

CORPORATE GOVERNANCE AND BANKING REGULATION

WORKING PAPER 17

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Abstract

The globalisation of banking markets has raised important issues regarding corporate governance regulation for banking institutions. This research paper addresses some of the major issues of corporate governance as it relates to banking regulation. The traditional principal-agent framework will be used to analyse some of the major issues involving corporate governance and banking institutions. It begins by analysing the emerging international regime of bank corporate governance. This has been set forth in Pillar II of the amended Basel Capital Accord. Pillar II provides a detailed framework for how bank supervisors and bank management should interact with respect to the management of banking institutions and the impact this may have on financial stability. The paper will then analyse corporate governance and banking regulation in the United Kingdom and United States. Although UK corporate governance regulation has traditionally not focused on the special role of banks and financial institutions, the Financial Services and Markets Act 2000 has sought to fill this gap by authorizing the FSA to devise rules and regulations to enhance corporate governance for financial firms. In the US, corporate governance for banking institutions is regulated by federal and state statute and regulation. Federal regulation provides a prescriptive framework for directors and senior management in exercising their management responsibilities. US banking regulation also addresses governance problems in bank and financial holding companies. For reasons of financial stability, the paper argues that national banking law and regulation should permit the bank regulator to play the primary role in establishing governance standards for banks, financial institutions and bank/financial holding companies. The regulator is best positioned to represent and to balance the various stakeholder interests. The UK regulatory regime succeeds in this area, while the US regulatory approach has been limited by US court decisions that restrict the role that the regulator can play in imposing prudential directives on banks and bank holding companies. FSA regulatory rules have enhanced accountability in the financial sector by creating objective standards of conduct for senior management and directors of financial companies. The paper suggests that efficient banking regulation requires regulators to be entrusted with discretion to represent broader stakeholder interests in order to ensure that banks operate under good governance standards, and that judicial intervention can lead to suboptimal regulatory results.

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Corporate Governance and Banking Regulation: *The Regulator as Stakeholder*

The role of financial regulation in influencing the development of corporate governance principles has become an important policy issue that has received little attention in the literature. To date, most research on corporate governance has addressed issues that affect companies and firms in the non-financial sector. Corporate governance regulation in the financial sector has traditionally been regarded as a specialist area that has fashioned its standards and rules 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 analyse the relationship between shareholders and directors and managers has given way to broader policy concerns to maintain financial stability and ensure that banks are operated in a way that promotes broader economic growth as well as enhancing shareholder value.

Recent research suggests that corporate governance reforms in the non-financial sector may not be appropriate for banks and other financial sector firms.¹ This is based on the view that no 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 non-financial 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 management practices in banks more accountable and efficient. Unlike other firms in the non-financial sector, a mismanaged bank may lead to a bank run or collapse, which can cause the bank to fail on its various counterparty obligations to other financial institutions and in providing 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 (*eg.*, creditors and depositors). Consequently, bank regulators place additional responsibilities on bank boards that often result in detailed regulations regarding their 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, and can act more efficiently than most stakeholder groups in ensuring that the bank adheres to its 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 other creditors. This would involve expanding the scope of fiduciary duties beyond shareholders to include depositors and creditors.⁶ 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 banks managers' and directors' incentive of bank managers and directors 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 United Kingdom, banking regulation has traditionally involved government regulators adopting standards and rules that were 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. In the United States, banking regulation has generally been shared between federal and state banking regulators. The primary objective of US regulators was to maintain the safety and soundness of the banking system. There were no specific criteria that defined what safety and soundness meant. Regulators exercised broad discretionary authority to manage banks and to intervene in their operations if the regulator believed that they posed a threat to banking stability or to the US deposit insurance fund. As US banking markets have become more integrated within the US as well as international in scope, US federal banking regulators increased their supervisory powers and developed more prescriptive and legalistic approaches of prudential regulation to ensure that US banks were well managed and governed. Today, under both the UK and US approaches, the major objectives of bank regulation involve, *inter alia*, capital requirements, authorisation restrictions, ownership limitations, and restrictions on connected lending.⁸ These regulatory standards and rules compose the core elements of corporate governance for banking and credit institutions.

As deregulation and liberalisation has 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 have allowed 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.⁹ 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 increasingly risky behaviour 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 the excessive risk-taking of financial firms poses to the broader economy.

Increasingly, international standards of banking regulation are requiring domestic regulators to rely less on a strict application of external standards and more on internal monitoring strategies that involve the regulator working closely with banks and adjusting standards to suit the particular risk profile of individual banks. Indeed, Basel II emphasises that banks and financial firms should adopt, under the general supervision of the regulator, internal self-monitoring systems and processes that comply with statutory and regulatory standards. This paper analyses recent developments in international banking regulation regarding the corporate governance of banks and financial institutions. Specifically, it will review recent international

efforts with specific focus on the standards adopted by the Basel Committee on Banking Supervision. Pillar II of Basel II provides for supervisory review that allows regulators to use their discretion in applying regulatory standards. This means that regulators have discretion to modify capital requirements depending on the risk profile of the bank in question. Also, the regulator may require different internal governance frameworks for banks and to set controls on ownership and asset classifications.

In the UK, the financial regulatory framework under the UK Financial Services and Markets Act 2000 (FSMA)¹⁰ requires banks and other authorised financial firms to establish internal systems of control, compliance, and reporting for senior management and other key personnel. 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.¹¹ These systems must be based on recognised 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.¹² The FSA will take disciplinary action if an approved person - director, senior manager or key personnel - deliberately violates regulatory standards or her behaviour falls below a standard that the FSA could reasonably expect to be observed.¹³

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.¹⁴ The FSA's balancing exercise relies less on the strict application of statutory codes and regulatory standards, and more on the design of flexible, internal compliance programmes 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.¹⁵ The regulator essentially steps into the shoes of these various stakeholder groups to assert stakeholder interests whilst 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.

Part I of this paper considers "governance" within the context of the *principal-agent* framework and how this applies to the risk-taking activities of financial sector firms. Part II 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 III analyses the FSMA regulatory regime for banking regulation and suggests that its requirements for banks and financial firms to establish internal systems of control and compliance programmes represents a significant change in UK banking supervisory techniques that 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.¹⁶ Part IV 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. Part V analyses the legal framework of US bank regulation and how it addresses corporate governance problems within banks and bank/financial holding companies. Part VI concludes with some general comments and how the internal self-regulatory approach of UK bank regulators is becoming the predominant model in sophisticated financial markets and represents the trend in international standard setting, but questions still remain regarding the regulation of multi-national bank holding companies and the legal risks that arise from uncertainty in the meaning of certain banking statutes that call into question the discretion of regulator's discretion to balance stakeholder interests and to exercise effective prudential oversight.

I. 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.¹⁷ The integral role that banks play in the national economy is demonstrated by the almost universal practice of states in 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 regulation which governs its activities.

B. The Principal-Agent Problem

The main characteristics of any governance problem is that the opportunity exists for some managers to improve their economic payoffs by engaging in unobserved, socially costly behaviour or "abuse" and the inferior information set of the outside monitors relative to the firm.¹⁸ These characteristics are related since 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.¹⁹ 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 inferior information relative to managers lies in the fact that monitors often employ incentive mechanisms rather than relying completely on explicit directives alone.²⁰

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 about two issues: the interest rate they receive on the loan, and the risk level of the loan. The interest rate charged, however, has two effects. First it sorts between potential borrowers (adverse selection)²¹ and it affects the actions of borrowers (moral hazard).²² These effects derive from the informational asymmetries present in the loan markets and hence the interest rate may not be the market-clearing price.²³

Adverse selection arises from different borrowers having different probabilities of repayment. Therefore, to maximise expected return, the bank would like to only lend to borrowers with a high probability of repayment. In order 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, hence expected profits are lower. The behaviour of the borrower is often a function of the interest rate. At higher interest rates firms are induced 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 try to tempt customers away from other banks with lower interest rates, they may succeed in only attracting bad borrowers – hence, they will not bother to do so.

To avoid credit rationing, banks use other methods to screen potential borrowers.²⁴ 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 practises in order to maximise the probability of repayment. The banks lending history produces valuable information that evolves over time. Banks therefore are depositories of information, which *in itself* becomes a valuable asset that allows banks to ascertain good borrowers from bad, 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 which 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 the conflicts between management and owners have become a focus of recent attention.²⁵

The resulting view, that financial markets can be subject to inherent instability, induces governments to intervene to provide depositor protection in some form or other. Explicit deposit insurance 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. These can involve limits on the range of activities; linking deposit insurance premiums to risk; and aligning capital adequacy requirements to business risk.²⁶

While such controls may overcome the agency problem between government and bank owners, it must be asked 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 which 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 improvement. However, because a government cannot, in practice, observe agents' private information, it can only achieve 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 governance structures of financial firms and institutions and the way information is disseminated in the capital markets.²⁷

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 recognise the threat that market intermediaries and some investment firms pose to the systemic stability of financial systems. In its report, the International Organisation 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.²⁸ IOSCO places primary responsibility for the management and operation of securities firms on senior management.

II. 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 evaluate and improve the legal, institutional, and regulatory framework for corporate governance in their countries.²⁹ 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.”³⁰ 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.³¹ 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 multi-functional 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.³² These reports set forth the essential strategies and techniques for the sound corporate governance of financial institutions, which can be summarized as follows:

- a. “[e]stablishing strategic objectives and a set of corporate values that are communicated throughout the banking organi[z]ation;”³³
- b. “[s]etting and enforcing clear lines of responsibility and accountability throughout the organi[z]ation;”³⁴
- c. “[e]nsuring 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;”³⁵
- d. “[e]nsuring that there is appropriate oversight by senior management;”³⁶
- e. “[e]ffectively utili[z]ing the work conducted by internal and external auditors, in recognition of the important control function they provide;”³⁷

- f. “[e]nsuring that compensation approaches are consistent with the bank’s ethical values, objectives, strategy and control environment;”³⁸ and
- g. “[c]onducting corporate governance in a transparent manner.”³⁹

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 management 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.⁴⁰

B. Basel II

The Basel Committee adopted the Capital Accord in 1988 as a legally non-binding international agreement among the world’s leading central banks and bank regulators to uphold minimum levels of capital adequacy for internationally-active banks.⁴¹ The New Basel Capital Accord (Basel II)⁴² 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.⁴³ Senior management is expected to have a thorough understanding of the design and operation of the bank’s capital rating system and its evaluation of credit, market, and operational risks.⁴⁴ 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.⁴⁵ Moreover, the reporting process to senior management should provide a detailed account of the bank’s internal ratings-based approach for determining capital adequacy.⁴⁶

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.⁴⁷ 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.⁴⁸ 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.⁴⁹ 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.

