



## THE TRAJECTORY OF REGULATORY REFORM IN THE UK IN THE WAKE OF THE FINANCIAL CRISIS

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### SUMMARY

Introduction

Causes of the financial crisis

Regulatory accountability and reform

Institutional structure

Regulatory style and objectives

- Moral hazard and 'too big to fail'
- Crisis management and the resolution regime
- 'Light-touch' regulation
- Principles-based regulation
- Macro-prudential regulation

Scope of regulation

- Hedge Funds
- Credit rating agencies
- The role of home and host states
- Adjustments to the FSMA 2000 regime

Capital adequacy

Market transparency and integrity

- Market transparency
- Market infrastructure
- Market integrity

Conduct of business regulation

Corporate governance

- The causal role of weak governance
- Remuneration practices.

Conclusion

### ABSTRACT

There has been much talk about regulatory reform around the world in the wake of the financial crisis but relatively little action. As a

major international financial centre the UK is very much at the centre of the debate and has a particular interest in the ultimate outcome.

The financial crisis has exposed the weaknesses of ‘light-touch’ regulation and ‘principles-based’ regulation, which characterised the UK system in the pre-crisis phase. Changes to the institutional structure of regulation recently announced by the new coalition government, combined with changes to regulatory style, are likely to have far reaching consequences for the practice and intensity of regulation in the UK. This article reviews and assesses recent and proposed regulatory changes and considers the relationship between corporate governance and regulation. It evaluates the impact on the UK system of initiatives undertaken at the international and EU levels as well as various interests and incentives within the UK that are likely to be influential in shaping the regulatory regime in years to come.

## RESUMEN

Ha habido mucho que hablar de la reforma regulatoria alrededor del mundo a raíz de la crisis financiera pero relativamente poca acción. Como un importante centro financiero internacional, el Reino Unido está muy en el centro del debate y tiene un particular interés en el resultado final. La crisis financiera ha expuesto las debilidades de la “light-touch” y “principles-based”, que caracteriza el sistema del Reino Unido en la fase previa a la crisis. Los cambios en la estructura institucional de la regulación recientemente anunciado por el nuevo gobierno de coalición, combinado con cambios al estilo de reglamentación, son propensos a tener consecuencias de gran alcance para la práctica y la intensidad de la regulación en el Reino Unido. Este artículo revisa y evalúa cambios normativos recientes y cambios propuestos en la regulación y considera la estrecha relación entre el gobierno corporativo y regulación. Se evalúa el impacto en el sistema del Reino Unido de las iniciativas emprendidas a nivel EU e internacional así como diversos intereses e incentivos en el Reino Unido que son susceptibles de ser influyente en la conformación del régimen regulatorio en años venideros.

## KEYWORDS

Financial regulation, regulatory reform, financial crisis, corporate governance.

## PALABRAS CLAVE

Regulación financiera, reforma regulatoria, crisis financiera, gobierno corporativo.

## INTRODUCTION

Almost two years after the collapse of Lehman Brothers, the debate about how to respond to the global financial crisis continues.

While there is no shortage of proposals, relatively little has been agreed and implemented either at the international, regional or national level. The UK is no exception and the recent change of government has created further uncertainty as to the trajectory of reform at the national level. Several local considerations make the UK an interesting case study of the dynamics of financial regulatory reform at this time. One is the tradition of 'light touch regulation' that was adopted with political approval during the past decade but now faces an evolutionary crisis in the face of criticism at home and abroad. While the rhetoric of government and regulators has already shifted, it is open to question whether regulatory practices can move quite so quickly. Another consideration is the disproportionately large scale of the financial sector (both domestic and international) in the UK by comparison with many other countries. The reliance on financial services inevitably imposes political constraints on the extent to which tighter regulation leading to contraction and job losses can be countenanced. Also relevant is the UK government's position as a shareholder or guarantor of companies controlling a large part of the UK's banking assets. That brings into focus a different perspective from the government's traditional focus on legislation and regulation. As an owner, the government has profit objectives that may run counter to its regulatory objectives and also faces the challenge of acting as an effective owner at a time when institutional investors stand accused of ignoring their monitoring and broader fiduciary obligations during the financial bubble that preceded the crisis.

The paper begins by considering the causes of the crisis and the mechanisms of regulatory accountability. Both are important for an understanding of the framing of the reform agenda in the UK and further afield, since reform proposals do not respond to some objective analysis of what went wrong, rather they are the outcome of a contested process of identification of causal factors, itself linked with concepts of responsibility and accountability for what went wrong. The paper then goes on to consider proposed reforms to the institutional structure of regulation and to style of regulation, both of which have attracted criticism over their role in the crisis. The paper then shifts its focus to regulatory rules, beginning with the delimitation of the regulatory perimeter, which has been widely viewed as too narrowly drawn at a time of significant innovation and expansion in financial techniques. Proposals for strengthening capital requirements are then considered in the light of developments at the international and EU level. Attention is then focused on market transparency and integrity, which have been linked with the fall in

investor confidence that became apparent during the crisis. The role of conduct of business regulation and the regulatory response in the crisis is then examined. The substantive part concludes with an analysis of how weak corporate governance was implicated in the crisis and reforms that are currently underway. The objective is to provide a high-level account of regulatory reform across the board in the UK, analysing how the system as a whole is changing and not just its individual components.

## CAUSES OF THE FINANCIAL CRISIS

The causes of the financial crisis are now well known even if their relative significance and ranking vary as between different regulators and commentators.<sup>1</sup> The lack of consensus over causes reflects two factors. First, it is widely recognised that the interplay of different causes of the crisis makes it difficult to attribute causality in any precise way to different factors. For national systems of regulation the problem is even more severe since it is very difficult to isolate national from international influences in a globalised marketplace. Second, since diagnosis of causes will inevitably carry implications for the nature and intensity of the regulatory response, it is inevitable that any attempt at diagnosis will be contested by political, regulatory and market-based groups who see their interests as threatened by emerging reform proposals. In that sense, the dynamics of regulatory reform cast a shadow over the diagnosis of causes.

The inherent difficulty in attributing causal influence is well illustrated by the initial question of the respective causal roles of broad macro-economic factors by comparison with regulatory deficiencies. That issue is significant since it carries direct implications for the degree to which regulatory reform is necessary, the form it should take and what it can achieve. While regulatory deficiencies have attracted most attention, loose monetary policy has been identified as a causal factor in the creation of an asset bubble in the United States before the onset of the financial crisis.<sup>2</sup> Moreover, while deficiencies in regulation are a common theme in the many national and international diagnoses of the causes of the financial crisis, that concept is in itself not simple. In many instances, references to regulatory deficiencies or weaknesses

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<sup>1</sup> For diagnosis of the causes of the crisis see e.g. The President's Working Group on Financial Markets 'Policy Statement on Financial Markets Developments' (March 2008) at [http://www.ustreas.gov/press/releases/reports/pwgpolicystatementturmoil\\_03122008.pdf](http://www.ustreas.gov/press/releases/reports/pwgpolicystatementturmoil_03122008.pdf); the FSA, 'Financial Risk Outlook 2009' (February 2009) at [http://www.fsa.gov.uk/Pages/Library/corporate/Outlook/fro\\_2009.shtml](http://www.fsa.gov.uk/Pages/Library/corporate/Outlook/fro_2009.shtml); and The Report of the High-Level Group on Financial Supervision in the EU (the de Larosière Report, February 2009) at [http://ec.europa.eu/internal\\_market/finances/docs/de\\_larosiere\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf). All these official reports attribute a secondary role to regulatory failure, pointing instead to macro-economic factors and financial market practices as the primary causes.

<sup>2</sup> M. Miller, P Weller and Lei Zhang 'Moral Hazard and the Greenspan Put' *The Economic Journal* Vol. 112, No 478, Conference Paper (Mar., 2002) pp C171-C186. For evidence that this policy continued to bolster asset prices right up to the onset of the financial crisis in 2007 see OECD Working Paper No 597 'Monetary Policy, Market Excesses and Financial Turmoil' (March, 2008).

conflate a number of issues that should be considered separately if the diagnosis of causal influences is to make a meaningful contribution to regulatory reform. A distinction between the significance of the institutional structure of regulation one the one hand and the operation of the substantive rules is generally recognised but further important distinctions need to be drawn within the substantive rules. First, a clear distinction needs to be drawn, especially in a system such as the UK where the regulator enjoys such broad powers and discretion, between formal grant of powers and the capacity or willingness to use them.<sup>3</sup> In the context of banking supervision for example it has been argued that there are real systemic dangers in giving supervisors discretionary powers to set regulatory capital for individual institutions since they are unlikely to exercise their powers at points when it is most needed.<sup>4</sup> Second, a distinction needs to be drawn between substantive regulatory rules and the style of regulation that is employed in any system. Regulatory style can be said to be a function of the discretion given to the regulator in structuring and operating the substantive rules. In the UK systems, the regulator has a relatively free hand in selecting and balancing the regulatory techniques through which the objectives of regulation are to be pursued and in determining the intensity of regulation by reference to the enforcement of the rules. In that sense, the formal legal structure of regulation can be of much less significance than the manner in which regulation is practiced. In the UK context, the concepts of 'light-touch' regulation, 'risk-based' regulation' and 'principles-based' regulation, none of which are referred to in the legislative framework, were the most distinctive features of regulatory practice prior to the crisis.

The role of regulatory deficiencies as a primary cause of the crisis now seems well established in the UK, even if there was some initial reluctance on the part of the FSA to accept that analysis.<sup>6</sup> From the perspective of ranking of causes, the Turner Review<sup>7</sup> and

<sup>3</sup> For a comparable observation in the US context, see E Spitzer, former New York Attorney General, commenting that 'Regulators don't need additional power, they just need to use their existing power appropriately.' Boston Review at <http://bostonreview.net/BR35.2/spitzer.php>.

<sup>4</sup> M Brunnermeier, A Crockett, C Goodhart, A Persaud and H Shin, 'The Fundamental Principles of Financial Regulation' (Geneva Report on the World Economy at <http://www.cepr.org/Pubs/BOOKS/Geneva/Geneva.asp>).

<sup>5</sup> The Financial Services and Markets Act 2000 ('FSMA 2000') and the Financial Services Act 2010.

<sup>6</sup> See the FSA 'Financial Risk Outlook 2009' (February 2009), citing the following as causal influences: a property price boom; increasing leverage in the banking and shadow banking system; rapid expansion of credit and falling credit standards; increasing complexity of the securitised credit model; and underestimation of bank and market liquidity risk. A similar trend was evident in the United States as none of the five causes of the financial crisis cited by the President's Working Group on Financial Markets referred expressly to regulatory failure: see E Pan 'Four Challenges to Financial Regulatory Reform' at [www.ssrn.com/abstract=1521504](http://www.ssrn.com/abstract=1521504).

<sup>7</sup> FSA, 'The Turner Review, A regulatory response to the global banking crisis' (March 2009) at <http://www.fsa.gov.uk/Pages/Library/Corporate/turner/index.shtml>. The review was commissioned by the Chancellor of the Exchequer in October 2008 in terms that requested the Chairman of the FSA (Lord Turner) to review the causes of the crisis and make recommendations for change in regulation and supervision of banks.

the FSA Regulatory Responses focused in particular on deficiencies in the regulatory capital regime and the failure (over an extended period of time) to match the rapid growth in credit with adequate capital buffers. A related factor was a failure to ensure adequate liquidity in individual banks and across the system, especially given the fundamental change in the nature of the funding of bank lending that resulted from reliance on securitisation and wholesale money markets. To the extent that these were failures that were common across many countries and can ultimately be traced back (at least in their basic form) to the Basel regime, they were relatively easy for the regulator to accept. The Turner Review and FSA Regulatory Response paid much less attention to the fact that the FSA as banking supervisor failed to use its powers to require higher levels of capital and liquidity as credit expanded in individual institutions and across the system, although this factor did draw adverse comment in the Treasury Select Committee scrutiny of the failure of Northern Rock.<sup>9</sup> However, changes in regulatory style now evident in the UK are an implicit recognition of the errors of the past and may well prove to be just as important as formal changes in institutional structure and regulatory rules.

## REGULATORY ACCOUNTABILITY AND REFORM

Accountability is linked with reform in the sense that both the mechanisms of accountability and the process of ‘accounting’ by regulators for their role in the crisis are likely to influence the framing of the reform agenda. That influence arises across a range of issues that are typically the focus of investigations that follow crises: the powers of regulators; their willingness to use their powers and the way they do in fact use them; and constraints (formal or otherwise) that may be imposed on the use of their powers. While these matters emerge from the operation of the mechanisms of accountability, it is inevitable that they will in many instances overlap with causes of the crisis as some causes may have been averted or limited in their effect had effective regulatory action been taken in time. In that sense the accountability perspective provides a concept of regulatory deficiency in terms of what could have been done that was not done, rather than the broader concept of regulatory deficiency as any aspect of the system that is sub-optimal, such as gaps in the scope of regulation or a lack of powers available to the regulator.<sup>10</sup>

<sup>8</sup> FSA Discussion Paper 09/2 ‘A regulatory response to the global banking crisis’ (March 2009) at [http://www.fsa.gov.uk/pubs/discussion/dp09\\_02.pdf](http://www.fsa.gov.uk/pubs/discussion/dp09_02.pdf). This review formed part of the FSA’s standard consultation process on regulatory rule-making, albeit that it was much broader in scope than is normally the case.

<sup>9</sup> See chapter 3 (The regulation of Northern Rock) in volume 1 of House of Commons Treasury Committee, ‘The run on the Rock’ HC 56-1 (Fifth Report of Session 2007-08).

<sup>10</sup> Of course, to the extent that a regulator (such as the FSA) has very broad discretion, the difference between what might have been done and what could have been done becomes more problematic but it does nevertheless still exist: for example, primary legislation would be required to extend the regulatory perimeter.

