and other stakeholder interests. The type of compliance program would depend on a number of factors, including whether the company is listed or not, whether it is large or small, and what type of systemic impact the company's operations have on the broader economy. Moreover, the regulation of corporate governance should be backed by civil and, in some cases, criminal sanctions, but the regulator should apply the various standards flexibly in consultation with the company and the relevant stakeholder groups.

UK financial regulation provides a model in this regard, showing how a comprehensive framework of corporate governance can be implemented in active collaboration between the regulator and senior management in a way that allows the regulator to play a balancing role between owners, management, and broader stakeholder interests. A particular aspect of UK bank regulation involves its recognition of the relationship between the internal governance framework of banks and the incentive structure for risk-taking. Because banks pose a systemic threat, the FSA seeks to protect the broader public interest by requiring compliance programs that promote the efficient pricing of risk to enhance macro-economic performance and financial stability. A more active regulatory approach for corporate governance in the nonfinancial sector would be better suited to achieving the long-term interests of most companies.

VI. CONCLUSION

Many observers agree that the banking and financial industry is one sector that has been greatly affected by major structural changes due, in part, to the pressures of increased globalization. The consequences of such changes include, but are not limited to, increased competition, squeezed profit margins, and intense pressure to cut prices and to quickly develop and market new products with shorter life cycles—all within significantly shorter turnaround times. In addition, the banking industry has been subjected to the competitive forces of deregulation in both its activities and its prices. These structural changes in the financial markets necessitate stronger regulatory frameworks of financial regulation, especially in the corporate governance of banks.

A major corporate governance challenge for banks involves the principal–agent problem and how it can undermine financial stability when the incentives of bank management and directors are not aligned with those of the owners of the firm. This may result in different risk preferences for management as compared to the firm's owners, as well as other stakeholders, including creditors, employees, and the public. Because of high transaction costs and institutional barriers, aligning the interests of these groups may be difficult, if not impossible, without regulatory intervention.

Under the FSMA, it is the financial regulator's role to represent the public's interest in seeing that banks and financial firms are regulated efficiently to enhance the safety and soundness of the banking system and thereby increase economic growth. UK banking regulation, as implemented by the FSA, contains prudential supervisory and regulatory standards to enhance the corporate governance of UK banks and financial institutions. These standards seek to address the principal–agent problem through

(a) enhanced monitoring; (b) improved disclosure and accounting practices; (c) better enforcement of corporate governance rules and the corporate governance framework; and (d) strengthening of institutions through market discipline. They also require banks to establish internal compliance programs to monitor other types of risk arising from the growing problem of financial crime.

UK bank regulation seeks to balance the interests of shareholders with creditors, depositors, and other stakeholder interests. UK financial policy recognizes the importance of authorizing the financial regulator to balance these interests to protect the safety and soundness of the financial system and to promote economic growth and development. It would be too extreme to describe financial regulation as a substitute for corporate governance practices—it would be more accurate to describe its role as reducing the collective-action problem by ensuring that the broader standards and objectives of financial regulation are adhered to for the good of the broader economy and for most of the various stakeholder interests. This model of corporate governance, which involves a proactive role on the part of the regulator in balancing the interests of the various stakeholder groups, might provide some lessons for those involved in the corporate governance debate in the nonfinancial sector.