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.⁵⁰ 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.⁵¹

Pillar Three sets forth important proposals to improve transparency by linking regulatory capital levels with the quality of disclosure.⁵² 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,"⁵³ 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 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.⁵⁴

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. It should be noted, however, 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.

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.

III. UK FINANCIAL REGULATION AND CORPORATE GOVERNANCE: THE STATUTORY AND REGULATORY REGIME

A. Corporate Governance and Company Law – *Recent Developments*

The Combined Code of Corporate Governance

This section reviews recent developments in UK corporate governance and discusses the relevant aspects of UK company law. 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, reform of corporate governance at 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.⁵⁵

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 companies.⁵⁶ The Cadbury Committee's main focus was on financial control mechanisms and the responsibilities of the Board of Directors, the auditor, and shareholders.⁵⁷ The Committee published a final report in 1992, which concluded that the cause of these problems were not the need for improved auditing and accounting standards, but widespread defects in the internal control systems of large UK companies.⁵⁸ In the report, the Committee defined corporate governance 'as the system by which companies are directed and controlled'.⁵⁹ Moreover, the Committee recommended that the boards of all listed companies registered in the UK should comply with the Code immediately or explain why they have not complied.⁶⁰

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.⁶¹ As a result, a revised Combined Code came into effect on 1 November 2003, based on proposals of the Financial Reporting Council.⁶² The revision incorporated proposals of the Higgs Review⁶³ regarding the role and effectiveness of non-executive directors and the proposals of Sir Robert Smith's report⁶⁴ on audit committees.⁶⁵ The Code was amended to reflect proposals in the Higgs review that a change in board structure should be based on two principles: (1) enhancing the role of non-executive directors, and (2) splitting the role of the CEO and board chairman.⁶⁶ The chairman should be an independent, non-executive director who can take a detached view of the company's affairs. Another important proposal of the Higgs Review was that independent, non-executive directors should be used more to transmit the views of shareholders to the Board.⁶⁷ In this way, non-executives 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.⁶⁸ 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.⁶⁹ This is

known as the ‘Comply or explain principle’.⁷⁰ The requirement to comply or explain does not apply to non-listed companies.⁷¹

In 2003-2004, the FSA undertook a review of corporate governance and the regulation of the capital markets that seeks to examine the following issues: the interaction of the Combined Code 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 recognises that corporate governance standards and practices must be devised with broader systemic issues in mind, which requires 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 regime or the Listing Rules for the capital markets. It has therefore not been subject to FSA investigations and enforcement.⁷² It should be recalled that the Cadbury Report recommended that the combined code be applicable to all companies – listed and unlisted.⁷³ The UK Government has taken this a step further by proposing in its White Paper, entitled *Modernising Company Law*, that the combined code should be legally obligatory and enforced by a new Standards Board.⁷⁴

B. English Company Law and Directors’ Duties

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.⁷⁵ This legal principle provides a point of departure for analysing the regulator’s role in devising corporate governance standards that seek to balance the various interests of shareholders, creditors and stakeholders. The UK Companies Act 1985⁷⁶ 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, whilst the main external governance system is the market for corporate control.⁷⁷ As discussed above, most of the provisions of the Combined Code are not legally binding and form a type 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 maximisation, it should be noted that English company law has traditionally stated that directors owe a duty to the company, not to *individual shareholders*.⁷⁸ 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*.⁷⁹

The starting point of analysis for this area of the law is the case of *Percival v Wright*,⁸⁰ in which the court held that directors of a company are not trustees for individual shareholders and may purchase their shares without disclosing pending negotiations for the sale of the company.⁸¹ In essence, a director owes duties to the company and not to individual shareholders.⁸² However, a director who does disclose

certain information to shareholders has a duty not to mislead the shareholders with respect to that information.⁸³ The rule in *Percival v Wright* has been subject to substantial criticism by various UK government committees, including the Cohen Committee⁸⁴ and the Jenkins Committee.⁸⁵ The law has now evolved to a point where the courts recognise that a fiduciary duty may be owed by directors to individual shareholders in special circumstances, such as where the company is a family-run business.⁸⁶

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.⁸⁷ Although the UK company law model is based on the notion of the shareholder 'city state',⁸⁸ the directors owe their fiduciary duties directly to the company, and only indirectly to the shareholders.⁸⁹ It is difficult, however, to separate the interests of the company from those of the shareholders. Indeed, the interests of the company are in an economic and 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 maximisation of those shareholder interests - that is, to maximise 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 interpreting the Companies Act 1985 is that a director's legal duties are owed to the company and that the company's interest 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 maximisation is the main criteria for determining the successful stewardship of a company.⁹⁰

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*,⁹¹ which involved the Marquis of Bute, who had inherited the office of president of the Cardiff Savings Bank when he was six months old.⁹² 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. 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.⁹³ 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 acts or omissions of a director or senior manager who had failed to keep himself informed of the bank or company's activities. In subsequent

cases, the courts were reluctant to apply such a lenient liability standard. In *Dovey v. Corvey*⁹⁴ 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.⁹⁵ The court found that the director had not acted negligently in receiving suspicious information from other company officers and in failing to investigate further any irregularities in company practice.⁹⁶ The significance of the case, however, was that the court recognised that a reasonable person test should be applied to determine whether a director had breached its 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 had possessed the particular ability and skills of the actual defendant in the case.⁹⁷ In *Marquis of Bute’s case*, it would not be difficult to show that the defendant did not possess the requisite skills at hand to make an informed judgment.⁹⁸ On the other hand, it would be easier to do so regarding an experienced and skilled senior manager who had 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,⁹⁹ the most recent of which is *Dorchester Finance Co., Ltd. v. Stebbing*,¹⁰⁰ where the court found that the reasonable person test should apply equally to both executive and non-executive directors. More generally, modern English company law would 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.¹⁰¹ Second, a director is not required to concern 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 at 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.¹⁰² 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 wrongdoing of those officers in the absence of grounds for suspicion.¹⁰³ Notwithstanding the courts’ efforts to define further the reasonable person standard for company directors, it can be criticised 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 the director individually owes a duty of good faith to the company, which means 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.¹⁰⁴ 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,¹⁰⁵ and they must act in good faith in respect to the best interest of the company, while not allowing their discretion to be limited in the decisions they make for the company.¹⁰⁶ Moreover, a director who finds himself or herself in the position of having a conflict of interest will be required to take corrective measures.¹⁰⁷

C. The Financial Services and Markets Act: *The Statutory Framework*

The Financial Services and Markets Act 2000 (FSMA)¹⁰⁸ 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 "appropriate" consumer protection, and to reduce financial crime.¹⁰⁹ 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.¹¹⁰ FSMA created the Financial Services Authority (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.¹¹¹

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.¹¹² In so doing, 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 between those who are subject to any form of regulation by the Authority."¹¹³

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.¹¹⁴ Although many leading economists have criticized the use of cost-benefit analysis,¹¹⁵ 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 offense¹¹⁶ that imposes civil liability, fines, and penalties for the misuse of inside information and market manipulation.¹¹⁷

The FSMA sets out a framework to protect the integrity of nine of the UK's recognized investment exchanges, including the London Stock Exchange, the London Metal Exchange, and the London International Financial Futures Exchange.¹¹⁸ The FSA has the power to scrutinize the rules and practices of firms and exchanges for anti-competitive 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.¹¹⁹

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 (MOUs) and mutual assistance treaties with foreign authorities that provide for co-operation and information-sharing.¹²⁰ The FSA, the UK Treasury, and the 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.¹²¹

D. 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.¹²² 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."¹²³ The FSA interprets this principle as setting forth an objective, reasonable person standard for all persons involved in the management and direction

of authorized financial firms.¹²⁴ 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.”¹²⁵ 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.”¹²⁶

In addition, the FSA has adopted its own statement of principles for all approved persons, which includes integrity in carrying out functions,¹²⁷ acting with due skill and care in carrying out a controlled function,¹²⁸ observing proper standards of market conduct,¹²⁹ and dealing with the regulator in an open and honest way.¹³⁰ 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.¹³¹ 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.¹³² Additionally, senior managers must take reasonable steps to ensure that the regulated business of their firm complies with all applicable requirements.¹³³ 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. Authorisation

FSMA Section 56 provides the legal basis for authorizing financial firms and individuals.¹³⁴ 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.¹³⁵ Any person who does so can be subject to civil fines and may be adjudicated guilty of a criminal offense.¹³⁶ 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.¹³⁷ 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.”¹³⁸

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.¹³⁹ 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.¹⁴⁰ Third, an applicant must be able to demonstrate financial soundness.¹⁴¹ 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.¹⁴² 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.¹⁴³ Controlled functions include, inter alia, internal audits, risk management, leadership of significant business units, and compliance responsibilities.¹⁴⁴ 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."¹⁴⁵ 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.¹⁴⁶

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.¹⁴⁷ 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.¹⁴⁸ 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 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.¹⁴⁹

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.¹⁵⁰ 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.¹⁵¹ 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.¹⁵² 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 FSA may impose "a penalty, in respect of the contravention, of such amount as it considers appropriate."¹⁵³

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.