Accountability regimes have been categorised as falling into three main categories: legal, administrative, and political.<sup>11</sup> Legal accountability is quite limited in the UK regulatory framework as each of the Tripartite Authorities<sup>12</sup> enjoys a degree of legal immunity: the FSA enjoys immunity in respect of the exercise of its functions<sup>13</sup>; the Bank of England has immunity in relation to its new statutory role in the maintenance of financial stability<sup>14</sup>; and, while actions of the Treasury may in principle be subject to judicial review<sup>15</sup>, the statutory and other powers available to government provide a solid legal basis for the intervention that has been undertaken during the financial crisis.<sup>16</sup> Thus, it is not surprising that legal accountability mechanisms have not played a significant role in holding the regulatory authorities to account for their role in the crisis. Administrative accountability regimes focus on accountability within organisations and have been described as ‘managerial rather than legal, continuous rather than episodic’<sup>17</sup>. There is certainly evidence that this process has been in operation within the FSA and the Bank of England, mainly in the form of departures of some senior figures<sup>18</sup>, but the internal nature of the process makes it difficult to assess its full extent. On the other hand, political accountability mechanisms are generally more open to observation. In the UK system of financial regulation the main mechanisms are ministerial powers of appointment, requirements to report to Parliament and public scrutiny before Parliamentary committee. Powers of appointment can be viewed as an accountability mechanism (at least so far as re-appointment is concerned) and are important both in relation to the Bank of England and the FSA: in the former case the Governor, two Deputy Governors and 9 members of the court of directors are all government appointees<sup>19</sup>; in the latter case the Chairman and board of directors are all government appointees.<sup>20</sup>

The annual reports of both the Bank of England and the FSA must be laid before Parliament and both bodies are open to (and have been subject to) scrutiny by the Treasury Select Committee. Of these

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<sup>11</sup> See J Mashaw, ‘Accountability and Institutional Design: Some Thoughts on the Grammar of Governance’, available at [www.ssrn.com/abstract=924879](http://www.ssrn.com/abstract=924879).

<sup>12</sup> See part 3 below for further discussion of the institutional structure of regulation in the UK.

<sup>13</sup> Section 1 and Sch 1, Part IV FSMA 2000.

<sup>14</sup> Banking Act 2009, s244.

<sup>15</sup> Judicial review is a process by which the courts can review the legality of acts of public authorities. See generally *Three Rivers District Council v Bank of England (No3)* [2003] 2AC 1.

<sup>16</sup> In particular, the UK government has a prerogative power to enter into contracts, thus providing a legal basis for the ‘bailouts’ agreed with individual banks during the crisis.

<sup>17</sup> Mashaw, above n11 p121.

<sup>18</sup> See e.g. ‘Bank of England deputy governor falls on his sword’, Independent 19th June 2008; and ‘Bruised Sants departure is another blow to the FSA’ Financial Times 9th February 2010.

<sup>19</sup> Under the Bank of England Act 1998 (as amended by the Banking Act 2009).

<sup>20</sup> Under the FSMA 2000.

political mechanisms the most critical has without doubt been the Treasury Select Committee, whose reports have often been withering in their criticism of the regulatory authorities and the boards of financial institutions.<sup>21</sup> However, the powers of appointment probably carry more significant implications in the long-term, especially in a model of regulation such as that in the UK where the regulatory authorities enjoy broad powers and therefore the style of regulation may be as important as formal legal powers.

The manner in which the regulatory authorities have accounted for their role in the crisis also carries implications for regulatory reform. Dubnick has identified three different modes of account-giving that focus on the role of the account giver.<sup>22</sup> In ‘reporting’ mode the account giver is obliged to provide information to the principal in a pre-determined manner and primarily seeks compliance with that requirement. This mode corresponds with routine forms of reporting (such as annual reports) but does not focus on responding to specific developments such as a crisis. By way of contrast, in the case of ‘mitigated account giving’ the form of ‘accounting’ is influenced significantly by the account giver, who is expected to respond to an implicitly or explicitly awkward situation. This mode corresponds to the scrutiny of the financial crisis by the Treasury Select Committee, in which the Tripartite Authorities have been required to explain their part in its origins and development. In ‘reframed account giving’ the account giver is engaged in an effort to control or transform his relationship with the account taker. This corresponds with many elements of the accounting offered by the Tripartite Authorities following the financial crisis in the form of detailed reviews<sup>23</sup>, which focus to a substantial extent on the influence of external factors (such as the role of unregulated ‘shadow banks’ and inappropriate use of largely unregulated credit rating agencies) and the need for change in the regulatory structure and rules rather than their own failings in terms of competence or willingness to use existing powers. Thus, it should be borne in mind that ‘reframed account giving’ has the capacity to push the regulatory reform agenda to over-emphasize the need for regulatory reform, to overstate its capacity to generate real change in regulatory practice and perhaps even to focus it on areas where it is not most needed. Precisely how that process will influence regulatory reform is difficult to predict since the dynamics of regulatory reform are complex, encompassing high-level political direction (at national, EC and international level), the style of regulation adopted by the regulator and the variable capacity of market discipline to perform a restraining role at different points in the economic cycle. At this

<sup>21</sup> See e.g. ‘The run on the Rock’, above n9.

<sup>22</sup> See M Dubnick ‘Accountability and the Promise of Performance’ Public Performance & Management Review, Vol 28 no3, March 2005, pp376-417.

<sup>23</sup> In particular, The Turner Review (above n7); The FSA Regulatory Response (above n8); FSA, ‘The supervision of Northern Rock: a lessons learned review’ (March 2008); MH Treasury ‘Reforming Financial Markets’ (CM 7667) (July 2009).

point in time there is a clear impression that reform has focused on relatively ‘soft’ targets that have not been strongly resisted because they are aligned with the interests of regulated entities: the reforms to the scope of regulation and to regulatory capital, discussed below, certainly seem to fall into that category. A fuller assessment must, however, await the outcome of international initiatives that may introduce more far-reaching reforms.

### INSTITUTIONAL STRUCTURE

As has been the case elsewhere, the financial crisis has prompted a review of the institutional structure of regulation in the UK. While there is no clear evidence from around the world that different institutional structures of regulation were better able to avert, limit or manage the crisis<sup>24</sup>, there has been concern in the UK that collaboration between the Bank of England and the FSA has been problematic.<sup>25</sup> According to the informal arrangement establishing the Tripartite Authorities in 1997<sup>26</sup> the Treasury was responsible for general policy and the overall structure of regulation: the Bank was responsible for financial stability<sup>27</sup>; and the FSA was responsible for prudential supervision. At least in the early phase of the crisis it was clear that there was considerable divergence between the FSA and the Bank of England over the extent to which the Bank should provide support to failing financial institutions as well as to the broader money market. Moreover, it was argued that even when the Bank did move (under government pressure) to a more interventionist stance, that its capability was limited by its lack of ready access to detailed information about individual institutions, which was held by the FSA as the prudential supervisor.<sup>28</sup>

The creation of the Council for Financial Stability in 2009, while couched in the rhetoric of the potential for more effective collaboration among the Tripartite Authorities, did not alter fundamentally their roles or interaction since their individual functions remain the same (albeit that both the FSA and the Bank of England now have financial stability as explicit statutory objectives).<sup>29</sup> The quality and effectiveness of their interaction and

<sup>24</sup> See e.g. the FSA’s Regulatory Response at p195 (graphing changes in banks’ market values over 2007/08 against different regulatory structures) and J Cooper ‘The Regulatory Cycle: From Boom to Bust’ chapter 28 in I MacNeil and J O’Brien (eds), *The Future of Financial Regulation* (Hart, 2010).

<sup>25</sup> See ‘The run on the Rock’ (above n9) para. 284.

<sup>26</sup> The arrangement was established through a memorandum of understanding, which was revised in 2006; see [http://www.fsa.gov.uk/pubs/mou/fsa\\_hmt\\_boe.pdf](http://www.fsa.gov.uk/pubs/mou/fsa_hmt_boe.pdf).

<sup>27</sup> Note that this is separate from the monetary policy function of the Bank, in respect of which it enjoys independence from government under the Banking Act 1998. As became clear during the financial crisis, the Bank is largely the agent of the Treasury for the purposes of crisis management.

<sup>28</sup> See ‘The run on the Rock’, above n9 at para 276, concluding that the Tripartite system did not operate effectively in dealing with the collapse of Northern Rock.

<sup>29</sup> See the Terms of reference of the Council for Financial Stability at [http://www.hm-treasury.gov.uk/fin\\_council\\_financial\\_stability.htm](http://www.hm-treasury.gov.uk/fin_council_financial_stability.htm).

collaboration is unlikely to be altered much by a change of name, although one would expect that the experience of the financial crisis would itself act as a catalyst for better collaboration. Nor does the failure to provide a formal statutory basis for the Council bode well for the future.<sup>30</sup> However, significant changes in regulatory practice, such as a move to macro-prudential regulation (discussed below) would require better collaboration than has been evident to date and might well be the catalyst for such a development.

The change of government in the UK following the May 2010 election and changes proposed in the EU regulatory framework may well carry greater implications for the UK in the longer term. While in opposition, the conservative party in the UK made clear that it would transfer responsibility for banking supervision back to the Bank of England<sup>31</sup> and transform the rump of the FSA into a consumer watchdog focused on conduct of business regulation.<sup>32</sup> It did not take long for the new coalition government to convert its plans into action as an announcement in the middle of June 2010 set out the proposals in more detail.<sup>33</sup> The most significant development is that the FSA will be disbanded, with the UK moving away from an integrated regulator to a ‘twin-peaks’ model in which prudential regulation (set up as a subsidiary of the Bank of England) will be separated from conduct of business regulation (to be undertaken by a new Consumer Protection and Markets Authority). A new Financial Policy Committee will effectively replace the tripartite system as well as the Council for Financial Stability: its focus will be on financial stability and macroeconomic regulation and it will granted the formal statutory basis that the Council for Financial Stability lacked. While the new system does bear some resemblance to a ‘twin peaks’ model, some characteristics of the UK system will remain distinctive: regulation will operate on an integrated basis across the banking, securities and insurance sectors; and prudential regulation will be located within the central bank, albeit as a separate legal entity. It remains to be seen how some of the problematic issues, such as the delimitation of prudential and conduct matters, as well as the expansion of the role of the Bank of England will work out in practice. What does seem clear at this stage is that there will be considerable regulatory upheaval both in terms of organisational structure and the relevant rulebooks.

<sup>30</sup> Although the Treasury website refers to the Council being provided for in statute by the Financial Services Act 2010, the relevant clauses were removed from the Bill to ensure that it was passed into law before the end of the Parliamentary session. The conservative opposition (now in government) opposed the creation of the Council on the basis that it did not address fundamental defects in the current institutional structure: see Hansard (House of Lords) 8 April 2010 column 1663.

<sup>31</sup> It was transferred to the FSA from the Bank by the Bank of England Act 1998.

<sup>32</sup> See ‘Tories pledge rapid reform on regulation’, Financial Times 23rd February 2010.

<sup>33</sup> See HM Treasury, ‘Statement to the House of Commons by the Financial Secretary to the Treasury, Mark Hoban MP, on Reforming the Institutional Framework for Financial Regulation’ at [http://www.hm-treasury.gov.uk/statement\\_fst\\_170610.htm](http://www.hm-treasury.gov.uk/statement_fst_170610.htm).

At the EU level, the Commission has proposed the creation of a European Systemic Risk Council (ESRC) and a European System of Financial Supervisors (ESFS).<sup>34</sup> While the ESRC is envisaged as having a monitoring and advisory role the ESFS is envisaged to have the power to make binding technical standards and interpretative guidelines to be followed by national authorities in making decisions in connection with individual institutions. The characterisation of the ESFS as a interventionist agency and a potential rival to national authorities is emphasised by the proposal that that the ESFS has ‘the means to ensure coherent application of Community legislation’ and to initiate enforcement against by the Commission against national authorities who are in breach of Community law.<sup>35</sup> It is therefore possible to envisage that once the ESRC and ESFS are in place there will be much more European engagement in the practice of regulation (as opposed to rule-making) than there has been to date. It remains to be seen just what effect that will have, although in principle it seems likely to dilute the capacity of national regulators to develop and operate distinctive styles of regulation.

## REGULATORY STYLE AND OBJECTIVES

Although the regulatory framework in the UK sets explicit objectives for regulation<sup>36</sup>, two features of the system open up the potential for the regulator to influence the style of regulation ‘in action’. The first is that the FSA is granted very broad powers in respect of rule-making<sup>37</sup>, encompassing both the nature of the rules and their substantive content. It is this feature which has enabled the FSA to develop its distinctive ‘principles-based’ approach to regulation as a response to the perceived limitations of a more rules-based system. Second, the division of responsibility between the Tripartite Authorities means that the nature of their collaboration, both on routine matters and in crisis situations, carries important implications for the success or otherwise of the regulatory system. These features exert an important influence on a number of different aspect of the UK system which, taken together, represent a distinctive style of regulation. From the international perspective, the style of regulation in the UK system can be viewed as a form of adaptation of international and EC measures to the local environment through the practice of regulation, rather than through adjustment of rules.

<sup>34</sup> See Communication from the Commission, ‘European Financial Supervision’, COM (2009) 252 final.

<sup>35</sup> Ibid, p10.

<sup>36</sup> The statutory objectives are set out in section 2 of FSMA 2000. They are: market confidence; financial stability; the protection of consumers; and the reduction of financial crime.

<sup>37</sup> See FSMA 2000 sections 138 and 157.

## Moral hazard and ‘too big to fail’

Moral hazard poses a problem for regulatory systems because financial institutions and their customers are likely to change their behaviour if there is either an explicit or implicit understanding that the relevant authorities<sup>38</sup> are likely to intervene in the event of financial difficulty to prevent insolvency. Such intervention is often based on the principle of ‘lender of last resort’, according to which central banks should provide financial assistance on a discretionary basis to banks which are illiquid but solvent to stem a crisis which could lead to the failure of a bank or banks.<sup>39</sup> While concerns over financial stability may override moral hazard concerns in specific circumstances, there is clearly a risk over the long-term if the authorities create an implicit expectation of intervention. Such expectations arise in particular in connection with institutions that are deemed ‘too big to fail’ because of their systemic significance.<sup>40</sup> While Northern Rock did not clearly fall into that category<sup>41</sup> and the Bank of England in particular stressed the moral hazard of intervention in that case<sup>42</sup>, the position changed when it became clear that other protective options were limited.<sup>43</sup> When it later transpired that RBS and then HBOS had been critically damaged by the unfolding crisis, there was no reference to moral hazard and government intervention in the form of recapitalisation through share issues (and later a government-promoted merger between Lloyds and HBOS) was deemed necessary to ensure financial stability. While it provided an immediate solution, that intervention left open the problem of how to deal with the problems of moral hazard and the ‘too big to fail’ issue in the longer term.

The Banking Act 2009 provided statutory recognition to the Bank of England’s role in the maintenance of financial stability, but it did not materially alter the pre-crisis position with respect to moral hazard. The new legislative framework does not clarify whether or in what circumstances the Bank of England should act as ‘lender of last resort’. While some regard this ‘creative ambiguity’ as having the potential to limit moral hazard, since it stresses the discretionary nature of ‘lender of last resort’ funding, others have argued that it simply confuses and

<sup>38</sup> In the UK, this is the Tripartite Authorities.

