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Is it possible to establish effective financial services regulatory controls in multi-national enterprises?

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Contents

Abstract

The effect of globalisation on international financial services regulatory compliance includes multi-national enterprises (MNEs) having to address a proliferation of jurisdictional controls including governance risk management, securities and insurance, anti-money laundering, and anti-bribery and corruption. Establishing financial services regulatory controls that are effective across jurisdictions in this environment requires both high level policies and diverse jurisdictional controls that can be monitored in detail to provide an audit trail for investigative regulatory scrutiny, and help protect the MNE from prosecution. In a swiftly, ever-changing regulatory landscape, compliance activities have to be agile to achieve this, of course with restricted resourcing. This work discusses how a governance culture that embraces soft law conventions as well as hard law requirements in a financial services MNE can be effective as a business enabling and risk minimising compliance programme.

Introduction

This work primarily discusses the jurisdictional challenge of compliance with diverse financial services regulatory requirements for multi-national enterprises (MNEs),[1] with a focus on the United Kingdom (UK) and European Union (EU). It includes the relevance of international soft law conventions of international Standard Setting Bodies (SSBs) such as those of the Organisation for Economic Development and Co-operation (OECD) and hard primary and secondary laws and regulations of individual jurisdictions, including those with extra-territorial reach. It also includes the issues of transparency, responsibility, accountability, risk management and democratic aspects of effective corporate governance and globalisation when embedding effective controls in a MNE.

The reactive nature of regulatory development, jurisdictional and sovereignty considerations together with technological and communications advancement impact the approach of financial services MNEs to establishing effective regulatory controls, especially as global financial markets are becoming more independent of geography.[2] MNEs have the choice of centralised or decentralised corporate governance approach to running their businesses, and in local country requirements, either to be proactive, ensuring that all is in order before they start to do business in a jurisdiction, or re-active and clear issues up as they arise in their local corporate entities, correcting

[1] The term "multi-national" is used in this work rather than "transnational" as the application of laws in jurisdictions of subsidiary entities presents multiple, equally important requirements on financial services firms.
[2] House of Lords European Union Committee, 2nd Report of session 2012-2013, *'MiFID II: Getting it Right for the City and EU Financial Services Industry,'* London: The Stationery Office Limited (July 2012)

behaviour on regulatory request. By example, today's financial services regulatory landscape encourages the latter behaviour rather than the former. However, the elements are there for a proactive approach to international regulation on a more cohesive basis, with the G20 for international regulatory standard setting, and Europe for cross-border regulation among sovereign states leading the way, especially with the establishment of the European Systemic Risk Board (ESRB) and regulatory reform in the UK towards a proactive approach. This is by no means a new idea, as in his essay, "Perpetual Peace," of 1795 Immanuel Kant:

> "…argued not for world government, but for a law-governed international society among sovereign states, in which the strong ties existing among individuals create mutual interests that cut across national lines…(creating) moral interdependence, and lead(ing) to greater possibilities for peace through international agreement."[3]

As financial services controls are aimed at the protection of consumers,[4] financial stability and market integrity, efforts to achieve this by the international community acting together as a harmonising force in protecting the investors of all jurisdictions, including curbing pro-cyclical market movements,[5] has attained greater urgency and focus since the 2007-2009 financial crisis (the financial crisis). The activities of international SSBs will be discussed further in Chapter 1.

Financial Services Regulators persist in trying to narrow the gap between industry practice and innovation, regulating the conduct of corporate entities to encourage risk minimization on a reactive basis, and there is a negative impact on controls when regulators are weak. Frequently following a financial scandal, developments are

[3] Koh, Harold Hongju, 'Why Do Nations Obey International Law?' *Faculty Scholarship Series.* Paper 2101 (1997) p 2610

[4] Whether they are retail securities investors or professional investors interested in sovereign bonds.

[5] Stiglitz, Joseph, *Globalisation and its Discontents*, New York: Norton (2003) p 100: Pro-cyclical capital flows are where, "…capital flows out of a country in a recession, precisely when the country needs it most, and flows in during a boom, exacerbating inflationary pressures."

made to UK law and regulations that strengthen corporate governance controls, moving them a little further away from adherence to voluntary codes, and towards mandatory obedience of laws and regulation. For example, in the UK the Bank of Credit and Commerce International (BCCI) was closed down by the Bank of England (BoE) in July 1991 after being found engaging in fraud, tax evasion, money laundering, arms trafficking, smuggling, unlawful property dealing, bribery and the support of terrorism.[6] This scandal resulted in the review of the Securities and Investments Board by its Chairman, Andrew Large, who produced a report[7] recommending greater transparency in regulation and the implementation of the government's plans on regulatory reform.[8] The lack of effective embedding of these controls because of the reactive and political nature of regulatory development, as in the case of the UK's Financial Services Authority (FSA), negatively impacts on the credibility of a jurisdiction's regulator. Regulations devised to control industry behaviour can only be effective if the individuals carrying out supervision and enforcement activity are adequately skilled and knowledgeable, and can apply them consistently and intelligently. Poor quality and delivery of enforcement results is more detrimental to a regulator's credibility than empowering of it, and inconsistent enforcement does not empower financial services compliance leaders in the board room. Effective financial services risk mitigation controls are also at the heart of good corporate governance for MNEs to better achieve sustainability by maintaining reputation and market share. Corporate governance and risk management of MNEs are the subjects of Chapter 2.