E. 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.¹⁵⁴ Statutory anti-money-laundering requirements for financial firms were first adopted under the Money Laundering Regulations of 1993.¹⁵⁵ 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."¹⁵⁶ Based on this power, the FSA has adopted specific rules to target money laundering and terrorist financing.¹⁵⁷

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,

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*.¹⁵⁸

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.¹⁵⁹

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.¹⁶⁰ 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.¹⁶¹

Regulated financial institutions are required to appoint a money laundering reporting officer (MLRO), who must be approved by the FSA.¹⁶² The MLRO must issue a detailed annual report to assess whether the financial institution has complied with the FSA Money Laundering Rules.¹⁶³ Banks and financial institutions must also make and retain records, including evidence of identity, details of transactions, and details of internal and external reports.¹⁶⁴

The FSA has undertaken a number of enforcement actions to enforce these standards and to impose sanctions on senior managers for failing to act reasonably in maintaining internal controls and reporting wrongdoing by lower level employees. In the *Credit Suisse Financial Products* case,¹⁶⁵ the FSA disciplined three senior managers of Credit Suisse Financial Products (CSFP, now Credit Suisse First Boston). Two were disciplined for inappropriate conduct and the other one (the former chief executive) was disciplined for failing to implement the appropriate system of internal controls.¹⁶⁶ The FSA imposed a fine of £150,000 on the former CEO for failing to detect or prevent attempts to mislead the Japanese tax authorities in an audit of the firm's Japanese operations.

Although the FSA found that the CEO had properly delegated responsibility for complying with the firm's audit to other managers who had failed to execute their delegated function, it held nonetheless that the CEO was liable and thus subject to sanctions. Specifically, the FSA held that the CEO had failed to monitor and supervise staff, and to discern and investigate and to take preventative measures after it became apparent that the firm's employees were engaged in illegal conduct under Japanese law.¹⁶⁷ The FSA's case rested on the fact that the CEO had received documents that would have provided him with the necessary information to discover the employees' misconduct had he read the documents. By failing to read the documents the CEO had violated the reasonable person standard for a person in his position, which prevented him from becoming aware of the misconduct which he agreed was inappropriate and illegal. The enforcement action shows how the FSA might act under the FSMA regime were a senior manager to breach the reasonable expectations of the FSA regulatory standards. Moreover, the case reveals the extraterritorial extent of the FSA's regulatory regime and how it can impose civil sanctions on financial market professionals for misconduct that takes place in other jurisdictions.

In summary, the FSMA regulatory model emphasises the role of the regulator in representing stakeholder interests and in seeking to achieve the overall public interest

of economic growth and a safe and sound banking system. UK financial regulation provides a more comprehensive framework of corporate governance that recognises the important role played by the regulator in representing broader stakeholder interests, including creditors, depositors and customers. Furthermore, the regulator seeks to promote the broader public and stakeholder interest by effectively enforcing regulatory standards in a manner that will deter misconduct and induce management to undertake efficient behaviour that promotes overall macroeconomic growth and stability. 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.

V. Corporate Governance and US Banking Regulation: Prudential Standards

The United States has traditionally had a federal-state structure for banking regulation. Federal and state regulators shared responsibility for ensuring the prudential soundness of US banks. Before the 1980s, it was not necessary for a foreign bank to obtain approval from a US federal regulator to operate as a bank in a US state so long as the foreign bank had obtained permission from the relevant state bank regulator. This federal structure of banking regulation began to evolve in the 1970s in response to dramatic changes in global financial markets. Increasing liberalisation and deregulation in global and US banking markets had exposed US banks to more volatility in the wholesale banking market, which led to increased systemic risk in the payment system and the likelihood of bank failures that could have a domino-like effect throughout the banking sector. In the late 1970s and 1980s, Congress responded by enacting legislation that delegated broad authority to federal bank regulators to supervise and control the activities of all banks operating in the US - whether they were US or foreign, or seeking federal or state licenses.

US banks and bank/financial holding companies are governed by a comprehensive system of statutory regulation that generally provides regulators with broad discretion to take measures to promote safety and soundness in the banking system, protect the deposit insurance fund, and promote competition in the banking sector. Because these regulatory objectives often conflict, and the legal powers delegated to regulators by Congress are broad, the US courts have been called upon in a number of cases to resolve disputes between regulators and bank management regarding the scope of the regulator's authority to adopt measures to regulate banking institutions. In the case of bank/financial holding companies, US courts have interpreted the bank holding company statutes narrowly as not authorising the Federal Reserve to issue regulatory directives against holding companies except when they apply to acquire, or merge with, banks.

This section argues that since the 1970s liberalisation and deregulation in the US banking sector has created substantial systemic risk that has led US regulators and courts to play a more interventionist role in the oversight of banking institutions. It assesses the legal framework for regulating moral hazard in the US deposit insurance system. It then examines recent judicial rulings concerning the authority of the Federal Reserve Board to impose source of strength requirements on bank holding companies and their banks. It argues that these decisions have exposed institutional gaps in the federal structure of US banking regulation and have undermined corporate governance in bank and financial holding companies.

US prudential regulation

The concept of prudential regulation in US banking law grew out of the vague statutory requirement that banks should be managed and operated in a safe and sound manner. The ‘safety and soundness’ principle has been the driving force in US banking regulation and corporate governance practices. It should not be forgotten that the ‘soundness’ principle was derived from the supervisory practices of the Bank of England which emphasised the need for fit and proper standards for senior managers and directors of banks. In both the US and UK, the soundness principle and prudential regulatory standards provided the basis for the development of standards and principles of corporate governance for banking institutions. Effective corporate governance principles were considered essential to preserve financial stability by regulating management practices of banks so that conflicts of interest and self-dealing was minimised. Moreover, US regulation has also set strict standards for the auditors and accountants of banking institutions with the potential for civil and criminal liability for failing to report accurately the financial condition of banks and other regulated financial institutions. Under UK and US regulation, it has been recognised that the integral role that banks play in the economy and the liquidity problems they face are due to the mismatch between the bank’s liabilities and its assets. This mismatch creates a negative externality that is a social cost that must be minimised through effective regulation. An important aspect of US banking regulation has been the governance practices of banks and financial institutions.

An important area that has not been adequately regulated by either the US or UK is the financial incentives provided by banks to their employees and shareholders. Indeed, the risk-taking strategies of senior management and directors are significantly influenced by their compensation arrangements and by their exposure to civil and criminal liability for their risk-taking practices. The goal, as discussed in section I, is to align their incentives with the incentives of shareholders, depositors and creditors. In other words, they must be required to incur the costs of their risk-taking activities. The regulator can only hope to approximate this in the real world. What has become generally recognised, however, is that regulators should be given broad statutory authority to exercise discretion in assessing the risk profile of a particular institution and to respond rapidly to developments in financial markets that affect risk-taking. For instance, this might involve controlling incentive arrangements for certain key personnel in the bank who exercise control over the bank’s leverage positions.

In addition, the regulator may impose administrative penalties and civil sanctions on banks or their directors and employees for taking actions that threaten financial safety and soundness. This type of discretion, however, can be criticised on the grounds that it places too much power in the hands of the regulator to act in a way that some might view to be arbitrary and capricious. Indeed, the discretionary power of the regulator may result in discriminatory treatment between banks or individuals that might violate human rights legislation. Moreover, it might violate a person’s right to have civil penalties or sanctions reviewed by a fair and impartial tribunal.¹⁶⁸

Regulatory discretion has been an important element of US banking regulation. The objective of ‘safety and soundness’ under US banking law has always implied a broad discretionary power for US banking supervisory agencies to apply

and enforce prudential standards on banking institutions. Before the 1980s, US federal banking law did not define the safety and soundness principle; this provided regulators with broad discretion to enforce banking law based on subjective factors that were not defined in regulation or statute.¹⁶⁹ The Fifth Circuit Court of Appeal in 1983 restricted this broad authority in the *Bellaire* case by overturning a US regulator's decision to require the capital standards of a bank viewed by the regulator to be weak to be higher than the capital charges applied to other banks. The regulator had grounded its decision on its statutory authority to promote 'safety and soundness' of the banking system. But the federal banking statute and regulation had not provided any apparent criteria to serve as a basis to justify the regulator in treating one bank differently from the others. In the absence of any published statutory or regulatory criteria that demonstrated a rational reason to treat one bank differently from another, the court found the regulator's decision to impose higher capital charges on one bank in relation to others to be a violation of equal protection under the law and due process of law. The court essentially held that the regulator had acted arbitrarily and capriciously by treating the bank in a discriminatory manner on the basis of standards and criteria that were not apparent in statute or regulation. The implication of the holding was that if Congress had expressly provided criteria in statute or had delegated power to the regulator to set criteria in regulations to justify the discriminatory treatment of banks that were a threat to the safety and soundness of the banking system, then such regulatory decisions would not have been arbitrary or capricious and therefore not in violation of US law.

A. *International Lending Supervision Act of 1983*

Congress responded to the *Bellaire* decision and the sovereign debt crisis by enacting the US International Lending Supervision Act (ILSA), which provides that each federal banking agency shall require, by regulation, banking institutions to disclose to the public information regarding material foreign country exposure in relation to assets and capital.¹⁷⁰ The ILSA also requires each appropriate federal banking agency to cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such banking institutions and by using such other methods that the relevant agency deems appropriate.¹⁷¹ Each federal banking regulator shall have the authority to establish minimum capital levels and management standards for a banking institution according to discretionary authority exercised in the particular circumstances of the banking institution.¹⁷² In other words, the federal banking regulator had the discretionary authority to take remedial action against banks or the management of banks who had failed to manage the bank in a safe and sound manner, if the bank had failed to maintain capital at or above the minimum level or to have committed 'an unsafe or unsound practice' within the meaning of the federal banking statutes.¹⁷³ The broad authority granted in the ILSA to federal banking regulators effectively overruled the *Bellaire* decision. ILSA conferred express enforcement powers on US federal bank regulators through the use of capital directives.¹⁷⁴

B. Deposit Insurance – The Federal Deposit Insurance Corporation and FIDICIA 1991

The Federal Deposit Insurance Corporation (FDIC) was established by statute during the Great Depression in 1931 to provide deposit insurance to the depositors of failed US banking institutions. The FDIC is charged with the difficult task of administering the deposit insurance fund. Its funding depends on risk premium payments (and the interest those payments earn) made into the fund by covered depository institutions. During its first sixty years, it assessed the insured institutions at the same rate flat rate for deposit-insurance coverage. Although the FDIC was crucial for restoring depositor confidence in the US banking system following the 1940s and undoubtedly played an key role in the recapitalisation of US banks, it has been criticised for creating moral hazard among bank managers and depositors who perceive respectively that they can be bailed out for making poor lending decisions with depositor's money.