<sup>39</sup> See A Campbell and R Lastra, ‘Revisiting the Lender of Last Resort - The Role of the Bank of England’, chapter 10 in I MacNeil and J O’Brien (eds), *The Future of Financial Regulation* (Hart, 2010); and generally W Bagehot, *Lombard Street: a Description of the Money Market* (London, C Kegan Paul & Co 1873).

<sup>40</sup> See generally, E Greene, K McIlwain and J Scott, ‘A Closer Look at “Too Big to Fail”’ 5(2) Capital Markets Law Journal 117.

<sup>41</sup> It represented only 3% of UK bank assets and its failure did not pose any significant threat to the inter-bank payments system.

<sup>42</sup> See ‘Turmoil in financial markets, what can central banks do?’ (September 2007), Paper submitted to the Treasury Select Committee by Mervyn King, Governor of the Bank of England at <http://www.bankofengland.co.uk/publications/other/treasurycommittee/other/paper070912.pdf>.

<sup>43</sup> In particular, the limited nature of the deposit guarantee scheme then in operation in the UK and the (perceived) restrictions imposed by the EC Market Abuse Directive (Directive 2003/6, OJ L096/16) on the provision of covert support (with a view to avoiding the market stigma associated with access to ‘lender of last resort’ support provided by The Bank of England).

complicates the resolution of crises.<sup>44</sup> Moreover, the reluctance of the UK government to countenance the insolvency of a large UK bank<sup>45</sup> during the recent crisis combined with the political influence<sup>46</sup> that may be exerted over ‘lender of last resort’ interventions suggest that moral hazard remains a significant issue within the system.

As far as ‘too big to fail’ is concerned, the effect of the government bailouts in the UK (and elsewhere) has been to increase concentration in both commercial and investment banking, with the result that the issue of ‘too big to fail’ has become even more significant as a regulatory concern. A regulatory response to the issue is complicated by the fact that ‘too big to fail’ encompasses several different considerations: banks that are too big to manage effectively; banks that are too big to close because of complexity and customer/ counterparty detriment; banks that are too big to separate from their markets because of systemic effects; and banks that are ‘too big to bail’ because the cost is too high. While (as discussed below) there have been improvements to the crisis management and resolution regime, such ex post measures leave open the issue of how to avoid ex ante the need to deal with the potential failure of an institution that is ‘too big to fail’. Various options have been proposed for dealing with that issue<sup>47</sup> but none have attracted strong support in the UK, not least because they represent significant constraints on banks without clear evidence that they would have helped to avoid the recent crisis.<sup>48</sup> Thus, the ‘too big to fail’ issue remains unresolved<sup>49</sup> and perhaps that is inevitable as it is very difficult and probably unhelpful to attempt to establish ex ante a point at which that position is reached and how the authorities may react. The central role of banks and financial institutions in the economy means that there will always be a point at which political intervention is deemed to be in the public interest and, as in the case of other key government decisions, it does not seem realistic or possible to limit freedom of action by reference to unknown future events, not least because the very nature of government intervention means that

<sup>44</sup> Campbell and Lastra, above n37 at 166, argue that ‘The assumed benefits of ‘constructive ambiguity’ do not actually exist. Ambiguity and uncertainty as to the procedures and loci of power are not constructive. In the event of a crisis, the procedures to be followed should be crystal clear ex ante for the institution affected, the other market participants and the public at large’.

<sup>45</sup> That approach stands in contrast to the willingness to permit the failure (albeit followed by nationalisation or sale of parts of the business) of financial institutions that did not have systemic implications such as The Dunfermline Building Society, London Scottish Bank plc and Bradford and Bingley Building Society.

<sup>46</sup> The Bank of England enjoys independence in relation to its role in monetary policy under the Banking Act 1998 but not in respect of its role in the maintenance of financial stability, in relation to which the Treasury can be expected to continue to exercise significant influence as the ultimate source of funds for rescue operations.

<sup>47</sup> The options are: limiting the size of financial institutions; increasing capital requirements to a level that limits the possibility of failure; separating ‘utility banking’ from investment banking; improving systemic risk monitoring and supervision; and implementing effective resolution regimes to permit effective regulatory intervention in failing banks. See generally, E Greene et al, above n38; and Treasury Committee, *Too Important to Fail - Too Important to Ignore* (HC 261) (March 2010).

<sup>48</sup> See HM Treasury Reforming Financial Markets (Cm 7667) paras 5.29–5.38.

<sup>49</sup> But see below part 4.2. referring to ‘living wills’ as a partial solution.

the political philosophy underpinning intervention (or the lack of it) is likely to change over time.

### Crisis management and the resolution regime

One of the clear lessons from the financial crisis was the lack of an adequate legal framework for crisis management of failing financial institutions in the UK.<sup>50</sup> While the Bank of England was able to respond to market-wide demand for extra liquidity, the possibility of intervention in individual institutions by the regulatory authorities was limited by a lack of formal powers enabling them to take control of failing institutions. Meanwhile, the option of permitting insolvency was complicated by the absence of a special insolvency regime for banks, which meant that customer deposits and other claims could be frozen for a long period of time pending the working out of the insolvency procedure.<sup>51</sup> Thus, it became clear over time that limited crisis management options were themselves a causal factor in determining the consequences of the crisis.

To remedy the situation, several changes have been made.<sup>52</sup> First, a special resolution regime ('SRR') was introduced by the Banking Act 2009. The SRR empowers the Bank of England, acting in consultation with the FSA and the Treasury to initiate three stabilisation options in respect of a failing bank: transfer to a private sector purchaser; transfer to a bridge bank; or transfer to temporary public ownership. While the first of these options is in principle available through the normal market mechanism of a takeover, the experience of the financial crisis was that such a transaction could not be agreed and implemented in volatile market conditions and with major concerns over the solvency of the relevant institution.<sup>53</sup> Second, the insolvency regime for banks was amended and linked to the SRR, the main policy objective being to ensure that the authorities could override the rights of shareholders and bondholders that would normally apply in a restructuring. Changes were also made to the deposit protection system to ensure that where a bank fails, depositors are paid out promptly.<sup>54</sup> Along with amendment of the general law on liquidation, a special administration regime for failing

<sup>50</sup> This defect was common to many systems: see e.g. The Basel Committee on Banking Supervision, 'Consultative Document Report and Recommendations of the Cross-border Bank Resolution Group' (September 2009) at <http://www.asbw.org/Consulta-Reporte.pdf>; E Hüpkens ' "Form Follows Function" - A new Architecture for Regulating and Resolving Global Financial Institutions' 10 European Business Organization Law Review 369-385 (2009).

<sup>51</sup> See 'The run on the Rock', above n9, at para 197: 'The Governor [of the Bank of England] pointed out that the UK authorities were alone in the G7 in being unable to deal with a distressed bank under a special resolution regime, relying instead on normal corporate insolvency laws.'

<sup>52</sup> For developments in cross-border crisis management see the principles agreed by the Financial Stability Forum in March 2009 at [www.financialstabilityboard.org/publications/r\\_0904c.pdf](http://www.financialstabilityboard.org/publications/r_0904c.pdf).

<sup>53</sup> See 'The run on the Rock', above n9, at paras 113-115.

<sup>54</sup> Under standard UK insolvency procedures the depositors would not be paid promptly even if they fell within the Financial Services Compensation Scheme under Part XV of the FSMA 2000.

banks was also introduced by the Banking Act 2009. It is intended to deal with circumstances where only part of a failing bank is transferred to a private sector purchaser or bridge bank: in those circumstances an administrator may be appointed to ensure that essential services and facilities that cannot be transferred are continued for a period of time. Both the liquidation and the administration procedures form part of the SRR in that the Bank of England is empowered to apply to the court for an order in each case. Finally, the FSA will require systemically significant financial institutions to produce so-called ‘living wills’ so as to facilitate the resolution of financial difficulty without systemic disruption and without the need for funding from public finances.<sup>55</sup> Such ‘living wills’ will comprise a recovery plan and a resolution plan; the former will focus on how a firm would respond to a severe stress (e.g. by selling parts its business and ‘de-risking’ its balance sheet) while a resolution plan would focus on how the firm would facilitate the exercise by the authorities of any of the options available under the SRR.<sup>56</sup>

While it is difficult to assess in retrospect the difference that these procedures would have made to the outcome of the financial crisis, it seems clear that they will play a significant role in the future. However, it is probably wrong to conclude that more effective crisis management eliminates the possibility of political intervention (in the form of financial support from public funds) in the future, especially if it is the case that the international trend moves more towards the protection of national subsidiaries rather than global groups in crisis situations involving systemically important firms. In that scenario, it is possible to envisage that political intervention would attract stronger national support as public funding would be focused on the national subsidiary rather than spread across a global group.<sup>57</sup>

### ‘Light-touch’ regulation

Although the FSA has never explicitly endorsed the ‘light-touch’ descriptor<sup>58</sup>, there is no doubt that it was in the ascendancy prior to the crisis and represented a de facto limitation on the very broad powers and extensive discretion that were given to the regulator (the FSA) by the enabling legislation, the FSMA 2000. The approach was described by the FSA itself in the following terms:

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<sup>55</sup> See FSA Discussion Paper 09/4 ‘Turner Review Conference Discussion Paper’ (October 2009) Annex 1.

<sup>56</sup> The resolution plan would build on existing protections that facilitate an orderly exercise of the resolution options, such as the requirement of segregation of client assets and the requirement for a ‘single customer view’ (setting out the net position of each customer with the firm) to be introduced by the end of 2010.

<sup>57</sup> See generally FSA Discussion Paper 09/4 for further discussion of this issue.

<sup>58</sup> See p86 of the Turner Review, referring to it as ‘somewhat of a caricature, and a term which the FSA never itself used.’

The historical philosophy was that supervision was focused on ensuring that the appropriate systems and controls were in place and then relied on management to make the right judgment. Regulatory intervention would thus only occur to force changes in systems and controls or to sanction transgressions which were based on historical facts. It was not seen as a function of the regulator to question the overall business strategy of the institution or more generally the possibility of risk crystallising in the future.<sup>59</sup>

Changes to the model of supervision implemented through the ‘Supervisory Enhancement Programme’ are based on the premise that ‘The new model of supervision is designed to deliver a more intrusive and direct regulatory style than the FSA has previously adopted and requires a ‘braver’ approach to decision-making by supervisors’.<sup>60</sup> Linked with that change in basic regulatory philosophy is a new approach to enforcement in which the FSA has abandoned the mantra of ‘not being an enforcement-led regulator’ in favour of a more overt and aggressive philosophy of ‘credible deterrence’. Recent high-profile investigations into insider-dealing rings said to be operating among market professionals<sup>61</sup> has provided plenty of high-profile evidence of the new approach but it remains to be seen how far it will be carried into other areas, especially since the FSA has in the past emphasised that supervisory engagement was often a superior alternative to formal enforcement.<sup>62</sup> There can be little doubt that the FSA’s change of tack in regulatory philosophy has been driven by the fallout from the financial crisis (and the resulting public demand for more intensive regulation) even if there are overlapping elements of on-going incremental change, such as the emphasis on senior management responsibility for firms’ compliance. It remains to be seen what the new approach will mean as markets recover, not least since one of the clear lessons of the crisis is that formal regulatory powers and rhetoric are often quite far apart from the reality of regulation ‘in action’.

### Principles-based regulation

The causal role of principles-based regulation<sup>63</sup> in the crisis is difficult to judge for several reasons. One is that it is often conflated with ‘light-touch’ regulation even if there is no obvious reason why the two should be linked as ‘light-touch’ regulation refers to the scale and intensity of regulatory intervention while principles-based regulation refers to the structure of the rule system that is

<sup>59</sup> FSA Regulatory Response para 11.14.

<sup>60</sup> FSA Regulatory Response para 11.15.

<sup>61</sup> See e.g. ‘Seven charged over insider trading ring’, Financial Times 31st March 2010.

<sup>62</sup> See generally I MacNeil, ‘The Evolution of Regulatory Enforcement Action in the UK Capital Markets: A Case of “Less is More”’ (2007) 2 Capital Markets Law Journal 345.

<sup>63</sup> See generally FSA, ‘Principles-Based Regulation: Focusing on the Outcomes that Matter’ (2007); and J Black, ‘Making a success of Principles-based regulation’ 1(3) Law and Financial Markets Review 191-206.

employed within a regulatory system. However, to the extent that a ‘principles-based’ approach permits regulated firms considerable freedom in interpreting and implementing regulatory principles and rules, it is understandable that it can quite easily slip into the mode of ‘light-touch’ regulation. Another reason is that in different regulatory domains ‘principles-based’ regulation carries different connotations: in accounting regulation it is often viewed as a superior alternative to a ‘rules based’ approach<sup>64</sup>, while in financial regulation it has become tainted by its linkage (at least in the UK context) with ‘light touch’ regulation. Finally, the characterisation of ‘principles-based’ regulation and ‘rules-based’ regulation as competing models confuses the fact that virtually all systems represent a mixture of both approaches<sup>65</sup> and therefore the attribution of specific causal effects to ‘principles-based’ regulation is problematic. Nevertheless, it has been clear ever since the FSA Chief Executive Hector Sants remarked, that ‘A principles-based approach does not work with individuals who have no principles’<sup>66</sup> that some change was likely in the FSA’s approach. While there is little evidence to date of any substantial change in the formal position of principles within the FSA rulebook, both the FSA’s re-denomination of ‘principles-based’ regulation as ‘outcomes-focused regulation’ and the change in basic regulatory philosophy and style outlined above suggest that there may well be significant changes ‘in action’.

#### Macro-prudential regulation

Linked with the new focus on financial stability in the statutory objectives of the FSA and the Bank of England is the issue of how the authorities should pursue that objective. Both the Turner Review and the FSA Regulatory Response noted that the regulatory approach in the past had put too much emphasis on the solvency and prudential supervision of individual financial institutions and not enough on systemic risk.<sup>67</sup> The solution proposed by both reviews is that regulatory policy be developed to give greater weight to macro-economic factors so as to make the financial system as a whole more resilient in the face of turmoil and economic downturn. The concept of macro-prudential regulation is described in the FSA Regulatory Response as ‘an assessment of how well the statutory Pillar 1 capital requirements provide effective risk capture across the banking sector given prevailing economic conditions, and structural

<sup>64</sup> See D Kershaw, ‘Evading Enron: Taking Principles Too Seriously in Accounting Regulation’ 68(4) Modern Law Review (2005) 594-625.