In 1991, as a response to savings and loan crisis of the 1980s, Congress sought to mitigate the moral hazard problem by enacting the Federal Deposit Insurance Corporation Act of 1991 (FIDICIA). The risk premium charged on each deposit was made more risk sensitive based on the risk weightings of each depository institution. An institution, for example, that has low levels of capital as a percentage of its assets and liabilities will be given a higher risk weighting and thus be required to pay higher insurance premiums into the insurance fund. The assessments that produce revenue for the deposit insurance fund enable the FDIC to absorb losses arising from a crisis caused by financial institution failure.

Under FIDICIA, the FDIC has been vested with discretion to make determinations of unsafe and unsound banking practices in violation of the FIDICIA that would place the insurance fund at risk. Indeed, US courts have adopted a standard of review under federal banking law for determining the lawfulness of agency action in regulating prudential standards of banking institutions. Indeed, in *Doolin Security Savings Bank v. F.D.I.C.*, the Fourth Circuit Court of Appeals ruled that the applicable standard of review under 12 U.S.C. § 1818 (h)(2) for determining whether the FDIC abused its discretion in establishing a particular risk-based capital adequacy scheme for federally-insured depository institutions was that a Court:

[C]annot reverse the FDIC Board action unless the findings upon which it is based are not supported by substantial evidence on the record as a whole, or unless the remedies formulated by the Board constitute an abuse of discretion or are otherwise arbitrary and capricious.¹⁷⁶

In exercising its authority, the FDIC has discretion to adopt a risk-based capital assessment scheme and procedure structure under which the FDIC may terminate an institution's insured status and terminate its banking license if it determines that the depository institution's practices are unsafe and unsound.¹⁷⁷ Before analysing this statutory scheme, it is important to provide a general background of the FDIC deposit insurance statute.

FIDICIA established a risk-based assessment system under which the premiums paid by federally insured financial institutions are based on risks the

institutions pose to the insurance fund. Specifically, Section 302(a) of the FDICIA requires the FDIC to establish final risk-based assessment regulations, and section 302(f) authorises the FDIC to promulgate transitional regulations governing the time period between the flat-rate assessment system and the risk-based assessment system required under section 302(a). The FDIC adopted the transitional regulations on 15 September, 1992,¹⁷⁸ and subsequently adopted the final regulations on 17 June, 1993¹⁷⁹. Both regulations were codified under Title 12 of the Code of Federal Regulations § 327.180

In section 302(a) of the FDICIA, Congress defined a ‘risk-based assessment system’ as:

a system for calculating a depository institution’s semiannual assessment based on –

- (i) the probability that the deposit insurance fund will incur a loss with respect to the institution, taking into consideration the risks attributable to –
 - (I) different categories and concentrations of assets;
 - (II) different categories and concentrations of liabilities, both insured and uninsured, contingent and non-contingent; and
 - (III) any other factors the [FDIC] determines are relevant to assessing such probability;
- (ii) the likely amount of any such loss; and
- (iii) the revenue needs of the deposit fund.¹⁸¹

The FDIC has responded by using a risk-based classification system based on detailed reports and expert evaluations of the financial condition of an institution. The FDIC’s regulations require the agency to analyse objective ‘capital factors as well as subjective ‘supervisory’ factors.¹⁸² The capital factors determine the institution’s ‘capital group’, signified as a 1, 2 or 3 in the risk classification. The supervisory risk factors determine the institution’s ‘supervisory sub-group,’ signified as an A, B, or C in the risk classification.¹⁸³ Further, the regulations provide that the FDIC will assign an institution a supervisory subgroup based on the FDIC’s ‘consideration of supervisory evaluations provided by the institution’s primary federal regulator.’¹⁸⁴

Issues of Constitutional Due Process

In determining whether FDIC procedures for issuing capital directives satisfied due process requirements of the US Constitution, the Fifth Circuit Court Appeals held in *FDIC v. Coughatta*¹⁸⁵ that the FDIC must adhere to a three-factor inquiry that courts are required to use in determining what type of procedures satisfy due process before the government may deprive an entity of a property interest protected by the Due Process Clause of the Fifth or Fourteenth Amendments.¹⁸⁶ The three factors are: (1) the private interest that will be affected by the official action; (2) the risk of an erroneous deprivation of such interest through the procedures used, and the probable value, if any, of additional or substitute procedural safeguards; and (3) the Government’s interest, including the function involved and the fiscal and administrative burdens that the additional or substitute requirement would entail.¹⁸⁷

Essentially, due process is flexible and calls for such procedural protections as the particular situation demands.¹⁸⁸

In assessing prudential supervisory practices, the Fifth Circuit in *Coushatta* concluded that procedures for determining capital adequacy and risk-based supervisory ratings satisfied due process. The court reasoned that the private interest of accurate capital directives is significant but that the risk of an erroneous deprivation of property because of the application of a directive is marginal. The court noted that a predeprivation evidentiary hearing (as opposed to an informal hearing) was not warranted because a bank has adequate opportunity to respond to the notice through written procedures. Also, the court found that the government's interests is substantial because delay would considerably weaken the benefits from a prompt directive, which seeks to rectify a bank's troublesome undercapitalization. Similarly, in *Doolin*, the Fourth Circuit reviewed the procedures allowing a bank to challenge a FDIC determination of risk-based capital ratings, and found the procedure to be in compliance with constitutional standards of due process.¹⁸⁹

The FDIC procedure allowing banks to contest their risk-based capital ratings meets the due process test because it provides banks with notice of its risk classification and an opportunity to challenge the classification through the review procedures established in the regulations.¹⁹⁰ Accordingly, the Courts have held that the due process clause does not require a predeprivation evidentiary hearing before a particular risk-based weighting is applied to banks' capital position.¹⁹¹

Similarly, the Office of Thrift Supervision¹⁹² has discretion to determine whether the business activities of savings banks are 'unsafe or unsound practices' and thus in violation of prudential supervisory standards of federal banking law. Such determinations may only be overruled by a court if it concludes that the agency action was arbitrary, capricious or an abuse of discretion, nor is there sufficient evidence to overcome the presumption of regularity and correctness afforded to the appointment. The Courts have generally upheld the discretionary authority of the OTS to apply prudential supervisory standards to federal savings banks that rely on a combination of objective and subjective standards for determining whether the bank was acting in a prudential manner.¹⁹³ These prudential assessments produce specific composite ratings of each savings bank. Banks may challenge the risk-based assessments that are applied to their activities by the OTS. The review procedure involves three-tier administrative review whereby an institution may challenge its risk-based ratings at the district level of the OTS, and then may appeal the decision to the OTS Director. Once administrative review with the OTS is exhausted, an institution may seek review before an administrative law judge pursuant to the Administrative Procedure Act.¹⁹⁴

Under the above legislation and regulations, federal banking regulators are thus given the authority to establish required minimum capital levels and to deny particular transactions or activities by banking institutions if they constituted 'unsafe and unsound' practices banking practice and to have general statutory enforcement powers to effect these standards.¹⁹⁵

The Challenge posed by Bank Holding Companies

According to Akhgbe et al (2004), bank holding companies and financial conglomerates pose a special type of agency problem for regulators because these financial companies often own separate subsidiaries and divisions that perform various financial functions, often in multiple jurisdictions. The complex structure of conglomerates and financial holding companies pose a particular type of agency problem which is not necessarily the same as within the individual bank or financial institution. This is an important question because most banks and financial institutions operate within holding companies and multi-national financial conglomerates that are composed of hundreds of subsidiaries and affiliate companies that operate in multiple jurisdictions. What is the nature of the principal-agent problem within these banking groups or conglomerates. It may depend on the structure of the management within the conglomerate. For instance, does the holding company have a centralized management structure controlled by the board of directors and managers of one company, or is it more diffuse with management authority shared among several or more subsidiaries and affiliates within the group? Identifying the exact nature of the principal-agent problem will likely depend on which company or individual(s) exercise, or have the ability to exercise, control over the group's operations. Saunders (1990) argues that this will depend on whether there is alignment of interests and incentives between managers and the block shareholders. This view is based on the notion that there are two main factors affecting risk taking within the financial holding company: managers' incentive and block ownership.

The goal of regulating bank and financial holding companies should be to align the incentives of the managers and directors of the holding company with those of the managers and directors of the subsidiaries which they control. The regulator has a further responsibility to ensure that the incentives of the holding company and its subsidiaries are socially optimal in so far as the social costs of financial risk-taking should be minimised throughout the conglomerate. The evidence from block ownership in bank holding companies shows that the presence of safety nets (eg., lender of last resort) increases the incentive for risk-taking in holding company structures, and these incentives can be difficult to estimate because most financial holding companies in G10 countries operate in multiple jurisdictions, which have different levels of safety net protection.

US Regulation of Bank Holding Companies: *The Legal Framework*

Since 1956, US banking law has sought to address the risks posed by managerial incentives and block shareholder interests within bank holding companies by adopting legislation that governs the structure and activities of these financial entities. Bank holding companies are a type of financial conglomerate. In modern financial markets, most banks operate in holding companies. In these corporate groups, banks may exercise control, or be controlled, or simply be affiliated to other banks and companies within the holding company structure. The holding company structure of banks creates particular principal-agent tensions that require a different approach than what would be the case for individual banks.¹⁹⁶ The Bank Holding Act of 1956 and the Financial Services Modernization Act of 1999 attempt to address the principal-agent problem within the group structure of banks and financial firms. To do so, the Board of Governors of the Federal Reserve System (Federal Reserve) have been

granted broad authority to adopt regulations to govern the management of banking and financial holding companies. These broad supervisory powers extend to considering and approving any proposal or transaction by a banking institution, or its affiliate, or the holding company which controls such banking institution, that would divert earnings, diminish capital, or otherwise impede such banking institution's progress in achieving its minimum capital level.¹⁹⁷ The Federal Reserve may deny such approval for particular transactions where it determines that certain management practices or transactions would adversely affect the ability of the banking institution to comply with such a plan. These powers to regulate the management of bank and financial holding companies have been influenced by judicial decisions that have developed two important doctrines of prudential regulation: *the source of strength requirement* and *change of bank control*.