<sup>65</sup> See C L Ford ‘New Governance, Compliance and Principles-Based Securities Regulation’ available at <http://ssrn.com/abstract=970130>. A cursory glance at the sheer scale of the FSA Handbook of Rules and Guidance (see [www.fsa.gov.uk](http://www.fsa.gov.uk)) serves to illustrate the point.

<sup>66</sup> H Sants, ‘Delivering intensive supervision and credible deterrence’, Speech at Reuters Newsmakers Event (12 March 2009) [www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0312\\_hs.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0312_hs.shtml).

<sup>67</sup> That analysis also attracted support from influential independent commentators: see M Brunnermeier et al ‘The Fundamental Principles of Financial Regulation’, above n4.

changes in the economy and financial sector'.<sup>68</sup> Giving effect to this policy would require changes across a number of areas, but three proposals are of particular importance. One is that banks should be subject to an asset-based leverage ratio. Such a ratio would differ from risk-adjusted capital adequacy ratios under the Basel regime in that assets would not be weighted and therefore errors in risk-weighting (which represent an assessment of risk) would be reduced. Such an approach could help to mitigate distortions arising from internal modelling of risk for those banks that are permitted to use the Internal Ratings Basis under Basel II. As well as providing a control technique at the micro-prudential level, it would also have a system-wide influence in improving the quality of assets (loans and other financial instruments) within the system as growth could not be achieved through expansion in low risk-weighted assets. Another component of the new approach would be counter-cyclical capital buffers, which would require formula-based reserves to be created during periods of economic growth to provide a buffer against the effects of economic downturn. This type of reserve differs from the concept of regulatory capital adopted in the Basel regime in that regulatory capital is intended to protect primarily against credit and market risk over the duration of the relevant assets (loans etc.) against which capital is held and no specific provision is made to protect against economic shocks or economic recession. As the Turner Review explained:

Under such a regime, required and actual capital would increase in good years when loan losses are below long run averages, creating capital buffers which would be drawn down in recession years as losses increase.<sup>69</sup>

Both the Bank of England and the FSA support this approach on the basis that it reduces the extent to which bank behaviour may increase the amplitude of the economic cycle and therefore protects both the financial system and the wider economy.

Leaving aside the issue of whether an international consensus on this type of approach can be achieved (which is not yet clear) there are two other potential barriers that will have to be surmounted. One is that counter-cyclical reserves will require banks to hold more capital<sup>70</sup> and will therefore increase the cost of credit; and while more regulation of banks has considerable public appeal, more costly credit does not. Second, the accounting treatment of such reserves

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<sup>68</sup> Para 5.4 The focus of macro-prudential regulation is not simply the banking or financial system but broader issuer such as inflation, asset prices, competition in markets, monetary and fiscal policy. See Bank of England Discussion Paper 'The role of macroprudential policy' (November 2009).

<sup>69</sup> P61.

<sup>70</sup> Based on the FSA estimation of counter-cyclical reserves of 2 to 3% of risk-weighted assets at the top of the cycle (see FSA Regulatory Response para.5.31), capital requirements might have to rise by as much as 20% above current levels.

poses problems that may result in the reform proposals becoming bogged down in arguments over their presentation. The significance of that issue is that it carries direct consequences for the stability of reported profits and the statement of net assets, both of which are linked to market valuations of banks' shares. A third component of macro-prudential regulation would be a core funding ratio, which would require a minimum core of banks' funding (deposits, money market borrowing etc.) to come from sources of adequate quality and that are sustainable through the economic cycle. That measure would impose a constraint on the overall quality of liabilities and would provide a policy tool that the regulatory authorities could adjust to constrain balance sheet growth in periods of economic expansion.

At the institutional level, a move to macro-prudential regulation would imply a more direct role for the Bank of England in prudential supervision and not just in financial stability. The new Financial Policy Committee will provide a forum in which this approach can be developed.<sup>71</sup> A significant issue is how much discretion should be left to the new Committee within the new macro-prudential framework. While discretion provides flexibility, it also makes decision-making less predictable for the markets and promotes uncertainty.<sup>72</sup> Moreover, as developments in institutional structure at the EU level (above) are likely to drive that system towards a greater focus on macro-prudential regulation, there is logic in aligning the UK system both for the purposes of input to policy formation in the ESRC and for the purposes of adjusting the practice of prudential supervision in the UK to a more macro-prudential focus. However, these changes are unlikely to be evident in the medium-term, not least since their precise scope and form are linked with the emerging (but by no means certain) consensus on changes to capital standards within the Basel framework and also on the dynamics of financial reform within the EU, where experience teaches that agreement on high level principles is not always indicative of agreement on how rules should be formulated or how they should work in practice.

## SCOPE OF REGULATION

In common with other countries, the limited scope of the 'regulatory perimeter' has been identified as a primary cause of the crisis in the UK. While there has been some expansion in the scope of the FSMA 2000 regulatory regime in recent years<sup>73</sup>, that trend has been overshadowed by the growth in entities that perform

<sup>71</sup> See part 3 above (Institutional Structure).

<sup>72</sup> See Bank of England, above n68, at 6.1.

<sup>73</sup> For example mortgage brokers and non-life insurance intermediaries were brought within the FSMA 2000 regulatory perimeter in 2008.

functions equivalent to regulated entities without being regulated on a comparable basis. The Turner Review noted ‘the importance of ensuring that bank-like activities do not migrate outside the regulatory perimeter in order to escape capital and liquidity requirements’.<sup>74</sup> Often referred to as ‘shadow banks’ these entities comprise primarily bank-sponsored SIVs<sup>75</sup>, investment banks and mutual funds, which often perform a similar maturity transformation<sup>76</sup> function to banks but were not subject to the same regulatory capital requirements as commercial banks.<sup>77</sup> Hedge funds, while not bank-like in their activities, were viewed as posing significant procyclical systemic effects, especially as they struggled to meet redemptions in falling markets.

While the Turner Review noted that limits to the scope of regulation and the associated growth in ‘shadow banking’ were factors in the emergence of the crisis, it was careful not to overstate the causal influence of regulatory arbitrage.<sup>78</sup> In particular it noted that investment banks did not escape regulation in either the EC or the US: in the former they were subject to the same capital requirements as commercial banks in respect of their trading books; while in the latter case the SEC applied the Basel trading book/market risk regime to investment banks. The most crucial problem with the investment banks according to Turner was not regulatory arbitrage but the inadequacy of the capital required under the Basel and EC<sup>79</sup> trading book regimes, combined with inadequate focus on liquidity. Mutual funds and SIVs were different in that they fell entirely outside the regulatory regime for banks despite engaging in maturity transformation that was in many ways similar to the banks. In that sense, regulatory arbitrage was a factor, but the causal influence is difficult to estimate since it remained open to regulators to require more capital to be set against assets that had

<sup>74</sup> Page 70.

<sup>75</sup> SIVs are ‘special investment vehicles’ set up (typically by originators of debt finance such as banks) to provide a structure for transactions such as securitisation. They are independent in formal legal terms from their sponsoring institution so as to avoid the accounting requirement to consolidate their activity with that of the sponsor. In that sense they can be described as a form of ‘off balance sheet’ financing. Independence also assists in ensuring that they are ‘bankruptcy remote’ from the creditors of their sponsor.

<sup>76</sup> Maturity transformation refers to the holding of assets and liabilities of different duration. Banks have always held long term assets (loans) but short-term liabilities (deposits), thereby helping to stabilise the cash-flow of households. Mutual funds (especially in the US) and SIVs (in many countries but specially the US and UK) increasingly undertook this function prior to the crisis, thereby earning the descriptor ‘shadow banks’.

<sup>77</sup> Turner Review at 70, noting that UK mutual funds did not act in this way.

<sup>78</sup> Regulatory arbitrage refers to the selection of different regulatory regimes to structure legal entities or transactions by reference to the overall compliance cost (implicit as well as explicit) of each regime. For general background see V Fleischer ‘Regulatory Arbitrage’, University of Colorado Working Paper Number 10-11 at <http://ssrn.com/abstract=1567212>.

<sup>79</sup> The EC regime for bank capital (including the ‘trading book’ in which banks act as principal in trading financial instruments) is contained in the Capital Requirements Directive (itself a combination of the Banking Consolidation Directive 2006/48/EC, L177/1 and the Capital Adequacy Directive 2006/49 EC L177/201), which is implemented in the UK by the GENPRU and BIPRU blocks of the FSA handbook.

(legitimately<sup>80</sup>) been moved off-balance sheet.<sup>81</sup> Thus, the capacity of regulators to use their powers was an issue that was closely linked with the scope of regulation, since the full scope of regulation can only be realised through a willingness to make full and consistent use of discretionary powers across the entire regulatory perimeter.

The limited reforms proposed to the scope of regulation in the UK reflect the limited causal influence of unregulated activity and regulatory arbitrage in bringing about the crisis.<sup>82</sup> The Turner Review regarded inappropriate incentives within the regulatory system (such as the lower capital requirements for banks trading books that encouraged an expansion in traded financial instruments that were exposed to market risk as well as credit risk) as a more important causal factor and other commentators have been more direct in drawing attention to the unwillingness of regulators to use their full powers in the run up to the crisis.<sup>83</sup> Nevertheless, important changes to the scope of regulation are being made. In the case of hedge funds and credit rating agencies, the EU has been the main catalyst for change rather than the UK. Potential changes to the respective roles of home and host member states carry less significance for the overall scope of regulation but do carry important implications for the distribution of regulatory competence within the perimeter.

### Hedge funds

Hedge funds have become a primary focus of attention in the debate over the scope of regulation around the world.<sup>84</sup> The Turner Review, however, was quite tentative in its proposals and did not make a firm case for an extension of regulatory intervention.<sup>85</sup> That approach was premised on a number of factors: first, that hedge fund managers (albeit not the funds themselves as separate legal entities) are already regulated in the UK; second, that the extent to which hedge funds employ leverage is quite modest by comparison with banks; third, that they normally only deal directly with sophisticated investors; and finally that any moves to extend prudential regulation to the funds themselves

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<sup>80</sup> Financial regulators do not and cannot (under existing rules) prevent the movement of risk assets off a bank's balance sheet. The legitimacy of such transactions is determined primarily by accounting rules which require a 'true sale' of the relevant assets.

<sup>81</sup> Under Pillar 2 of the Basel framework and also under the FSA's regulatory capital regime.

<sup>82</sup> Recent revelations that have emerged from the report of the supervisor of the bankruptcy of Lehman Brothers (see 'SEC launches Repo 105 probe', Financial Times 30th March 2010) provide evidence of regulatory arbitrage - in Lehman's case as between English law requirements for recognition of a valid 'repo' transaction and the accounting treatment of such a transaction in consolidated group accounts prepared under US GAAP - but do not alter the broader view that that regulatory arbitrage was not a major causal influence in the crisis.

<sup>83</sup> See Brunnermeier et al, n4; MacNeil, n187; Spitzer, n3.

<sup>84</sup> See IOSCO, 'Hedge Funds Oversight: Final Report' (June 2009).

<sup>85</sup> See pp72-73. The FSA Regulatory Response was similarly tentative, focusing on the benefits of indirect regulation of hedge funds through regulation of regulated entities (such as investment banks providing prime brokerage services) that have relationships with hedge funds: see paras 6.14-6.27.

would be problematic as most are based in ‘offshore’ jurisdictions. The EU’s proposed Directive on Alternative Investment Fund (‘AIF’) Managers follows the indirect approach to regulation of hedge funds through the regulation of fund managers.<sup>86</sup> In essence the Directive aims to regulate the proprietary investment strategy that is adopted by managers as a proxy for regulation of the fund itself. Thus, in addition to a requirement that AIF managers be authorised by national regulators, the proposed Directive will require AIF managers to satisfy national regulators with respect to their risk management, particularly liquidity, operational and counterparty risks associated with short selling; the management and disclosure of conflicts of interest; the fair valuation of assets; and the security of the depository/custodial arrangements. The Directive also proposes that the EC Commission be empowered to set limits to the level of leverage that may be employed by reference to different types of fund. While the UK’s existing regulatory regime for hedge fund managers means that it cannot in principle object to the EU proposal, its leading position as a location for hedge fund management means that it cannot readily support forms of regulation that threaten its competitive position. Thus, it is not surprising that the legislative progress of the proposal was delayed by direct intervention by the British Prime Minister<sup>87</sup>, especially since there is the suspicion in some quarters that this represents only the first part of a broader EU movement to rein in the ‘light touch’ approach to regulation in the UK, which many have viewed as being at least a cultural if not a direct causal factor underlying the crisis.

### Credit rating agencies

The role of credit ratings and the credit rating agencies (‘CRAs’) in the crisis illustrates the complexity of the causal influences that contributed to the crisis. Outside the United States<sup>88</sup>, credit rating agencies were not regulated prior to the crisis.<sup>89</sup> However, they formed a material part of the regulatory structure since, as the FSA commented ‘The regulatory framework places significant reliance on external ratings as part of the calculation of capital requirements under the Capital Requirements Directive’.<sup>90</sup> In that sense a significant aspect of capital adequacy regulation was contracted out to private organisations whose

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<sup>86</sup> See COM (2009) 207 final.

<sup>87</sup> See ‘Brown delays hedge fund reform’, Financial Times 16th March 2010. Following the change of government in the UK in early May, it subsequently became clear that the delay was no more than that, with the result that the UK is likely to have to accept stricter hedge fund regulation: see ‘Osborne bows to EU hedge fund rules’, Financial Times 20th May 2010.

<sup>88</sup> See T Mollers, ‘Regulating Credit Rating Agencies: the new US and EU law - important steps or much ado about nothing?’ 4(4) Capital Markets Law Journal (2009) 477-501 for a comparison of the US and EU approaches.

<sup>89</sup> While article 81 of the EC Capital Requirements Directive (2006/48, L177/1) required that credit ratings used in connection with the risk weighting of assets (for the purposes of the calculation of regulatory capital) be issued by a rating agency that was recognised as ‘eligible’ by at least a single member State, that process did not amount to licensing or supervision in a form comparable to that imposed on banks, insurers and investment firms under the EC regulatory regime.

<sup>90</sup> FSA Regulatory Response, para 1.57.

initial allocation of credit ratings and subsequent changes (especially downgrades) would carry serious implications for the entire global financial system, especially as leverage increased over time.

It is also clear that investors relied too much on credit ratings in making investment decisions, especially in the case of structured finance products such as CDOs<sup>91</sup>, where credit ratings in many cases became a substitute for fundamental analysis and due diligence by investors.<sup>92</sup> As the crisis unfolded, that reliance was exacerbated by the incorporation of ratings ‘triggers’ into financial products. While such contractual techniques were devised as a protective device for investors, it became clear during the crisis that they posed real problems for risk management in financial institutions as well as threatening financial stability by creating uncertainty as to the scale and location of losses that followed a credit downgrade.

Over-reliance on credit ratings was also evident in the operation of the financial guarantee insurance market, where ratings of both the insurers and the underlying credit risk covered by guarantees were the main drivers of the market.<sup>93</sup> While these considerations alone raise serious concerns about the central role that credit ratings have come to occupy, they are given further weight by the conflicts of interest that are faced by the credit ratings agencies. Those conflicts arise from the business model operated by the agencies under which they charge issuers for ratings and are often (particularly in the case of innovative products in structured finance) employed to provide consulting services in respect of the products that they will rate.<sup>94</sup> The risk in such cases, even where there are internal processes for managing conflicts, is that the agency provides a favourable rating to an issuer to secure fees.<sup>95</sup> For the system as a whole this has the effect both of over-pricing the relevant products at the outset and creating the potential for systemic instability as a wave of selling by investors follows subsequent downgrades<sup>96</sup>.

The relatively rapid adoption by the EC authorities of a Regulation<sup>97</sup> on credit rating agencies in 2009 reflected the causal impact of credit ratings in the crisis<sup>98</sup>, the relatively undeveloped state of

<sup>91</sup> Collateralised debt obligations. These instruments are a technique for repackaging underlying debt obligations for onward sale to investors in the form of asset-backed bonds.

<sup>92</sup> Ibid para 1.56.

<sup>93</sup> See the Joint Forum (comprising the Basel Committee, the International Organisation of Securities Commissioners and the International Association of Insurance Supervisors) ‘Differentiated nature of financial regulation’ (January 2010) p78: available at <http://www.bis.org/publ/joint24.pdf>.

<sup>94</sup> See F Partnoy, ‘How and Why Credit Rating Agencies are Not Like Other Gatekeepers’, available at <http://ssrn.com/abstract=900257>.

<sup>95</sup> Ibid p70.

<sup>96</sup> Some institutional investors may be forced to sell by their investment mandate following downgrades, contributing to a downward spiral.

<sup>97</sup> Regulation (EC) 1060/2009, OJ L302/1.

<sup>98</sup> See recital 10 of the Regulation.

EC regulation and the rather weak ‘comply or explain’ framework adopted by the ISOCO Code of Conduct<sup>99</sup>, which relies on voluntary compliance. The new EC framework is based on registration and supervision, undertaken primarily by the national authority in the country in which registration is sought<sup>100</sup> but with a role for CESR<sup>101</sup>, to whom the application is to be made in the first instance, and for a college of supervisors drawn from the competent authorities of member States in which the activities of the credit rating agency is likely to have a significant impact. Among the requirements for registration are important provisions relating to conflicts of interest and disclosure of credit rating methodology. As to the former, the Regulation draws a distinction between ‘consultancy and advisory services’<sup>102</sup>, which may not be provided to the rated entity and ‘ancillary services’ which may. The objective is to restrict the ability of CRAs to act in the dual capacity of adviser to the rated entity and independent assessor of the credit quality of the entity’s debt securities. As to the latter, the Regulation requires that CRAs make a wide range of disclosures including: historical performance data to be made available in a central repository established by CESR; its methodologies and key rating assumptions; the identity of significant clients; details about its legal structure and ownership; and a split of fees as between those derived from credit rating and those from other activities.<sup>103</sup> The new regulatory regime is also viewed by the EC authorities as a means to tackle the lack of qualitative competition in the market for credit ratings since regulatory approval (combined with increasing convergence between the US and EU regimes) has the capacity to overcome the entry barrier for new entrants posed by their lack of market reputation. However, even the Regulation itself recognises the initial and provisional nature of the regulatory regime that it creates: there remain important issues to be clarified and developed, especially as regards the boundary between consulting and credit-rating activities, the capacity of individual member States to supervise CRAs and the appropriateness of the existing rating recommendations and symbols for structured finance products.<sup>104</sup>

### The role of home and host states

The identification of separate roles for the home state of a bank and a host state in which it conducts foreign operations is long-established

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<sup>99</sup> See IOSCO ‘Code of Conduct Fundamentals for Credit Rating Agencies’ at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD173.pdf>.

<sup>100</sup> The primacy of national regulators is reflected in the fact that the registration decision (article 14(4)) and enforcement measures (article 23) are reserved to the competent national authority, albeit subject to consultation obligations.

<sup>101</sup> The Committee of European Securities Regulators: see <http://www.cesr-eu.org/>.

<sup>102</sup> The Regulation (Annex 1 part B para 4) cites as examples of ancillary services market forecasts, estimates of economic trends and pricing analysis.

<sup>103</sup> See article 6 and section E of Annex 1 to the Regulation.

<sup>104</sup> See Mollers, above n84, p499-500.

in both the Basel and EC regulatory frameworks.<sup>105</sup> While the former prioritises the role of the host state in supporting consolidated supervision of international activities by the home state, the latter is more far reaching in its scope and effect, reflecting the high-level objective of the creation of a single market and the harmonisation programme which has sought to implement that objective. In particular, two techniques adopted within the EC regime constrain the role of host states in relation to branches of EC banks: first the ‘single licence’ principle according to which authorisation and supervision is the responsibility of the home state<sup>106</sup>; and second, the ‘passporting’ principle which permits the establishment of branches by EC authorised banks on the basis of their home state authorisation.<sup>107</sup> While the EC system was premised on likely benefits in terms of competition and lower funding costs for business and consumers, the regulatory risks inherent in the system became clear following the collapse of three Icelandic banks that operated in the UK under the EC ‘passport’.<sup>108</sup> Under the EC system supervisory requirements and deposit guarantee arrangements are set by the home state and in this case it became clear that the scale of the losses suffered by depositors vastly exceeded the fund available under the Icelandic guarantee arrangements. Quite apart from the political ramifications that ensued in Iceland regarding the responsibility and accountability of its bankers and regulators, these events drew attention to the consequences of disparity in regulatory capacity and resources between the different participants in (an ostensibly) harmonised system. At the broader international level, it became apparent during the crisis that national regulators were focused on protecting and rescuing domestic banks rather than the local operations of foreign banks.

In response to the crisis, reforms have been proposed both within the EU and in the international system. The FSA, for example, has put forward three options for modification of the current EC regime: first, a system of peer review to ensure effective supervision ‘in action’ in all member States; second, extending the powers of host states over branches; and third, making the operation of ‘passporting’ subject to an EU-wide regulatory framework such as a pre-funded deposit guarantee scheme.<sup>109</sup> While progress on this

<sup>105</sup> As regards the Basel regime see ‘The Core Principles for Effective Banking Supervision’ (1977) and for the EC the Capital Requirements Directive, above n75.

<sup>106</sup> Article 41, first sub-paragraph, of Directive 2006/48EC provides that host Member States retain responsibility for the supervision of liquidity of branches of EU credit institutions, but only “pending further coordination”.

<sup>107</sup> The passport does not apply to subsidiaries, which must be authorised by the host state.

<sup>108</sup> For general background see <http://www.hm-treasury.gov.uk/landsbanki.htm> (30th April 2010). Passporting covers EEA member states such as Iceland.

<sup>109</sup> FSA Regulatory Response p156. The reference to an ‘EU wide framework’ seems to envisage rules and regulatory bodies operating at EU level rather than the current system of EU-produced rules implemented in different ways in different member States. See also p101 of the FSA Regulatory Response canvassing the twin options of ‘more Europe’ or ‘less Europe’; and p102 of the Turner Review supporting ‘more Europe’.

issue is linked with the evolution of the role of the new European System of Financial Supervisors, it seems that both the objective of that body and emerging policy proposals<sup>110</sup> within the EU favour deeper integration rather than the allocation of greater powers to host member States. Also linked with this issue is the treatment of systemically important banks. While the FSA's approach to that issue has been to argue in favour of some form of regulatory capital surcharge to reflect the heightened systemic risk posed by such institutions<sup>111</sup>, an alternative proposal has focused on requiring systemically significant branches to incorporate as local subsidiaries thereby subjecting them to the same capital and liquidity regime as domestic banks.<sup>112</sup> The direction of change on this issue is likely to prove very significant for the EU in particular as the common currency area rules out the possibility of the use of monetary policy at the national level to constrain expansion in bank lending, whereas powers available to host states to adjust liquidity requirements or counter-cyclical charges could provide an alternative policy tool to achieve that objective.<sup>113</sup>

#### Adjustments to the FSMA 2000 regime

In response to concerns<sup>114</sup> that the FSA lacks direct powers over unregulated parent companies that control regulated entities within a group structure, the FSA has made changes to the 'approved persons' regime. That regime limits the performance of 'controlled functions' to 'approved persons' and represents a technique whereby the FSA can both control entry into the relevant function and its performance. Changes made to the FSA Handbook in 2009<sup>115</sup> brought within the definition of 'controlled function' persons (such as partners, officers, senior managers or employees) of a parent undertaking or holding company whose decisions or actions are regularly taken into account by the governing body of an authorised firm. This serves the purpose not only of extending the reach of FSA regulation but also of reinforcing the FSA's policy of increased focus on competence and capability in senior management appointments in regulated firms as well as the recognition of personal (as opposed to entity) responsibility for failures.

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<sup>110</sup> See e.g. the Commission working document published in connection with the public hearing on 26 April 2010 regarding changes to the Capital Requirements Directive, proposing (at para 28) greater home state supervision over the liquidity of bank branches operating in other member States (document available at [http://ec.europa.eu/internal\\_market/consultations/docs/2010/crd4/consultation\\_paper\\_en.pdf](http://ec.europa.eu/internal_market/consultations/docs/2010/crd4/consultation_paper_en.pdf)).

<sup>111</sup> See FSA Discussion Paper 09/4, 'Turner review Conference Discussion Paper' para 3.54.

<sup>112</sup> See Brunnermeier et al, above n4, para 3.4 and chapter 7.

<sup>113</sup> See A Persuad 'Macro-Prudential Regulation' World Bank, Crisis Response, Note Number 6 at <http://rru.worldbank.org/documents/CrisisResponse/Note6.pdf>.

<sup>114</sup> See the FSA Regulatory Response paras 6.7 - 6.13.

<sup>115</sup> See FSA Policy Statement 09/14, 'The approved persons regime - significant influence function review' (July 2009). Further refinement of the regime is proposed in FSA Consultation Paper 10/3 'Effective corporate governance (Significant influence controlled functions and the Walker review)' (January 2010).

The expansion in the information-gathering powers of the FSA is contained in the Financial Services Act 2010.<sup>116</sup> Currently, the FSA's powers can be exercised only within the regulatory perimeter, albeit that this extends to collection of information on unregulated activity that is undertaken by a regulated entity and on exposure to unregulated counterparties of regulated entities. The expanded power will enable the FSA to collect information that is relevant to the stability of the financial system directly from owners or managers of investment funds or persons connected to them and service providers to authorised firms.<sup>117</sup> While the effective exercise of this power may in some cases be limited by the territorial limits of the FSA's jurisdiction (e.g. in respect of 'offshore' funds managed from the UK), its overall effect is likely to be beneficial in facilitating the development of a more complete picture of the nature and scale of risk accumulation and transfer, especially in the less transparent areas of the market.<sup>118</sup>

### CAPITAL ADEQUACY

In common with most other countries, the UK regulatory authorities concluded that inadequate capital in the banking sector was a major cause of the financial crisis. That conclusion was hardly surprising in the light of the recapitalisation of several major UK banks (RBS, HBOS, Lloyds) by the government or, in the case of the stronger banks (such as Barclays, HSBC and Standard Chartered) recapitalisation by shareholders and new investors. The first stage in the process of bolstering capital was the demand from the markets that counterparties be adequately capitalised as a condition for access to wholesale funding. It was this influence that drove both government and private investment in the banking sector and resulted in capital ratios rising significantly by the end of 2008. The sharp rise in financial markets in 2009 brought further benefits as even those banks that had been in danger of sinking in 2008 benefitted as rising asset values boosted their balance sheets.<sup>119</sup> Against that background, regulatory proposals for higher minimum capital requirements were probably of less immediate significance although there can be little doubt that they are necessary to ensure adequate levels of capital since market discipline is unlikely to prove a reliable constraint as the crisis recedes. However, recognition of the necessity for reform has not been translated into action at the international level. While the Basel Committee has

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<sup>116</sup> Section 18.

<sup>117</sup> Moreover, the Treasury is empowered to prescribe further categories of person in respect of whom the FSA's extended information-gathering power may be exercised.

<sup>118</sup> While the transaction reporting regime established by article 25 of MiFID provides regulators with transaction details from the OTC market in respect of trading in financial instruments admitted to trading on regulated markets, there remains a substantial volume of OTC trade that is not in such instruments (e.g. credit default swaps).

<sup>119</sup> See p22 of the FSA Financial Risk Outlook 2010 for details of the recent evolution of UK banks' capital adequacy ratios.

set out a clear agenda for increasing capital requirements<sup>120</sup>, political agreement at the international level is a more problematic issue, despite the considerable impetus provided by support from the Obama administration in the US.<sup>121</sup> Furthermore, with the effect of the rescue measures and implicit support through monetary policy already feeding through to bank profitability (and stronger capital ratios), the likelihood of dilution of the Basel's committee's far reaching proposals before their end-2012 target implementation date seems ever more likely . Nevertheless, it can be argued that minimum levels of capital are in any event not a very clear guide to appropriate levels of capital in individual cases, a point explicitly recognised by Pillar 2 of the Basel Framework and the ARROW framework adopted by the FSA in the UK. From that perspective, the solution lies in the hands of national regulators, who should be bolder in their implementation of Pillar 2.

Changes to the capital regime in the EU following the financial crisis have focused on implementation of the interim measures adopted by the Basel Committee in July 2009.<sup>122</sup> The main effect of the changes to capital requirements that are in the process of being adopted in the EU<sup>123</sup>, and will be implemented in the UK from January 2011<sup>124</sup>, is that higher levels of capital will be required in respect of positions held in the 'trading book'<sup>125</sup> of banks and in respect of repackaging securitizations (e.g. in the form of collateralised debt obligations). The effect on individual institutions will depend on the extent to which they engage in such activity. There are also provisions that encourage greater due diligence to be undertaken prior to investment in securitized products through the attachment of a higher risk weighting where that does not occur and also a requirement that originators of securitizations retain a material economic interest as an incentive to monitor more effectively the quality of the underlying assets. In aggregate, the FSA expects the capital changes to be equivalent to around a one percentage point increase in the ratio of capital to risk weighted assets (based on balance sheets at the end of 2009,

120 See the Basel Committee's Consultative Document 'Strengthening the resilience of the banking sector' (December 2009).