Supervisory Authority for Bank Holding Companies: *The Institutional Gap*

Statutory regulation of US bank holding companies began when Congress enacted the Bank Holding Company Act of 1956 (BHCA).¹⁹⁸ The congressional intent behind the BHCA was to prevent the concentration of ownership and control of banking facilities, and to prevent the combination of both banking and non-banking enterprises so that banks would not engage in business wholly-unrelated to banking.¹⁹⁹ The BHCA also addressed a concern regarding monopolistic control of credit and directed the Federal Reserve to review bank acquisitions under several standards, including financial and managerial soundness, and access to capital.²⁰⁰

Specifically, the BHCA grants the Board supervisory control over the formation, structure and operation of bank holding companies and their non-bank subsidiaries. Section 3(a) of the Act²⁰¹ provides that no company may acquire control of a bank without prior approval by the Board. In determining whether to approve an application, section 3(c) of the Act²⁰² directs the Board to consider 'the financial and managerial resources and future prospects of the company or companies and the banks concerned.'

The Board has argued that the Act has provided it broad authority to oversee the safety and soundness of bank holding companies and the financial institutions that operate within them. The Board has also argued that section 3 (c) grants it statutory authority to impose source of strength charges on bank holding companies and the banks they own or control. The alternative view has been that the Board only has authority to review the safety and soundness of bank holding companies and their banks and to impose source of strength charges when the bank holding company has applied to acquire or merge with a bank.

The former view is supported by Board's regulations adopted pursuant to its authority under the BHCA. The Board adopted Regulation Y in 1984 which provides:

§ 225.4 Corporate Practices

- (a) *Bank holding company policy and operations.* (1) A bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not contact [sic] its operations in an unsafe or sound manner²⁰³

In April 1987, the Board reinforced this view by publishing a policy statement that provided:

It is the policy of the Board that in serving as a source of strength to its subsidiary banks, a *bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks* during periods of financial stress or adversity and should maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks. . .

A bank holding company's failure to meet its obligation to serve as a source of strength to its subsidiary bank(s), including an unwillingness to provide appropriate assistance to a troubled or failing bank, will generally be considered an unsafe or unsound banking practice in violation of Regulation Y, or both.²⁰⁴

The Board also asserts broad authority to adopt whatever regulatory measures are necessary in this area by relying on section 5(b) of the BHCA²⁰⁵ that states:

The Board is authorized to issue such regulations and orders as may be necessary to enable it to administer and carry out the purposes of this chapter and prevent evasions thereof.

The case law has generally supported the Board's authority in this area. In *Board of Governors v. First Lincolnwood Corp.*²⁰⁶, the Supreme Court upheld the Board's authority to impose source of strength requirements on a bank holding company as part of its application to acquire a bank. The issue was whether the Board could deny the application based *solely* on the financial unsoundness of a bank within the holding company, or was the Board also required to show that the application would have had an uncompetitive effect on the banking industry. The Supreme Court held that it was permissible for the Board to rely solely on a showing of financial unsoundness as grounds to reject the holding company's application. The Supreme Court stated in relevant part:

The language of the statute supports the Board's interpretation of § 3 (c) as an authorization to deny applications on grounds of financial and managerial unsoundness even in the absence of any anti-competitive impact. Section 3 (c) directs the Board to consider the financial and managerial resources and future prospects of the applicants and banks concerned '[i]n every case,' not just in cases in which the Board finds that the transaction will have an anti-competitive effect..²⁰⁷

The Court, however, was careful to state that its holding was not intended to extend the Board's authority to day-to-day supervision of banks, but allowed the Board to disapprove an application to prevent the formation of an unsound holding company.

In the dissent's view, the Board, by looking beyond the transaction before it, attempted to exercise day-to-day regulatory authority over banks which Congress denied to it and conferred on the Comptroller. We disagree with the basic premise of the dissent's argument. As the Board found, the *effect* of this transaction would have been the formation of a financially unsound bank holding company. Thus, the Board's attempt to prevent this effect and to induce respondent to form an enterprise that met the Board's standards of financial soundness was entirely consistent with the language [of the statute].²⁰⁸

In *First Lincolnwood* the Supreme Court relied on the express provisions of section 3 (c) that required the Board to consider financial soundness of the subsidiary bank in determining whether to approve a holding company's application; however, the Court made it clear that it did not interpret the BHCA as granting the Board authority to regulate the day-to-day financial soundness of the subsidiary banks.

In a similar case, the Supreme Court in *Board of Governors v. Dimension Financial Corp.*,²⁰⁹ considered whether the Board exceeded its authority in expanding its regulatory coverage to include non-bank firms within bank holding company structures. Under Regulation Y, the Board had defined non-bank institutions or non-bank financial firms as being subject to source of strength requirements. The Court rejected this position by holding that the Board had exceeded its statutory authority in attempting to include non-bank financial firms within its regulatory authority.

These cases demonstrate that the primary purposes of the BHCA are to prevent the concentration of control of banking resources, and to separate banking from non-banking enterprises. *First Lincolnwood* is narrowly written and expressly limits the Board's authority, in respect to granting or denying a holding company application, to consider financial and managerial soundness of subsidiary banks. Section 3 (c) of the BHCA expressly grants this authority to the Board. The BHCA, however, does not grant the Board authority to consider the financial and managerial soundness of the subsidiary banks after it approves the application, and *First Lincolnwood* finds this regulatory authority lacking in the day-to-day operations of a subsidiary bank.

This view was further supported by the Fifth Circuit Court of Appeal in *MCorp Financial Inc. v. Board of Governors of the Federal Reserve System*.²¹⁰ *MCorp* presented the legal issue of whether the Federal Reserve Board had the authority to order a bank holding company to transfer funds to its ailing subsidiary when the order was not part of the holding company's application to acquire a bank. The Board had argued that MCorp's failure to transfer its assets to a weak banking subsidiary was an unsafe and unsound practice in violation of sections 1818(b)(1) and (3).²¹¹ The Board argued that MCorp had failed to act as a source of strength for its bank subsidiaries in violation of Board regulation and policies, and that this failure constituted an unsafe or unsound practice. The Board therefore imposed source of strength charges on MCorp requiring it to inject funds into its banking subsidiaries. MCorp sought judicial review of the Board's order by arguing that the Board did not have supervisory authority to issue source of strength capital directives to a bank holding company or to its banks unless the Board's order was a condition for the company's proposed acquisition or takeover of a bank.

The MCorp case stands for the proposition that the Board does not have the authority to compel a solvent bank holding company to transfer its funds to its troubled subsidiaries, even for the purpose of maintaining the subsidiaries' financial soundness.²¹² The enforcement of such a source of strength regulation would require a holding company to transfer funds to its troubled subsidiary banks. The Fifth Circuit held that such a prudential requirement 'can hardly be considered a generally accepted international standard of prudential operation.'²¹³ The court observed that

such a transfer of funds would require the holding company to disregard its own corporation's separate legal status and would amount to a wasting of the holding company's assets in violation of its duty to its shareholders. Further, the court noted that one of the main purposes of the BHCA was to separate banking from commercial enterprises, and that purpose would not be served if the Board is permitted to treat a holding company as merely an extension of its subsidiary bank.²¹⁴ The Supreme Court upheld the Fifth Circuit's ruling as it applies to the Federal Reserve Board's authority to impose source of strength directives on bank holding companies.

Moreover, section 23A of the Federal Reserve Act addresses self-dealing among holding company subsidiaries.²¹⁵ Section 23A prohibits a bank from extending credit to a nonbank affiliate unless the extension of credit is secured by collateral having a market value of at least 100 per centum of the loan. For example, the Federal Reserve will institute proceedings against any bank holding company if it causes any of its subsidiary banks to extend unsecured credit to an affiliated institution of the bank holding company.²¹⁶ The Federal Reserve has authority to seek an order against a holding company to make it cease and desist any transactions which violate the provisions of section 23A, or 'to take affirmative action' as may be appropriate.²¹⁷

Changes in Bank Control

Another important issue regarding corporate governance of bank holding companies concerns regulating how shareholders and companies can acquire and relinquish control of banks. Congress has defined any change in control of a US bank, whether by takeover, acquisition or other transfer of control, to be an unsafe and unsound banking practice, unless the change of control is approved in advance by the relevant federal banking authority.²¹⁸ The CBCA provides:

- (1) No person, acting directly or through or in concert with one or more persons, shall acquire control of any insured depository institution through a purchase . . . of voting stock of such insured depository institution unless the appropriate Federal banking agency has been given sixty days' prior written notice of such proposed acquisition . . .
. 219

The control of a bank is 'the power, directly or indirectly, to . . . vote 25 per centum or more of any class of voting securities of an insured depository institution.'²²⁰ Control of a bank may be found if any group of shareholders enters an agreement to act in concert to acquire control of a bank. Evidence of such agreement could be, *inter alia*, a proxy assignment, purchase and sale agreement, voting agreement, cross-pledge, collateral guaranty, or cross guaranty. In the absence of such formal agreements, the regulator may rely on circumstantial evidence to make a determination that a group acted in concert with the intent of obtaining control of a bank in violation of the statute.²²¹ Essentially, to find concerted effort, an agreement need not be written and may be informal, and group activity may be proven circumstantially.²²² Further, persons acting in concert need not know each other.²²³

In addition to the statutory provisions of the CBCA, Regulation O²²⁴ specifically provides that a bank may not extend credit to officers, directors, or principal shareholders unless the extension of credit is 'made on substantially the

same terms. . . as, and following credit underwriting procedures that are not less stringent than, those prevailing at the time' for other persons.²²⁵ Moreover, the loan must be approved by a majority of the disinterested directors.²²⁶ Essentially, the bank cannot make loans to insiders (i.e. officers, directors, shareholders and their family members) unless the terms of the loan are on substantially the same terms as loans to others, and that standard underwriting procedures with respect to credit risk are followed. The purpose of the Regulation is to prevent insiders from obtaining loans based on inadequate collateral capital that have above-normal credit and market risk.

Moreover, Regulation O prohibits any other unsafe and unsound banking practices that may expose the bank to substantial losses. Such unsafe and unsound practices may include generous compensation and employment agreements for directors and controlling shareholders. For example, in *Lindquist*, the FDIC found that an unsound loan to an insider by a particular bank, which was controlled by another insider, violated Regulation O because it exceeded five percent of the capital and unimpaired surplus of the bank and did not receive approval of a majority of the disinterested directors on the bank's board. In addition, section 215.4 (a)(1) of Regulation O prevents a bank from providing a loan to an entity for which some of the proceeds are used to purchase shares in the lending bank, thus providing a capital infusion.

D. The Regulation of Financial Holding Companies: the Case of the Financial Services Modernization Act 1999

In 2000, Congress enacted the Financial Services Modernization Act of 1999 (otherwise known as the Gramm-Leach-Bliley Act)²²⁷, which is the most significant US banking legislation since the Glass-Steagall Act was of 1933. The statute authorised the Federal Reserve Board to adopt regulations that allow bank holding companies or foreign banks to apply for a universal bank structure at the holding company level. The new universal holding companies would be known as 'Financial Holding Companies' ('FHCs') and would be able to establish wholly-owned subsidiaries that could provide an array of financial services that were restricted under previous banking law. For our purposes, the prudential supervision provisions are most important. Section 103 of the Act requires that for a banking holding company to make an election to become a FHC, it must show that its subsidiaries are 'well capitalised' and that affiliated or subsidiary institutions are 'well-managed'.

A well-capitalised bank essentially means that a bank has and maintains at least the capital levels required to be well-capitalised under the capital adequacy regulations or guidelines applicable to the bank under the 'prompt corrective action' standards of section 38 of the Federal Deposit Insurance Act.²²⁸ The Act does not require that a financial holding company (FHC) meet a specific consolidated capital standard to operate as a holding company as a condition for engaging in expanded financial activities through non-bank subsidiaries. However, because a FHC is also a bank holding company (BHC), the Federal Reserve Board's Regulation Y²²⁹ requiring financial and managerial soundness for a BHC and its bank subsidiaries when it applies to acquire a bank will also apply to FHCs when they apply to acquire banks. These source of strength requirements will also apply to BHCs and foreign banks when they apply to the Board for FHC status.

Together, the Bank Holding Company Act and the Financial Services Modernization Act represent important efforts to address governance problems with bank/financial holding companies, but serious questions are raised by the *MCorp* regarding the scope and extent of regulatory authority of the Federal Reserve Board to exercise prudential oversight in this area.

V. BANK REGULATION AND CORPORATE GOVERNANCE: ANALYSIS

The responsibility for the overall governance of a financial institution should lay with management, which should have responsibility 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.²³⁰ 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.”²³¹ 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,²³² 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 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.²³³ The firm should make available to the regulator 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.

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 globalisation. 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.

This paper suggests that bank regulation should seek to balance the interests of shareholders with creditors, depositors, and other stakeholder interests in order to achieve the overall objective of financial stability. 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. In contrast, US banking regulation adopts a more prescriptive approach in which the regulator applies more precise and uniform criteria for assessing the safety and soundness of a banking institution. The regulator is concerned not only with financial stability but with vindicating the rights of creditors and depositors to

the extent that it protects the deposit insurance fund. It is necessary that the regulator have sufficient discretion to achieve these objectives and not be unnecessarily circumscribed by judicial review, as the experience of US regulators reveals. This paper suggests that US judicial intervention in the regulation of bank and financial holding companies regarding source of strength requirements prevents the regulator from taking the necessary prudential measures to ensure that bank holding companies are well-capitalised.

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. The advent of Basel II and international corporate governance standards for financial institutions necessitates that bank regulators from all relevant jurisdictions address these issues in a more systematic way than what has been the case in the past.

¹ See e.g. Renee Adams & Hamid Mehran (April, 2003) 'Is Corporate Governance Different for Bank Holding Companies?' *Federal Reserve Bank of New York Economic Policy Review* vol. 9, pp. 123-141 (explaining why governance may differ for bank holding companies)[Adams & Mehran]

² See John Eatwell & Lance Taylor (Polity Press: 2000) *Global Finance At Risk* pp. 21-27 (discussing the pricing of risk by banks and how systemic risk can arise and undermine financial stability)[Eatwell & Taylor].

³ The mispricing of risk by banks creates the negative externality of systemic risk. See *ibid.*, pp. 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.P. Davis, *Debt, Financial Fragility and Systemic Risk* (Clarendon Press Oxford) pp. 109-116.

⁴ Adams & Hamid, *supra* n. 1, p. 124.

⁵ Jonathan R. Macey & Maureen O'Hara 'Corporate Governance and Banks' (April, 2003) *Federal Reserve Bank of New York Economic Policy Review* vol. 9, pp. 123-141 (proposing expanded fiduciary duties for bank directors).

⁶ *Ibid.* at 92.

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

⁸ *Ibid.*

⁹ Avinash Persaud (2002) '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); see also paper published by State Street Bank.

¹⁰ 2000, c. 8 (Eng).

¹¹ *Ibid.* s. 66.

¹² *Ibid.* s. 1.

¹³ Financial Services Authority, Consultation Paper 17: 'Financial Services Regulation: Enforcing the New Regime' 33, (Dec. 1998) <http://www.fsa.gov.uk/pubs/cp/cp17.pdf>.

¹⁴ See *ibid.* p. 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').

¹⁵ See *infra* and accompanying text (discussing senior management arrangements, systems, and controls).

¹⁶ See *infra* and accompanying text (discussing the reasonable person standard applicable to directors and corporate officers under the FSA's regulatory regime).

¹⁷ See John Hawkins & Philip Turner, 'Managing foreign debt and liquidity risks in emerging economies: an overview' pp. 8-9, *BIS Policy Papers* (Sept. 2000) <http://www.bis.org/publ/plcy08>.

¹⁸ Franklin Allen and David Gale (2000) *Comparing Financial Systems* (1997) pp. 93-97.

¹⁹ Joe Stiglitz (1989) ‘Principal and agent’ in *The New Palgrave: Allocation, Information and Markets* p. 241, (J. Eatwell, M. Milgate, & P. Newman, eds.(Macmillan Press, Ltd. 1989).

²⁰ 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.

²¹ Joseph E. Stiglitz (1987) ‘The Causes and Consequences of the Dependence of Quality on Price’, 25 *J. Economic Literature* 1, p. 6.

²² *Ibid.*, p. 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. Joseph Stiglitz, ‘On the causes and consequences of the dependence of quality on price’ *Journal of Economic Literature* (1987).

²³ Joseph E. Stiglitz & Andrew Weiss, (June 1981) Credit rationing in markets with imperfect information, 71 *American Economic Rev.* 393, pp. 393-394, 409.

²⁴ For a discussion of methods used to screen borrowers, see Stiglitz, *supra* n. 87, p.7.

²⁵ See Bruno Biais & Marco Pagano *New Research in Corporate Finance and Banking* (Oxford: 2002) pp. 190-202 (discussing conflicts between shareholders and management).

²⁶ For details on attempts to align regulatory capital with economic risk, see Basel Committee on Banking Supervision, *Second Consultative Paper of the New Basel Accord* (Jan. 16, 2001), <http://www.bis.org/publ/bcbsca03.pdf> [hereinafter *Second Consultative Paper*].

²⁷ Mas-Colell, A., Whinston, M. and Green, J. (Oxford Univ. Press, 1995) *Microeconomic Theory* pp. 368-374. (discussing private information and second-best solutions).

²⁸ Intl. Organisation of Securities Commissions *Objectives and Principles of Securities Regulation*, <http://www.iosco.org/pubdocs/pdf/IOSCOPD82-English.pdf> (Sept. 1998).

²⁹ Org. for Econ. Co-operation & Dev., *OECD Principles of Corporate Governance*, <http://www.oecd.org/dataoecd/47/50/4347646.pdf> (1999).

³⁰ *Ibid.* at 11.

³¹ 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> (2002) (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”).

³² The most important of these reports are Basel Comm. on Banking Supervision, *Principles for the Management of Credit Risk*, <http://www.bis.org/publ/bcbs125.pdf> (2000); Basel Comm. on Banking Supervision, *Framework for Internal Control Systems in Banking Organisations*, <http://www.bis.org/publ/bcbs40.pdf> (1998); Basel Comm. on Banking Supervision, *Enhancing Bank Transparency: Public Disclosure and Supervisory Information that Promote Safety and Soundness in Banking Systems*, <http://www.bis.org/publ/bcbs41.pdf> (1998); and Basel Comm. on Banking Supervision, *Principles for the Management of Interest Rate Risk*, <http://www.bis.org/publ/bcbs29a.pdf> (1997).

³³ Basel Comm. on Banking Supervision, *Enhancing Corporate Governance for Banking Organisations* 5, <http://www.bis.org/publ/bcbs56.pdf> (Sept. 1999).

³⁴ *Ibid.*

³⁵ *Ibid.* at 6.

³⁶ *Ibid.* at 7.

³⁷ *Ibid.*

³⁸ *Ibid.* at 8.

³⁹ *Ibid.*

⁴⁰ 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.

⁴¹ For an in-depth discussion of the Basel Capital Accord by a former regulator, see Jonathan Ward, *The Supervisory Approach: A Critique* (CERF Working Paper No. 02, 2002) and Jonathan Ward, *The New Basel Accord and Developing Countries: Problems and Alternatives* (CERF 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).