121 See 'Differences persist over tougher regime' (Financial Times of 26 April) reporting on differences between the G20 members and within the IMF over the scale of the increase required and the techniques to be used.

122 See the Basel Committee's 'Enhancements to the Basel II framework' (July 2009).

123 The changes are contained in amendments to the Capital Requirements Directive, above n75. For further details regarding the on-going process see [http://ec.europa.eu/internal\\_market/bank/regcapital/index\\_en.htm](http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm). These standards take the EU beyond those of the Basel Committee guidelines and promote greater harmonisation within the EU.

124 The changes will be made mainly through the FSA rulebook but changes to the institutional structure of regulation resulting from the EU proposals discussed in part 3 will be implemented in regulations made by the Treasury: see FSA Consultation Paper 09/29 'Strengthening Capital Standards 3' (December 2009) and HM Treasury 'Implementing amendments to the CRD' (December 2009).

125 This activity is often referred to as 'proprietary trading' and involves taking risk on to banks' balance sheet as a principal rather than acting in a representative capacity for a client to whom the risk is ultimately transferred.

which include new capital raised in 2008 and 2009).<sup>126</sup> Although the incremental regulatory requirement is quite small, the overall increase in capital has been substantial and it seems clear that, at least for the foreseeable future, regulators' capacity to use discretionary powers to require even higher levels of capital has been strengthened.<sup>127</sup>

While the EC measures referred to above did not specifically address liquidity<sup>128</sup>, the UK has taken independent action on this front, reflecting the distinct causal role of the withdrawal of liquidity in the crisis. The overall effect is to strengthen liquidity within the financial system and reduce reliance on short-term money market funding. Branches of foreign firms as well as UK authorised firms<sup>129</sup> will be expected to comply with the two high level principles of 'adequate liquidity' and 'self-sufficiency', although the latter is open to waiver or modification by the FSA. While these changes have generally been welcomed in the markets it has been observed that disproportionate costs (in terms of systems and reporting obligations) may be imposed on firms who do not pose significant systemic threats.<sup>130</sup>

Linked with the inadequacy of capital is the accounting treatment of assets and liabilities held by financial institutions. The significance of accounting treatment is that capital (including reserves attributable to shareholders) does not have an independent existence: it represents simply the residual difference between assets and liabilities and is therefore a function of the values attached to each. Second, as leverage increases within the financial system, the manner in which assets and liabilities are recorded assumes greater significance since the residual capital becomes ever smaller by comparison with the balance sheet and therefore more volatile. The Turner Review recognised the role of 'mark to market' accounting<sup>131</sup> in fuelling the credit boom, (since it helped to create the impression of new capital as markets rose) and

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126 FSA Consultation Paper 09/29 'Strengthening Capital Standards 3' (December 2009).

127 Reflecting the shift in regulatory dynamics in support of regulatory intervention, the FSA Chairman has recently proposed that the FSA consider adopting a system of sectorial risk-weighting of banks' assets with a view to limiting rapid increases in bank lending to specific sectors, such as occurred in relation to (largely speculative) construction in the years prior to 2007: see 'Turner calls for powers to control asset bubbles', Financial Times 17th March 2010. The power to adopt such measures is already vested in the FSA, but exercise of the power would represent a change in regulatory philosophy towards a much more interventionist stance.

128 Note, however, that the Committee of European Banking Supervisors (CEBS) did issue recommendations in December 2009 on Liquidity Buffers and Survival Periods: see <http://www.c-ebs.org/Publications/Standards-Guidelines.aspx>. This followed the publication in September 2008 of the Basel's Committee's (revised) 'Principles for Sound Risk Management and Supervision'.

129 The regime will apply to all 'BIPRU' firms, including UK banks, investment firms and building societies as well as UK branches of EEA and non-EEA banks.

130 See G Walker, 'Liquidity risk management - policy conflict and correction' 4(4) Capital Markets Law Journal (2009) 451.

131 The practice is an application of the general accounting principle that an asset should be recorded at the price that it could be sold at the balance sheet date.

equally in exacerbating the downturn as the cycle turned.<sup>132</sup> However, having implicated ‘mark to market’ in the upswing, neither Turner nor the FSA Regulatory Response expressed fundamental dissatisfaction with ‘mark to market’ accounting, thereby leaving the door open for it to retain its role in the capital adequacy framework. Broader questions about the role of ‘mark to market’ accounting in the financial reporting framework (applicable to all companies) are beyond the remit of the FSA albeit that the financial sector is probably most affected. Ultimately, that issue is likely to require resolution at the international level since it is not feasible for the UK to act alone on accounting standards now that listed companies report under International Financial Reporting Standards, which are the responsibility of the International Accounting Standards Board.

## MARKET TRANSPARENCY AND INTEGRITY

Regulation of markets relies heavily on disclosure as a regulatory technique but the financial crisis has drawn attention to deficiencies in its operation. Two dimensions of disclosure have been particularly problematic. One is its role as a regulatory technique for protecting investors and another is its role as a technique for enhancing market transparency and integrity. As regards the first role, it has been argued that there has been over-reliance on the capacity of investors to make rational investment decisions even when extensive information is provided by issuers in compliance with disclosure obligations. On that view, the role of disclosure in the financial crisis calls for ‘a substantial overhaul of its processes, volume, timing and format to make it more effective’.<sup>133</sup> On another view, that process might extend as far as prohibiting certain transactions (such as complex securitisations) in which the information asymmetry problem exceeds the bounds that can realistically be remedied by disclosure.<sup>134</sup>

As far as the role of disclosure in enhancing transparency and market integrity is concerned the position of the UK is complex. On the one hand the UK has a record of applying ‘gold-plating’ to EC minimum standards Directives in its ‘official listing’ regime, ownership disclosure regime and transaction reporting regime, the rationale being that high standards promote investor protection and enhance market liquidity. On the other hand, the UK has also been a leader in the development of the ‘over the counter’ (‘OTC’) and structured finance markets<sup>135</sup>, where disclosure of trading and

<sup>132</sup> Turner Review p65.

<sup>133</sup> E Avgouleas, ‘What Future for Disclosure as a Regulatory Technique? Lessons from Behavioural Decision Theory and the Global Financial Crisis’ (p231) in I MacNeil and J O’Brien (eds), *The Future of Financial Regulation* (Hart, 2010).

<sup>134</sup> Steven L. Schwarcz, ‘Disclosure’s Failure in the Subprime Mortgage Crisis’ (2008) Utah Law Review, 1109; Duke Law School Legal Studies Paper No. 203. Available at <http://ssrn.com/abstract=1113034>.

<sup>135</sup> The OTC market refers to the range of transactions (especially derivatives) that are undertaken on a bilateral basis between banks. There is no organised ‘market’ as such. Structured finance refers to financing techniques that repackage existing financial instruments: e.g. securitisation as a means to ‘sell’ mortgage portfolios to bond investors.

market positions (both to regulators and market participants) is much more limited than in regulated markets. As much of the pre-crisis increase in trading volume and innovation in financial instruments occurred in those markets, the UK has a clear interest in ensuring that those markets remain centred in London, even if some changes to their mode of operation may be necessary. Thus, the argument that inadequate disclosure in respect of trading in and exposure to some instruments such as derivatives (where much of the trade is on the OTC market) was an important causal factor in the crisis can expect to receive only qualified acceptance in the UK.

The Turner Review did not specifically address the role of disclosure, although it did consider the role of efficient market theory as a foundation for regulation, concluding that there had been too strong a reliance on the self-correcting capacity of markets and that the “inherent instabilities in liquid markets” should feature more prominently in the regulatory approach.<sup>136</sup> That would suggest some limitation of the role of disclosure in investor protection although the precise direction of any such initiative remains difficult to read, at least as far as the wholesale financial markets are concerned.<sup>137</sup> Nor did the FSA Regulatory Response highlight the limitations of disclosure as a regulatory technique, focusing instead on a relatively modest reform agenda centred on selective improvements to the transparency regime in certain market segments.<sup>138</sup>

#### Market transparency

The FSA Regulatory Response drew attention to the need to review transparency arrangements in markets.<sup>139</sup> In doing so, it distinguished several different aspects of transparency: (a) pre- and post-trade transparency in the trading system; (b) transparency of positions to other market participants; (c) transparency in the nature of products for investors; and (d) transparency to the regulator about market transactions. As regards (a) it noted that equity markets are subject to a harmonised EU regime under MiFID<sup>140</sup> that covers both pre-trade and post-trade transparency<sup>141</sup> but that markets in other securities are not covered, with the result that there are disparate regimes

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<sup>136</sup> Turner Review p42

<sup>137</sup> In retail financial markets, there has already been evidence pre-crisis of a reduced role for disclosure in both the EC and UK regimes: see N Moloney *How to Protect Investors* (CUP 2009) chapter 5.

<sup>138</sup> That impression is borne out by the FSA's subsequent Discussion Paper 09/5 'Enhancing financial reporting disclosures by UK credit institutions' (October 2009), which focused on improving comparability of disclosures between credit institutions and reducing complexity.

<sup>139</sup> FSA Regulatory Response pp172-175.

<sup>140</sup> The Markets in Financial Instruments Directive, 2004/39/EC [2004] OJ L145/1.

<sup>141</sup> The equity regime in MiFID applies to shares admitted to trading on a regulated market, whether the trades take place on a regulated market, multilateral trading facility or OTC. Pre-trade transparency refers to the prices and volumes in which prospective transactions may be executed while post-trade transparency refers to the prices and volumes of executed trades. Both forms of transparency carry implications for the efficiency of markets in pricing securities.

in place across different member States, often with no regulatory intervention in OTC markets. While CESR concluded in its 2008 review of the bond markets<sup>142</sup> that there was no need for intervention, it later changed its view in favour of enhanced disclosure.<sup>143</sup> Similarly, the FSA favours further development of post-trade transparency in non-equity markets, as does IOSCO.<sup>144</sup> As regards (b), the FSA noted that a general obligation to disclose the nature and size of trading positions would undermine the operation of markets but recognised that the long-standing exception made in the case of equity markets (based on the role of ownership disclosure in corporate governance and control) was necessary and should be extended to all long positions in voting shares.<sup>145</sup> The focus in respect of (c) has been on asset-backed and structured products, where a lack of investor understanding of risk led to inadequate due diligence and over-reliance on credit ratings. The regulatory response to this issue will inevitably be linked with the EU regulation of credit rating agencies and initiatives sponsored by IOSCO and CESR. The latter has already recommended post-trade transparency requirements for asset-backed securities, which are often admitted to trading on regulated markets, and CDOs and credit default swaps (neither of which are commonly admitted to trading and therefore not currently within the MiFID post-trade transparency regime). In respect of (d), the FSA noted that it already has a substantial input of information, as even OTC market transactions may be subject to reporting requirements under MiFID if the relevant instruments are admitted to trading on a regulated market, but that there could be a more effective focus on key risks, especially in regard to the systemic risk that may arise in such markets as a result of counterparty exposure or a reduction in liquidity, both of which have been features of the recent crisis.<sup>146</sup>

### Market infrastructure

In the wake of the financial crisis, there have been calls for changes to be made to the market infrastructure for OTC derivatives. They range from proposals to mandate that such instruments

<sup>142</sup> This was a review undertaken for the purposes of providing advice to the Commission in connection with the report on pre-and post-trade transparency required by article 65(1) of MiFID: for background see the DG Internal Market and Services Working Document (April 2008) at [http://ec.europa.eu/internal\\_market/securities/docs/isd/nemt\\_report\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/isd/nemt_report_en.pdf).

<sup>143</sup> See CESR/09-348 (10 July 2009), recommending that the 2010 Commission revision of MiFID extend post-trade transparency to bonds for which a prospectus has been published or which have been admitted to trading on a multilateral trading facility. This measure was seen to have the potential to restore market confidence (by limiting asymmetry of information regarding trading prices and volumes in the absence of a post-trade reporting regime) and improving liquidity in normal times.

<sup>144</sup> See e.g. IOSCO Transparency of Structured Finance Products (September 2009).

<sup>145</sup> This extension occurred in June 2009 in the UK through changes to the FSA Handbook: see DTR 5.1 (Notification of the acquisition or disposal of major shareholdings) extending ownership notification requirements to financial instruments that are equivalent in economic terms to voting shares. At the EU level CESR has proposed an EU-wide regime for such instruments, which currently fall outside the disclosure requirements of the Transparency Obligations Directive: see CESR /09-1215b (January 2010).

<sup>146</sup> See also IOSCO consultation paper 'Transparency of Structured Finance Products' (September 2009) recommending greater post-trade transparency for structured finance products.

be required to trade ‘on exchange’ to more limited proposals that certain contracts (such as credit default swaps) be cleared through a central counterparty. The latter has gained support from regulators including the FSA on the basis that such arrangements can reduce systemic counterparty risk and enhance the transparency to regulators of the positions taken by individual firms. However, unilateral action by the FSA on this front is unlikely, not least because of EU initiatives<sup>147</sup> are on-going, but also because there are risks associated with over-extending any requirement for central clearing: in particular that systemic risk is simply transferred to and accumulated within clearing houses and also that the standardisation in derivative contracts required for entry into clearing poses a threat to flexibility and innovation within the market. The FSA has stressed that the global nature of the derivatives market requires that any movement to expand clearing must not limit the ability of firms and clearing houses to manage risk on a cross-border basis and must allow for consistent and reliable information flows among the national regulators.

### Market integrity

When the uncertainty associated with the financial crisis prompted increased market volatility, the capacity for short-selling to destabilise the shares of financial institutions who were engaged in capital-raising, as well as the broader market, became apparent. It was clear in particular that, in some instances, short-selling was accompanied by the creation of false and misleading market rumours. In the UK the FSA responded by introducing, on an emergency basis, a prohibition on short-selling of financial sector stocks and a disclosure obligation in respect of short positions.<sup>148</sup> The policy reasons given by the FSA for its move were that while short-selling was ‘a legitimate technique in normal market conditions’, it can be used to support abusive practices and may contribute to disorderly markets when ‘herding’ leads to prices overshooting in response to the signal that a share is overvalued.<sup>149</sup> The legal nature of the prohibition and disclosure obligation<sup>150</sup> was that either the creation of a short position or failure to disclose an existing short position would constitute market abuse.<sup>151</sup> While the prohibition was not renewed when it expired<sup>152</sup>, the disclosure obligation was extended

<sup>147</sup> See the CESR/ESCB consultation on clearing, settlement and central counterparty systems at [http://www.cesr-eu.org/index.php?page=contenu\\_search\\_res&searchkeyword=clearing&exactphrase=on&doonly=all&searchdatefromday=1&searchdatetomonth=1&searchdatefromyear=2005&searchdateatoday=27&searchdatetomonth=5&searchdatefromyear=2010&xx=54&yy=18](http://www.cesr-eu.org/index.php?page=contenu_search_res&searchkeyword=clearing&exactphrase=on&doonly=all&searchdatefromday=1&searchdatetomonth=1&searchdatefromyear=2005&searchdateatoday=27&searchdatetomonth=5&searchdatefromyear=2010&xx=54&yy=18).

<sup>148</sup> The measures took effect on the 18th September 2008: see FSA Consultation Paper 09/1 ‘Temporary short selling measures’.

<sup>149</sup> Ibid, p4.

<sup>150</sup> The disclosure obligation is triggered when a net short position (representing an economic interest in the issued share capital of an issuer) exceeds or falls below 0.25%, 0.35%, 0.45% and 0.55% and each 0.1% threshold thereafter. Disclosure in this context means public disclosure, not just disclosure to the regulator.

until June 2009 and then indefinitely.<sup>153</sup> The Financial Services Act 2010 gives the FSA broader powers to make rules on short-selling, including restrictions based on financial stability grounds.<sup>154</sup> At the EU level, a model for a pan-European short-selling disclosure regime has been proposed by CESR.<sup>155</sup> It differs from the UK disclosure model in that it has a lower (0.2%) threshold for disclosure of short positions in shares to regulators and a higher threshold (0.5%) for public disclosure. Also relevant in this context is the change in regulatory style that is now evident in the UK in the wake of the financial crisis and in particular the greater willingness on the part of the FSA to take enforcement action over alleged infringements of the market abuse regime.<sup>156</sup>

## CONDUCT OF BUSINESS REGULATION

In contrast with the clear view expressed in relation to the causal role of regulatory failings associated with capital adequacy and financial stability, conduct of business regulation has not generally been viewed as a major causal factor in its own right.<sup>157</sup> Conduct of business regulation received relatively little attention in either the Turner Review or the FSA Regulatory Response, albeit that both implied that too much attention had in the past been paid to conduct of business regulation by comparison with capital/ liquidity regulation. By comparison with the intense focus that emerged in the US on consumer protection (especially as regards mortgage-origination and underwriting<sup>158</sup>), there was less focus on that issue in the UK, probably because the financial instruments most clearly implicated in the crisis were linked to US sub-prime mortgages.<sup>159</sup>

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<sup>151</sup> Market abuse is defined by s118 FSMA 2000, while s123 empowers the FSA to impose financial penalties for market abuse. In the case of authorised firms or their employees, other disciplinary measures may also be pursued by the FSA, such as the withdrawal of approval from 'approved persons'.

<sup>152</sup> On the 16th January 2009.

<sup>153</sup> See FSA Consultation Paper 09/15, 'Extension of the short selling disclosure obligation' (June 2009).

<sup>154</sup> See section 8 of the Act.

<sup>155</sup> See CESR, 'Model for a Pan-European Short selling Disclosure Regime', CESR/10-088. In the meantime the temporary measures adopted by the German authorities illustrate the divergence of approach within the EU: see [http://www.bafin.de/cln\\_179/nn\\_720486/SharedDocs/Artikel/EN/Service/Meldungen/meldung\\_100518\\_cds\\_leerverkaufsverbot\\_allgemeinverfuegungen\\_en.html?\\_\\_nnn=true](http://www.bafin.de/cln_179/nn_720486/SharedDocs/Artikel/EN/Service/Meldungen/meldung_100518_cds_leerverkaufsverbot_allgemeinverfuegungen_en.html?__nnn=true).

<sup>156</sup> See J Symington (Head of Wholesale Department, FSA) 'The FSA and enforcing the market abuse regime' (November 2008) referring to credible deterrence and the role of criminal prosecutions; and 'Seven charged over insider trading ring', Financial Times 31 March 2010.

<sup>157</sup> That is, considered separately from light-touch regulation and principles-based regulation, both of which carry direct implications for conduct of business regulation.

<sup>158</sup> See e.g. The Department of the Treasury, 'A New Foundation: Rebuilding Financial Supervision and Regulation' (June 2009), p57.

<sup>159</sup> While the Turner Review found evidence of falling mortgage underwriting standards in the UK, mortgage defaults have not been a major source of losses for the UK banks and repossessions remain below the peak reached in the early 1990s recession.

The Turner Review commented that the FSA's supervisory approach before the financial crisis, especially in the case of banking, resulted in 'A balance between conduct of business regulation and prudential regulation which, with the benefit of hindsight, now appears biased towards the former.'<sup>160</sup> That assessment reflects not only the recognised failures of the FSA in prudential supervision but also the substantial resources devoted by the FSA to its conduct of business initiatives in the retail market, in particular the Retail Distribution Review and the Treating Customers Fairly Initiative.<sup>161</sup> While that assessment, combined with significant strengthening in the FSA's staff engaged in prudential supervision<sup>162</sup>, would suggest some downgrading of conduct of business regulation in terms of regulatory priorities, the recent analysis of retail conduct risks and issues in the FSA Financial Risk Outlook 2010 suggests that there remain important concerns.<sup>163</sup> Pressure on banks as a result of recent losses and higher capital requirements are viewed as posing the risk that they may look to boost profits through unfair treatment of customers. Greater demand for capital protected products in the wake of the volatility and fall in asset values witnessed in 2008 poses the risk of the development of complex products providing poor value without meeting customers' needs. In the insurance sector, which attracts a large part of discretionary investment through unit-linked products, there are concerns over risks borne by the insurer and the customer respectively as well as a reliance on commission-driven distribution networks. While most of the emerging conduct risks do not require to be addressed by legislative or regulatory changes, there is one significant change that carries long-term implications. Once the FSA's Retail Distribution Review is implemented (from the end of 2012) it will no longer be possible for advisers to be paid a commission by the provider of retail investment products. That change reflects a long-standing concern of the FSA over the potentially distorting impact of commission-driven sales on consumer preferences and behaviour rather than a direct response to the financial crisis.<sup>164</sup>

## CORPORATE GOVERNANCE

Two aspects of corporate governance have been linked with the emergence of the financial crisis. One is the widespread failure on the part of boards of directors, and in particular independent non-executive directors, to understand and control the risks that were taken by their companies. Another is the role of inappropriate and excessive forms of remuneration, which is closely linked with

<sup>160</sup> Page 87.

<sup>161</sup> See further N Moloney, *How to Protect Investors* chapter 4, part IV.

<sup>162</sup> See the Chief Executive's report in the FSA 2008/09 Annual Report, noting a 34% rise in core supervisory staff.

<sup>163</sup> See pp61-70.

<sup>164</sup> See further N Moloney, *How to Protect Investors* chapter 4, part XI.

governance since one of the main concerns of governance codes is the setting of appropriate levels of remuneration.

### The causal role of weak governance

The causal role of weak corporate governance in the emergence of the crisis has been contested. In its initial analysis of the emerging crisis the FSA did not attribute a causal role to weak governance<sup>165</sup> but subsequently changed its position<sup>166</sup>. The Turner Review recognised that ‘improvements in the effectiveness of internal risk management and firm governance are also essential’, but its main focus was on the causal role of poor design and operational failures in the prudential supervision of banks and other financial institutions. The Walker Review<sup>167</sup> commissioned by the Prime Minister in February 2009 was premised on there being a link between losses suffered by the UK banks and weak corporate governance. That link was accepted in the final report which commented:

It is not the purpose of this Review to assess the relative significance of the many different elements in the build-up to the recent crisis phase. But the fact that different banks operating in the same geography, in the same financial and market environment and under the same regulatory arrangements generated such massively different outcomes can only be fully explained in terms of differences in the way they were run. Within the regulatory framework that is set, how banks are run is a matter for their boards, that is, of corporate governance.<sup>168</sup>

The Walker Review identified weaknesses in particular in the following areas: the expertise of non-executive directors; the linkage of pay with performance; and inadequate capability within major investing institutions to protect the interests of those for whom they act. Walker’s analysis of the role of corporate governance chimes with the approach adopted by the OECD<sup>169</sup> and some studies of earlier financial crises<sup>170</sup>, but others commentators have disputed the causal role of weak governance. Adams for example has argued that

<sup>165</sup> See the causal factors cited in n6 above (from the FSA, Financial Risk Outlook 2009).

<sup>166</sup> See FSA Consultation Paper 10/3 ‘Effective Corporate Governance’, p3: ‘Although poor governance was only one of many factors contributing to the crisis, it has widely been acknowledged to have been an important one.’

<sup>167</sup> ‘A review of corporate governance in UK banks and other financial industry entities’ (July 2009), available at [http://www.hm-treasury.gov.uk/walker\\_review\\_information.htm](http://www.hm-treasury.gov.uk/walker_review_information.htm).

<sup>168</sup> Ibid, p5.

<sup>169</sup> See OECD, ‘The Corporate Governance Lessons from the Financial Crisis’ Financial Trends No. 96 Vol. 2009/1, arguing that ‘The financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements’ and noting weaknesses in corporate governance procedure that resulted in information about risk exposures failing to reach the Board and risk management being activity rather than enterprise-based.

<sup>170</sup> See e.g. the analysis of the early 1990s Nordic banking crisis in DG Mayes, L Halme and A Liuksila, Improving Banking Supervision (Hounds Mills, Palgrave 2001) 91.

it is not clear that ‘ex ante... boards of financial firms were doing anything much different from boards in other firms’.<sup>171</sup> Similarly, she argues that the general perception of excessive pay in financial institutions is not borne out by the evidence once firm size is taken into account. On that basis, Adams concludes that the absence of a clear causal link between governance failure and the financial crisis should urge caution in reforming governance since there may be negative unintended side-effects. Another study<sup>172</sup>, which includes UK banks, found that the corporate governance quotient<sup>173</sup> of banks was not a good predictor of their financial performance during the financial crisis and that the financial strength as at the end of 2006 was a better indicator, especially as measured by capital ratios. More recently, Moody’s analysis of the corporate governance of 20 large US and European banks pointed to the lack of any clear link between the performance of banks during the crisis and either the presence of independent directors on the board or their experience.<sup>174</sup> While these studies may raise some doubts as to the global implications of weak governance, the stark divergence in performance between two cohorts of banks in the UK (a ‘bailout group’<sup>175</sup> and a ‘stand-alone group’<sup>176</sup>) does tend to support the Walker Review conclusions in the UK context. Another factor that may be relevant is the limited capacity of measures of quality of corporate governance to capture the quality of management in the sense of making the right strategic decisions as opposed to following appropriate governance procedures for making those decisions.<sup>177</sup> In that sense, it might be said that no amount of good governance can compensate for bad judgement, albeit that good governance can limit the selection of directors with proven poor judgement or limit their influence within an organisation.

With a view to improving the effectiveness of non-executive directors in financial institutions, the Walker Review recommended that there should be more attention paid to ensuring that non-executive directors have the financial expertise to challenge the executive board, as well as meeting the independence requirements of the Combined Code. Walker also stressed the need for greater board-level engagement in

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<sup>171</sup> R Adams, ‘Governance and the Financial Crisis’, available at [http://ssrn.com/abstract\\_id=1398583](http://ssrn.com/abstract_id=1398583) at 15. The argument is based on evidence relating to governance characteristics (of US listed companies) that apply equally to financial and non-financial firms, such as board independence, board size, amount and structure of pay.

<sup>172</sup> A Beltratti and R M Stulz, ‘Why did some banks perform better during the credit crisis? A cross-country study of the impact of governance and regulation’, available at [http://ssrn.com/abstract\\_id=1433502](http://ssrn.com/abstract_id=1433502).

<sup>173</sup> The quotient (often abbreviated to CGQ™) is a (unsolicited) rating of the corporate governance practices of major global companies (including UK FTSE All Share constituents) by the RiskMetrics Group.

<sup>174</sup> See the Financial Times of 25th March 2010, Lex Column ‘Banks boards’.

<sup>175</sup> Comprising Royal Bank of Scotland, Lloyds TSB and Bank of Scotland. 176

Comprising Barclays, HSBC and Standard Chartered.

<sup>177</sup> See e.g. B Tricker Corporate Governance (OUP 2009) at 35-36, distinguishing governance from management.

the monitoring of risk and in decisions on the entity's risk appetite and tolerance. Specifically, Walker recommended the creation of a board risk committee and a chief risk officer, independent from business units, who should report to the committee and participate in risk management and oversight at the highest level on an enterprise-wide basis.

### Remuneration practices

Walker's engagement with remuneration in financial institutions represented an extension of concern over excessive and inappropriate remuneration that has been at the centre of the corporate governance debate in the UK in the last twenty years.<sup>178</sup> During that time, it has been addressed in various ways: in case of quoted companies, the Companies Act requires a directors' remuneration report<sup>179</sup> each year on which shareholders have an advisory vote<sup>180</sup>; the Companies Act also controls payments to directors for loss of office<sup>181</sup>; the Combined Code requires that listed companies should delegate responsibility for setting remuneration for all executive directors to a remuneration committee comprising non-executive directors; and the Combined Code and ABI guidelines<sup>182</sup> set out guidance on the level and make-up of remuneration. Yet, despite these multiple interventions the financial crisis, and in particular state-sponsored bailouts, exposed 'unsafe remuneration policies, which led to this calamitous state'.<sup>183</sup> Walker stopped short of recommending any kind of cap on remuneration<sup>184</sup>, opting instead for enhancement of disclosure<sup>185</sup> and expansion of the role of the remuneration committee 'to cover all aspects of remuneration policy on a firm-wide basis with particular emphasis on the risk dimension.'<sup>186</sup>

The Walker Review overlapped with the Financial Reporting Council's ('FRC') biennial review of the Combined Code and left the FRC with the problem of whether and how to integrate the Walker recommendations into the Combined Code. The view ultimately taken by the FRC was that the Code should remain

<sup>178</sup> For an overview of recent developments in the EU and at the international level, see G Ferrarini and M C Ungureanu, 'Executive pay at ailing banks and beyond: a European perspective' 5(2) Capital Markets Law Journal 197-217.

<sup>179</sup> Companies Act 2006 ss420-422.

<sup>180</sup> Companies Act 2006 s439.

<sup>181</sup> Companies Act 2006 s217.