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42. Basel Comm. on Banking Supervision, *The New Basel Capital Accord* (Consultative Document), <http://www.bis.org/publ.bcbsca03.pdf> (Apr. 2003) [hereinafter *Basel II*].
43. *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.*
44. *Ibid.*
45. *Ibid.* at ¶ 401.
46. *Ibid.* at ¶ 402.
47. *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").
48. *See Basel II, supra* n. 117, at ¶¶ 677–756 (discussing the supervisory review process).
49. *Ibid.* at ¶ 680.
50. *Ibid.* at ¶¶ 758–759; Ward, *supra* n. 116 (Working Paper No. 04), at 9.
51. *See Basel II, supra* n. 117, at 156–168 (detailing both quantitative and qualitative disclosure requirements).
52. *See ibid.* at ¶ 758 (explaining that "[t]he purpose of Pillar [Three] . . . is to complement the minimum capital requirements [of Pillar One] . . .").
53. *Enhancing Corporate Governance for Banking Organisations, supra* n. 108, at 10.
54. *Ibid.*
55. 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 (May, 2003) *The Need for Corporate Governance*.
http://www.gapent.com/sox/corporate_governance.htm (discussing high profile scandals in the UK).
56. *Ibid.*
57. Comm. on Fin. Aspects of Corporate Governance (1992) 'Report of the Committee on the Financial Aspects of corporate Governance' ss. 1.2.,1.6 (London: Gee & Co., Ltd.) [hereinafter *The Cadbury Report*].
58. *Ibid.* ss 1.6-1.9.
59. *Ibid.* s. 2.5
60. *Ibid.* s. 3.7.
61. *See* Terry Broderick, 'High-level debate on corporate governance and financial market reform' *European Financial Services Regulation*, Issue 8, (Nov. 2003) pp. 1-2 (discussing reforms in the European Community).
62. Financial Reporting Council (23 July 2003), *The Combined Code on Corporate Governance 1*, <http://www.frc.org.uk/documents/pdf/combinedcodefinal.pdf> [hereinafter *The Combined Code*]. Higgs proposed a number of reforms, including a requirement that at least one-half of the board be non-executives and that one-half of that total should be independent. *Ibid.* s. 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. *Ibid.* s. A.3.1. The board chairperson should also meet an independence test. *Ibid.* s. A.2.2.
63. The Higgs Review, 'The Review of the Role and Effectiveness of Non-executive Directors (Jan. 2003) (London: Dept. of Trade & Industry) [hereinafter *The Higgs Review*]. The Higgs Review was intended to be descriptive, rather than prescriptive, and set 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. Derek Higgs, 'The role and effectiveness of non-executive directors' in CAIM (Summer, 2003) Issue 14, p. 1.
64. *See* Fin. Reporting Council (Jan. 2003) *Audit Committees Combined Code Guidance* (London: 2003), <http://www.asb.org.uk/documents/pdf/acrereport.pdf>. [hereinafter Smith Report].
65. *The Higgs Review, supra* n. 45, p.1, s. 1.
66. *See The Combined Code, supra* n. 39. The Higgs report proposes that at least one-third of its members should be non-executive directors, and that a majority of them should be independent. Higgs, p. 2. The Report also proposes that non-executives should serve as a majority on the audit,

remuneration and appointment committees. The CEO and chairman should not be the same person.
Ibid.

⁶⁷ See Ian Jones and Michael Pollitt, 'Understanding How Issues in Corporate Governance Develop: Cadbury Report to Higgs Review' *ESRC Centre for Business Research Working Paper 277* (Dec. 2003)(Judge Institute, University of Cambridge) pp. 14-15.

⁶⁸ *The Combined Code*, *supra* n. 39., p. 1.

⁶⁹ The Financial Services Authority, *The Listing Rules*, para. 12.43A(a) http://www.fsa.gov.uk/pubs/ukla/chapt_12-3.pdf (accessed 25 Feb. 2004)..

⁷⁰ *The Combined Code*, *supra* n. 39, p. 2.

⁷¹ See Fin. Reporting Council, (Nov. 1999) *The Combined Code: Requirements of Auditors under the Listing Rules of the London Stock Exchange* s. 26, http://www.frc.org.uk/images/uploaded/documents/Bull_99-05.pdf (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 non-public). *The Cadbury Report*, *supra* n. 23, s. 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* (June, 2001) vol. 1, 53, <http://www.dti.gov.uk/cld/review/htm>; select Company Law Review.

⁷² See the UK Department of Trade and Industry's White Paper, *Modernising Company Law* (July, 2002) s. 5.11(proposing that a new body, the Standards Board, be established to enforce the Combined Code on Corporate Governance)[hereinafter *White Paper*].

⁷³ *The Cadbury Report*, *supra* n. 23, s. 3.1.

⁷⁴ *White Paper*, *supra* n. 54, ss. 5.11, 5.14.

⁷⁵ See *infra* nn. 57-67 and accompanying text (discussing directors' duties under English company law).

⁷⁶ 1985, c. 6.

⁷⁷ Gower and Davies *Modern Company Law*, *supra* n. 29, pp. 294-95.

⁷⁸ 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 owed by directors to the company that arise out 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 *discussion in* Gower and Davies, *Modern Company Law* pp. 374-75.

⁷⁹ Gower and Davies, p. 374.

⁸⁰ [1902] 2 Ch 421, 425-26 (rejecting shareholders' demand that share sales be set aside on grounds that company chairman and directors breached duty owed to shareholders).

⁸¹ *Ibid* at 428. 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. *Ibid.* See *Chase Manhattan Equities Ltd. v. Goodman* [1991] BCLC 897 (stating that silence did not constitute a misrepresentation).

⁸² This case has been actively criticised in New Zealand and Australia. The New South Wales Court of Appeal in *Brunninghausen v Glavanics* (1999) 32 ACSR 294 recently refused to follow the decision, thus following the lead taken by the New Zealand Court of Appeal in *Coleman v Myers* [1977] 2 NZLR 225.

⁸³ This duty derives from the law of deceit, see *Gore-Brown* s. 12.17 and *Prudential Assurance Co. Ltd. v. Newman Industries Ltd* [1980] 2 All ER 841.

⁸⁴ Cmnd 6659.

⁸⁵ Cmnd 1749.

⁸⁶ See e.g. *Peskin v Anderson* [2000] 2 BCLC 1 at p 14 per Neuberger J and *Peskin v Anderson* (CA) [2001] 1 BCLC paras. 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'.

⁸⁷ Section 459 of the Companies Act 1985, however, provides specific statutory duties. 1985, c. 6, s. 459.

⁸⁸ Lord Wedderburn, 'The Legal Development of Corporate responsibility – For Whom Will Corporate Managers Be Trustees?', in K.J. Hopt & Teubner, G. *Corporate Governance and Directors' Liabilities: Legal, Economic and Social Analyses on Corporate Social Responsibility* (1985)(Berlin: Walter de Gruyter).

⁸⁹ This principle means that the enforcement of the director's 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 J. Dine (2000) *Corporate Governance Groups* (Cambridge: Cambridge University Press).

⁹⁰ The Combined Code, *supra* n. 37, ss. 1, 4.

⁹¹ *In re Cardiff Sav. Bank (Marquis of Bute's Case)*, [1892] 2 Ch. 100.

⁹² *Ibid.* p. 105.

⁹³ *Ibid.*

⁹⁴ [1901] AC 477.

⁹⁵ *Ibid.* pp. 492-493.

⁹⁶ *Ibid.*

⁹⁷ See *In re City Equitable Fire Insurance Co., Ltd.*, [1925] 1 Ch. 407, 408 (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').

⁹⁸ The Marquis became president of the bank when he was six months old. *In re Cardiff Sav. Bank* [1892] 2 Ch. P. 105

⁹⁹ *Eg., Re City Equitable Fire Insurance Co., Ltd.* [1925] 1 Ch. 407.

¹⁰⁰ [1989] BCLC 498

¹⁰¹ *In re City Equitable Fire Ins. Co., Ltd.*, [1925] 1 Ch. p. 408.

¹⁰² *Ibid.*

¹⁰³ *Ibid.*

¹⁰⁴ See discussion in Gower and Davies *Modern Company Law* p. 381.

¹⁰⁵ 1985, c. 6, s. 35(3).

¹⁰⁶ *Ibid.* s. 309 (2).

¹⁰⁷ See *Ibid.*, s. 317 (stating director's duty to disclose interest)..

108c. 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).

109 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 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).

110 See Briault, *supra* n. 108, p. 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, the Securities and Futures Authority, and the Investment Management Regulatory Organisation. *Ibid.* at 6 n. 1. The FSA also assumed responsibility for banking supervision from the Bank of England's Supervision and Surveillance Division. *Ibid.* 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).

111. Briault, *supra* n. 108, 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.

112 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>).

113 2000, c. 8, s. 2.3.

114. *Id.* , p. s. 155(2)(a).

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115. *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 Econ. 2001).
116. 2000 c. 8 at § 118.
117. *See* Barry Rider, Kern Alexander & Lisa Linklater, *Market Abuse and Insider Dealing* chs. 6–8 (Butterworths 2002) (discussing market abuse offenses).
118. The UK Treasury was delegated authority to issue statutory orders that designate the types of exchanges to which provisions of the FSMA would apply. At present, there are nine exchanges subject to FSMA, but this will probably change in the future.
- ¹¹⁹119. 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, c. 60 (Eng.).
120. *E.g.* Comm. of European Securities Regulators, *Multilateral Memorandum of Understanding on the Exchange of Information and Surveillance of Securities Activities*, http://www.europafesco.org/DOCUMENTS/FESCOPEL/KEYDOC/Fescopol_MOV.pdf (Jan. 26, 1999).
121. *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 Basle Supervisors’ Committee, the EMI Banking Supervisors’ Sub-Committee, and “on other international committees where necessary.” *Id.* at § 15.
122. 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).
123. *Id.*
124. 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*].
125. 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).
126. *Id.*
127. *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).
128. *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).
129. *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).
130. *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).
131. *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).
132. *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 the *firm* for which he is responsible in his *controlled function*.” *Id.* (emphasis in original).
133. *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).
134. 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.
135. *Id.* at § 56(2).