<sup>182</sup> The ABI is the Association of British Insurers. Its guidelines represent the collective view of insurers as long-term shareholders. The ABI has a long-standing role in setting governance standards in the UK, along with the National Association of Pension Funds, the Association of Investment Companies

<sup>183</sup> Walker Report para 7.1.

<sup>184</sup> Although that did not in itself preclude the government

<sup>185</sup> The Financial Services Act 2010 (s4) implements Walker's recommendation by authorising the Treasury to make regulations requiring (enhanced) disclosure of remuneration paid to executives of FSA-authorised firms.

<sup>186</sup> Walker Report, Recommendation 29.

unitary in its nature and not contain sector specific provisions: thus, only those recommendations in the Walker Review that are applicable generally to listed companies will be taken into the Combined Code.<sup>187</sup> However, a potentially significant development for investor engagement is that the FRC has accepted the Walker Review proposal that it should develop and take responsibility for a Stewardship Code that would effectively replace the Statement of Principles<sup>188</sup> formulated by the Institutional Shareholders Committee and the section of the Combined Code dealing with institutional shareholders.<sup>189</sup> In line with the prevailing approach under the Combined Code, compliance with the Stewardship Code on the part of asset managers will be on a ‘comply or explain’ basis. The Walker Review regarded this approach as likely to provide a ‘quasi-official imprimatur’ for the Stewardship Code as well as oversight and review by the FRC in a manner similar to the Combined Code.

While the FSA’s mandate does not directly encompass governance issues, there are inevitable overlaps between governance and regulation, especially in the context of the control of risk.<sup>190</sup> The FSA viewed excessive and inappropriate remuneration as a ‘contributory factor rather than a dominant factor behind the financial crisis’ but nevertheless took the view that regulatory intervention in remuneration was justified as a means of promoting effective risk management and facilitating effective governance by shareholders. Its intervention took the form of changes to the Senior Management Arrangements, Systems and Controls (SYSC) component of the FSA Handbook requiring compliance with a new Remuneration Code that is also inserted into that component. The Code comprises a mixture of rules, guidance and evidential provisions<sup>191</sup>, with the core obligation being that:

A firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote effective risk management.<sup>192</sup>

<sup>187</sup> See FRC, 2009 Review of the Combined Code: Final Report (December 2009). Examples of generally applicable recommendations made by the Walker Review are: amendment of the role of senior independent director (recommendation 11); board evaluation (recommendations 12 and 13). The ‘rump’ of the Walker Review not taken into the Combined Code (or the Stewardship Code to be adopted by the FRC) is open to adoption by banks and financial institutions but it will not have the status of ‘guidance’ under the Combined Code in the way that the Turnbull and Smith guidance do. The recommendations made in relation to remuneration have largely been subsumed into the FSA’s Remuneration Code.

<sup>188</sup> The Institutional Shareholders Committee, ‘The Responsibilities of Institutional Shareholders and Agents - Statement of Principles’ (updated June 2007), reproduced in Annex 8 of the Walker Review.

<sup>189</sup> See FRC, ‘2009 Review of the Combined Code: Final Report’ (December 2009), paras 3.76-3.77. The FRC will consult separately on a Stewardship Code.

<sup>190</sup> For a general discussion, see I MacNeil, ‘Risk Control Strategies: An Assessment in the Context of the Credit Crisis’ chapter 9 in I MacNeil and J O’Brien (eds) *The Future of Financial Regulation* (Hart, 2010).

<sup>191</sup> An evidential provision is a type of rule that has evidential value in showing that another rule (such as the core obligation) has been breached or complied with. It is not in itself a binding rule since there may be other methods of compliance.

<sup>192</sup> FSA Handbook, SYSC (Senior Management Arrangements, Systems and Controls) 19.

The use of guidance and evidential provisions limits the extent to which the Code is mandatory and aims to avoid a ‘one-size-fits-all’ approach to remuneration. While the Code clearly does extend the FSA’s supervisory process into the field of remuneration<sup>193</sup>, it remains to be seen what, if any, its effect will be. While the post-crisis environment provides a platform for greater regulatory and shareholder constraint over remuneration, the failure of a series of governance reforms in the past twenty years suggest considerable caution in the framing of expectations. So too does the perceived inability of the government as controlling shareholder to exercise significant influence over remuneration (in the case of its controlling stakes in RBS and Lloyds/HBOS) since that policy may well be interpreted as a truer reflection of the realities of governance in financial firms, in contrast with the aspirational rhetoric of the FSA’s Code.

## CONCLUSION

While it is difficult to attribute causality in connection with the financial crisis, there are a number of factors around which a consensus has emerged. Rapid credit expansion without adequate growth in regulatory capital emerges as the primary factor, implicating both monetary policy and regulatory capability. In those areas where financial firms themselves were the primary movers, three issues stand out. First, poor risk management especially in regard to the implications of market disruption. Second, pricing errors, especially in structured finance where reliance on flawed credit ratings proved to be particularly damaging. Third, weak governance, evidenced by a lack of credible challenge to the strategic direction of some financial firms and poorly-designed incentives. Finally, from the perspective of market structure and organisation, lack of transparency was an important factor. All these issues form an important part of the regulatory response in the UK and worldwide.

There are several reasons why the progress of regulatory reform in the UK has been relatively slow, despite the severity of the crisis and its effect on the broader economy. One factor, which is evident in other countries also, is the need to agree international reform measures especially within the Basel framework for banking supervision. The international nature of many banks and increasingly of the organised markets on which financial instruments are traded means that it is difficult for any individual country to become a first mover in implementing regulatory reform.<sup>194</sup> That observation is particularly relevant for the UK given its significance as a global

<sup>193</sup> Note also that the FSA announced in Consultation Paper 09/15, ‘Reforming remuneration practices in financial services’ (August 2009) that it was incorporating remuneration risk into ARROW (the Advanced Risk Responsive Operating Framework) and other supervisory programmes (p3).

<sup>194</sup> Although the UK has shown itself willing to introduce a bank levy head of the US and the EU: see Financial Times of 22nd June 2010 ‘UK Bank Levy’.

financial centre. Second, the focus on crisis management, especially during 2009, drew attention away from regulatory reform to more immediate concerns over survival and re-shaping the financial sector through nationalisation, government guarantees and mergers. Third, considerable uncertainty has been caused by the timing of the UK Parliamentary election and political disagreement over the institutional structure and style of regulation in the UK system. While the recent statement by the government regarding the institutional structure provides some certainty, much remains to be clarified in terms of the working of the system. Moreover, implementation of the EU proposals for new European level bodies will complicate matters further. The only real certainty is that the institutional structure will be quite different once those changes have been made.

The heavy emphasis in the regulatory reform debate and proposals on capital and liquidity threatens to mask other failings within the system. Conflicts of interest have attracted relatively little attention other than in the form of the high-level question as to whether investment banks (or a sub-set of their activity such as proprietary trading) should be separated from mainstream commercial banking. That limited focus tends to underplay the significance of conflicts of interest both within the legal structures that are created in connection with financing techniques (e.g. SIVs, conduits, limited partnerships) and the transactions through which these structures distribute financial instruments to investors. Those conflicts of interest are the focus both of provisions of the FSA Handbook<sup>195</sup> and of common law fiduciary duties, which apply in many of the circumstances encountered in structuring and distributing financial products. On the basis of the virtual absence of FSA enforcement action in this area it can only be concluded that there were no material breaches during the pre-2007 boom in securitisation and structured finance. That outcome leads to the conclusion that the crisis has generated a ‘compliance conundrum’ in which risk has materialised in an extreme form without triggering a significant set of (conflict of interest) rules that were intended to mitigate risk. There are in principle two explanations for such a conundrum. One is that the nature of the crisis genuinely did not implicate conflicts of interest in a material way: that is the implicit position of the FSA. The other is that the conundrum simply disguises the true position temporarily and that much more attention may be about to focus on this issue. The latter explanation finds some support in the so-called ‘Volker rule’<sup>196</sup> being discussed in the United States and recent moves by the SEC against Goldman Sachs<sup>197</sup> (viewed by some as just the

<sup>195</sup> A cursory search under ‘conflict of interest’ in the FSA Handbook reveals that there are in excess of 100 relevant provisions.

<sup>196</sup> The proposed rule would prohibit banks from engaging in proprietary trading.

<sup>197</sup> See <http://www.sec.gov/litigation/complaints/2010/comp21489.pdf>.

beginning of a wave of litigation directed against the investment banks in particular<sup>198</sup>).

While it would be wrong to conclude that developments in litigation in the US will be matched on this side of the Atlantic, not least because of difference in the incentives and procedural rules associated with civil litigation, there are already some signs that private litigation is emerging in the UK in response to the crisis. There are a number of issues in particular that have already been the subject of litigation such as: contractual capacity<sup>199</sup>; customer classification<sup>200</sup>; the legal status of ‘termsheets’<sup>201</sup> (which record the main terms of a transaction prior to completion of the full documentation); and ‘mis-selling’ claims based on common law and regulatory obligations<sup>202</sup>. On the one hand such private litigation can be viewed positively as a substitute for the absence of public enforcement by the FSA of functional equivalents of private law duties in its rulebook covering matters such as conflicts of interest and duties owed to clients. Viewed in that light, the threat of private litigation provides effective deterrence while the focus of regulatory rules is more on the systems and procedures that are established within authorised firms to protect clients.<sup>203</sup> On the other hand, private litigation can be viewed as having a potentially destabilising issue should inexperienced courts find themselves adjudicating on the market documentation and practices that they do not understand.<sup>204</sup> That dilemma raises a broader issue of the extent to which conduct in financial markets escapes the scrutiny of courts applying general legal standards (such as fiduciary duty and associated conflict of interest rules) in favour of more specialist and technocratic control mechanisms mediated by regulators and private arbitration forums.<sup>205</sup>

Also relevant in this context is a lack of analysis of the meaning of ‘market failure’ by reference to the private law rules that underpin the market. In the UK and elsewhere regulatory agencies frequently make reference to ‘market failure’ as a basis for regulatory intervention but rarely is any attempt made to define what the concept means or to consider how it might be resolved through techniques

<sup>198</sup> See F Partnoy, ‘Wall Street beware: the lawyers are coming’, Financial Times 12 April 2009. See also J Bethel, A Ferrell and G Hu, ‘Legal and economic issues in litigation arising from the 2007-2008 credit crisis’ at <http://ssrn.com/abstract=1096582>.

<sup>199</sup> See Haugesund Kommune, Narvik Kommune v Depfa ACS Bank [2009] EWHC 2227 (Comm).

<sup>200</sup> See Spreadex Ltd v Sanjit Sekhon [2008] EWHC 1136 (Ch).

<sup>201</sup> See Maple Leaf Macro Volatility Master Fund v Rouvroy and Trylinski [2009] EWHC 257 (Comm).

<sup>202</sup> See UBS v HSH Nordbank AG [2009] EWCA Civ 585.

<sup>203</sup> However, earlier cases such as J P Morgan v Springwell Navigation [2008] EWHC 1186 (Comm) suggest some caution over the degree of protection that the courts will be prepared to extend to clients.

<sup>204</sup> See J B Golden, ‘The Future of Financial Regulation: the Role of the Courts’, chapter 5 in I MacNeil and J O’Brien (eds), *The Future of Financial Regulation* (Hart, 2010)

<sup>205</sup> See Partnoy, above n 187.

other than regulatory intervention.<sup>206</sup> In the light of the widespread perception of the failure of regulation during the recent crisis, that is perhaps a perverse outcome, but it is nevertheless true. In particular, insufficient consideration is generally given to the potential for contractual and structural/organisational techniques to improve the working of markets in ways that would avoid the need for regulatory intervention.<sup>207</sup> There are probably two reasons for this. One is that market-based organisations<sup>208</sup> that are responsible for contractual documentation and market practice operate independently from the regulators and are not directly subject to their jurisdiction. In that sense, the regulators' mission is not to engage with the legal infrastructure of the markets but to intervene when it is seen to fail. That may well be an approach that has to change as the limited capacity of regulation to resolve 'market failure' becomes evident. Another relevant factor is that the way in which structural and organisation techniques are used in financial innovation<sup>209</sup> is by definition always changing and therefore the risks that they pose may not be well understood at any point in time. Thus, even in the case of a well-resourced regulator, there are inherent difficulties in attempting to determine whether particular techniques are inherently risky: it is much simpler to resort to regulatory techniques that measure risk by reference to financial thresholds even when it is known that this will lead to another round of innovation that seeks to circumvent the restrictions.

Both the crisis and the response to it are indicative of a complex relationship between governance and regulation. While there is some evidence to suggest that regulation may have been regarded as an adequate substitute for good governance prior to the crisis, it seems equally clear that much of the post-crisis process of holding individuals to account is being undertaken through governance mechanisms rather than regulatory processes. Thus, resignations from the board of directors, with varying degrees of encouragement from institutional investors, have been a more prominent feature post-crisis than regulatory action against individuals, albeit that there have been recent significant moves on that front by the FSA.<sup>210</sup> The potential for governance to play a more substantial role in the future seems clear, especially since institutional investors with diversified portfolios have an obvious interest in the control of systemic risk, albeit that they face the same collective action problems in dealing with that issue as they do with other governance matters.

<sup>206</sup> See D Rouch, 'Self-regulation is dead: long live self-regulation' *Law and Financial Markets Review* (2010) 102-122.

<sup>207</sup> The debate about the role of 'clearing' transactions through a central counterparty in stabilising markets is a relatively rare example of attempts to improve the market other than through regulation, albeit that regulation may ultimately mandate the use of clearing in some sectors such as derivatives.

<sup>208</sup> Such as LMA (the London Market Association), ICMA (the International Capital Markets Association) and ISDA (the International Swaps and Derivatives Association).

<sup>209</sup> Examples include the use of SIVs and complex trust structures in securitization.

<sup>210</sup> See e.g. 'Ex-RBS director agrees to FSA ban', *Financial Times*, 18th May 2010.

Finally, it is clear that the new focus on financial stability will be the key factor in the development of the UK system in the years ahead. While the definition of what that means and the development of macro-prudential techniques to implement policy are important issues that await clarification, it should not be forgotten that there are also broader policy issues that must come into play. Thus, as the Bank of England has recently argued, macro-prudential policy must be set within a framework in which societal preferences for stability over growth are debated and implemented within an appropriate accountability framework.<sup>211</sup> That poses a challenge for government both at the level of principle and in terms of linking financial regulation with other aspects of government policy, but it is an issue that cannot be avoided if financial stability is to form a solid basis for regulatory policy in the years ahead.

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<sup>211</sup> See Bank of England, above n68 at 29.

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