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136. *Id.* at § 56(4).
137. *See id.* at §§ 51–54 (setting forth provisions governing the authorization process).
138. *Id.* at § 2(1)(b).
139. Fin. Servs. Auth., *FSA Handbook: Enforcement* § 8.5.2(1)(a), http://www.fsa.gov.uk/handbook/BL3ENFPP/ENF/Chapter_8.pdf (Jan. 2004).
140. *Id.* at § 8.5.2(1)(b).
141. *Id.* at § 8.5.2(1)(c).
142. Fin. Servs. Auth., *FSA Handbook: Threshold Conditions* § 2.4.6, http://www.fsa.gov.uk/handbook/BL1CONDpp/COND/Chapter_2.pdf (Jan. 2004).
143. Fin. Servs. Auth., *Consultation Paper 26: The Regulation of Approved Persons*, 4 <http://www.fsa.gov.uk/pubs/cp/cp26.pdf> (July 1999).
144. Fin. Servs. Auth., *FSA Handbook: Supervision* § 10.4.5, http://www.fsa.gov.uk/handbook/BL3SUPppb/SUP/Chapter_10.pdf (Jan. 2004).
145. 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).
146. *Ibid.* at § 1.2.1 (available at http://www.fsa.gov.uk/handbook/BL1SYSCpp/SYSC/Chapter_1.pdf).
147. *Ibid.* at § 2.1.1 (available at http://www.fsa.gov.uk/handbook/BL1SYSCpp/SYSC/Chapter_2.pdf).
148. *Ibid.* 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*].
149. The defense of ignorance put forth by the Marquis de Bute, discussed *supra* nn. 68–71 and accompanying text, would not be available under these regulations.
150. *Consultation Paper 35*, *supra* n. 148, at 10.
151. *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).
152. *See ibid.* at § 66(2)(b) (defining misconduct to include the indirect act of being “knowingly concerned” in an offense).
153. *Ibid.* at § 206(1).
154. *See* Financial Services and Markets Act 2000, c. 8 at § 146 (authorizing the FSA to make rules relating to money laundering).
155. (1993) SI 1993/1933. The Money Laundering Regulations 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).
156. 2000, c. 8 at § 146.
157. *E.g.* Fin. Servs. Auth., *Money Laundering Sourcebook*, <http://www.fsa.gov.uk/vhb/html/ml/Mltoc.html> (Jan. 2004).
158. *FSA Handbook: Senior Management Arrangements, Systems and Controls*, *supra* n. 167, at § 3.2.6 (emphasis in original).
159. Fin. Servs. Auth., *FSA Handbook, Money Laundering* § 3.1.3(a), http://www.fsa.gov.uk/handbook/BL2MLpp/ML/Chapter_3.pdf (Jan. 2004).
160. *Ibid.* at § 7.2 (available at http://www.fsa.gov.uk/handbook/BL2MLpp/ML/Chapter_7.pdf).
161. *Ibid.* at § 7.2.2(1).
162. *Ibid.* at § 7.1.1.
163. *Ibid.* at §§ 7.1.11(6), 7.2.2(1)(a)(i).
164. *Ibid.* at § 7.3.2(1).
- ¹⁶⁵ See FSA enforcement action at <http://www.fsa.gov.uk/pubs/final/index-2002.html>
- ¹⁶⁶ This case involved facts that occurred in 1996-97 before the FSA was established and therefore was subject to the Financial Services Act 1986 and to enforcement proceedings by the former self-regulatory body, the Securities and Futures Authority (SFA), for breach of High Level principles 5, 7 and 9. These principles today would be enforced under the FSA’s ‘Senior Management Arrangements, Systems and Controls’ (SYSC).
- ¹⁶⁷ At the time, the FSA’s fine was the largest it had ever imposed on an individual.
- ¹⁶⁸ See art 6(1) of the European Convention on Human Rights. See also, *R (on the application of Fleurose) v. Securities and Futures Authority Ltd* [2001] EWHC Admin 292, [2001] 2 All ER (Comm 481).

¹⁶⁹ See A.C. Harrell, 'Deposit Insurance Reform Issues and the Implications for the Structure of the American Financial System', in J.J. Norton, *International Banking Regulation and Supervision in 1990s: Change and Transformation*, pp. 310-314.

¹⁷⁰ 12 U.S.C. § 3906 (b) (2002). The appropriate federal banking agencies are thus required to 'promulgate regulations or orders necessary to implement this section. See 12 U.S.C. §3906 (c). The foreign exposure requirement was important because US banks lost substantial amounts on loans to Latin American sovereign debtors, which threatened the stability of the US banking system. The US government orchestrated an intervention that bailed out the US banks by providing guarantee on the repayment of private loans to the banks through the issuance of Brady Bonds.

¹⁷¹ 12 U.S.C. § 3907 (a)(1) (2002).

¹⁷² *Ibid* § 3907 (b)(1).

¹⁷³ *Ibid* § 3907 (b)(1). For instance, the federal banking regulator may issue a directive to a banking institution that fails to maintain capital at or above its required level that may require it to submit and adhere to a plan acceptable to the appropriate federal banking agency describing the means and timing by which the banking institution shall achieve its required capital level. 12 U.S.C. § 3907 (a)&(B)(1).

¹⁷⁴ 12 U.S.C. § 3907 (b)(2)(B)(ii).

¹⁷⁵ The Federal Deposit Insurance Corporation was established in 1931 in response to the banking failures of the early years of the Great Depression.

¹⁷⁶ *Sunshine State Bank v. FDIC*, 783 F. 2d 1580, 1584 (11th Cir. 1986); see also, *Bullion v. FDIC*, 881 F. 2d 1368, 1372-1373 (5th Cir. 1989)(adopting the same standard of review under § 1818(h)(2) for civil penalty hearings regarding violations of 12 U.S.C. § 1828(j)(4)(D).

¹⁷⁷ See Federal Deposit Insurance Corporation Improvement Act of 1991, (FDICIA), Pub. L. No. 102-242, 105 Stat. 2236 (1991).

¹⁷⁸ 57 Fed. Reg. 45263 (Oct 1, 1992).

¹⁷⁹ 58 Fed. Reg. 34357 (June 25, 1993).

¹⁸⁰ See 12 C.F.R. § 327. The transition regulations were in effect from January 1, 1993 to January 1, 1994.

¹⁸¹ 12 U.S.C. § 1817(b)(1)(C).

¹⁸² *FDIC v. Coughatta*, 930 F. 2d 122 (5th Cir.), *cert. denied*, 502 U.S. 857 (1991).

¹⁸³ 12 C.F.R. § 327.3 (e)(1).

¹⁸⁴ 12 C.F.R. § 327.3(e)(1)(ii).

¹⁸⁵ 930 F. 2d 122 (5th Cir.), *cert. denied*, 502 U.S. 857 (1991).

¹⁸⁶ The fundamental requirement of due process is the opportunity to be heard 'at a meaningful time and in a meaningful manner. *Matthews v. Eldridge*, 424 U.S. 319, 333 (1976).

¹⁸⁷ *FDIC v. Coughatta*. at 335.

¹⁸⁸ *Coughatta*. at 334.

¹⁸⁹ The FDIC procedures allow the bank to submit the request and supporting documentation to the FDIC Division of Supervision. The procedures also provide for an opportunity to request an informal oral hearing, which the FDIC may grant, in its discretion, 'when the Division of Supervision determines that an informal oral presentation would be productive under the applicable circumstances. 58 Fed. Reg. 34357, 34359 (June 25, 1993).

¹⁹⁰ 12 C.F.R. § 327.3.

¹⁹¹ *Doolin*, 53 F. 3d at 1403.

¹⁹² The Office of Thrift Supervision regulates and applies prudential supervisory standards to the operations of federal savings banks that are not regulated by the Comptroller (Treasury) nor by the Federal Reserve Board.

¹⁹³ See *Doolin*, 53 F. 3d at 1405.

¹⁹⁴ 5 U.S.C. 702 (1998)(provides general right to judicial review of agency action).

¹⁹⁵ 12 U.S.C. § 1818 (ii).

¹⁹⁶ I am indebted to Michael Blair QC for this observation.

¹⁹⁷ *Ibid* at § (3)(A).

¹⁹⁸ 12 U.S.C. § 1841 *et seq.*

¹⁹⁹ Senate Rep. No. 1095, 84th Cong. At p. 5 (1955). In the 1956 legislation, bank holding companies were exempt from the legislation if they owned or controlled only one bank, the so-called one-bank exemption. H.R. Rep. No. 91-387, at p. 2 (1969). Congress eliminated this exemption when it adopted amendments to the 1970 Bank Holding Company Act.

²⁰⁰ H.R. Rep. No. 609, 84th Cong. P. 2 (1955).

²⁰¹ 12 U.S.C. § 1842 (a).

²⁰² 12 U.S.C. § 1842 ©.

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- 203 Regulation Y, 49 Fed. Reg. 820 (1984)(codified at 12 C.F.R. § 225.4 (a)(1).
- 204 Policy Statement, 52 Fed. Reg. 15707, 15708 (1987)(emphasis added). This policy statement became effective on 24 April, 1987. The Board solicited comments on the policy, with a view to revising the statement in light of such comments. No subsequent revision has been published.
- 205 12 U.S.C. § 1844 (b).
- 206 439 U.S. 234 (1978).
- 207 *Ibid* at 243.
- 208 *Ibid* at 250.
- 209 474 U.S. 361 (1986).
- 210 900 F.2d 852 (5th Cir., 1990)
- 211 Sections 1818(b)(1)&(3) authorises the Board to file charges against a bank holding company which the Board believes has violated or is about to violate a ‘law, rule or regulation’, or is engaging in ‘unsafe and unsound’ practices.
- 212 *MCorp. Financial v Board of Governors*, 900 F. 2d 852, 862 (5th Cir. 1990).
- 213 *Ibid*, at 863.
- 214 Since Congress enacted a new financial services act to replace the Glass-Steagall Act in November of 1999, which took effect in March of 2000, it will be interesting to see how the courts interpret its provisions that allow Financial Service Holding Companies to own unlimited interests in commercial non-bank enterprises.
- 215 12 U.S.C. sec. 371c (1998).
- 216 *M. Corp.* 900 F. 2d at 858.
- 217 12 U.S.C. § 1818(b)(1).
- 218 *Lindquist & Vennum v. F.D.I.C.*, 103 F. 3d 1409 (8th Cir. 1997).
- 219 12 U.S.C. § 1817 (j)(1).
- 220 12 U.S.C. § 1817 (j)(8)(B).
- 221 *Lindquist*, 103 F. 3d at 1413; see also, *FDIC v. Annunzio*, 524 F. Supp. 694, 699 (N.D. W. Va. 1981).
- 222 *SEC v. Savoy Industries*, 587 F.2d 1149, (D.C. Cir. 1978).
- 223 *Blumenthal v. United States*, 332 U.S. 539, 557 (1947).
- 224 12 C.F.R. § 215.4 (1998).
- 225 12 C.F.R. § 215.4 (1998).
- 226 *Ibid*.
- ²²⁷ Pub. L. 106-102, 113 Stat. 1338. Gramm-Leach-Bliley took effect on March 11, 2000.
- ²²⁸ 12 U.S.C. § 1831o.
- ²²⁹ 12 C.F.R. § 225.
230. Financial Services and Markets Act 2000, c. 8 at § 1.
231. 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).
232. See Michael Power, 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).
233. See FSA Handbook: Supervision, supra n. 166, at § 10.9.13 (discussing proprietary trading).

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