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[6] Hoare, Steve, 'Judge Surprised by Collapse of BCCI Trial,' *The Lawyer* (3 November 2005)
[7] Large, Sir Andrew, *'Report to the Chancellor on the Reform of the Financial Regulatory System,'* (The Large Report) London (July 1997)
[8] Walker, George A., *International Banking: Law, Policy, and Practice,* London: Kluwer Law International (2001) p 247

The three fold purposes of financial services regulation promote the interests of investors and protect those who save, it regulates securities distribution in the primary and secondary markets[9], and it provides regulation to ensure the orderly functioning of the financial market. Jurisdictions develop regulatory regimes overseeing individuals and entities for use in their own countries. The rules country regulators make, their supervision of obedience to those rules, enforcement where they find non-compliance, and litigation when the rules are broken are micro-prudential[10] in nature. They are important in maintaining investor confidence in the market, but discount the macro-prudential[11] risks that can build up in the financial system. Technological and communications advances, in particular the internet have opened up financial markets, and with no internationally held responsibility for regulating financial services, soft law conventions serve to deter MNEs from engaging in regulatory arbitrage: capitalising on loopholes in financial regulation to circumvent unfavourable requirements.

> "Despite problems of authority, process, and legitimacy…soft law securities regulation is generally desirable internationally as it counteracts competitive races to the bottom, and makes regulatory cooperation more palatable."[12]

The fundamental legal requirements on this are most broadly promulgated by the World Trade Organisation and the Treaty of Rome.[13] Prior to the financial crisis,

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[9] Primary market is the market of securities when first issued, when the capital raised goes to the issuing entity. Secondary transactions are when the first owner sells securities on to others in the market.

[10] Micro-prudential regulation refers to the regulation of individuals and entities that does not take into consideration the interconnections across the financial system, or the impact they may have.

[11] Macro-prudential regulation refers to the interconnected financial system, and seeks to control the impact of financial services players on other entities and jurisdictions across the financial system.

[12] Kelly, Claire and Karmel, Roberta, 'The Hardening of Soft Law in Securities Regulation,' *Brooklyn Journal of International Law*, Vol. 34, Brooklyn Law School, Legal Studies Paper No. 141 (2009)

[13] Treaty Establishing the European Economic Community (Treaty of Rome 1957)

insufficient attention was given to the risks of globalisation, and as the cost to EU Member States of bailing out banks represented 13% of EU Gross Domestic Product in 2008[14] it is perhaps unsurprising that the EU is committed to minimising the impact of any future crisis by implementing the reforms led by the G20 via the Financial Stability Board (FSB) and Basel 3. Globalisation will be discussed further in Chapter 3.

This work seeks to establish that by using jurisdictional hard law it is not possible to embed effective regulatory controls in a financial services MNE that are coherent, manageable and which offer a robust foundation on which to build effective corporate governance without embracing international soft law conventions. This research has been based on primary sources of information. However, secondary sources of information have also been referenced where necessary, including works by Alexander, Ferran, Senden and Stiglitz for international SSBs and globalisation, and Cadbury, Norton and Walker on corporate governance.

[14] Barnier, Michel, '*Towards More Responsibility and Competitiveness in the European Financial Sector,'* Brussels: Internal Market and Services, European Commission (2010) p 11

Chapter 1

International Standard Setting Bodies: Their Contribution to Establishing Effective Regulatory Control Systems

1.1 Introduction

The financial crisis has given new focus to macro-prudential systemic market matters, and soft law conventions are having real impact on the establishment of effective regulatory controls. The impact of regulatory controls suggested by international SSB conventions may be considered as impaired by them being non-enforceable and therefore prone to being overlooked. However, it would be an error to assume that because of this they are not important influencers of MNEs and governments, and as a development of EU law:

> "…soft law instruments have acquired a particular meaning, significance and legal status."[15]

1.2 The Financial Crisis

The financial crisis, which caused the "virtual collapse" of the financial system[16] in the UK and Europe, has raised questions on the activities of international SSBs and financial regulation on a global scale. The G20, and the Basel Committee on Banking Supervision, formed by the G10 in 1974,[17] are important initiators of change in international financial services regulation, whose recommendations are evidenced in

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[15] Senden, Linda, *Soft Law in European Community Law*, Portland, Oregon: Hart Publishing (2004) p 110

[16] Gadbaw, Michael, 'Systemic regulation of global trade and finance: a tale of two systems,' *Journal of International Economic Law* (2010) p 551

[17] Basel Committee on Banking Supervision, *'History of the Basel Committee and its Membership,'* Basel: Bank for International Settlements (August 2009)

the newly reinforced EU financial architecture. Leading up to the financial crisis micro-prudential, disclosure based, instruments of financial services regulation were largely ineffective as no systemic risk mitigation system was incorporated into the regulatory paradigm, presenting local regulators with the challenge of trying to use micro-prudential regulatory controls to manage macro-prudential issues in the broader financial system.[18] Above all, it has been identified that:

> "…the recent financial crisis has demonstrated the importance of having a robust macro-prudential supervisory framework and micro-prudential supervisory regime with the objective of controlling systemic risk."[19]

As the impact of the financial crisis became evident, Jaques de Larosiere, Chair of the High-Level Expert Group on EU Financial Supervision, delivered a report[20] to the European Commission, with the aim of promoting:

> "…much stronger, coordinated supervision for all financial actors in the European Union. With equivalent standards for all, thereby preserving fair competition throughout the internal market…to build confidence among supervisors. And real trust. With agreed methods and criteria. So all Member States can feel that their investors, their depositors, their citizens are properly protected in the European Union." [21]

Stronger, more coordinated supervision was delivered in the EU on January 1st 2011, when three European Supervisory Authorities (ESAs): the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority became operational, replacing the Level 3 Lamfalussy committees,[22] which had no power over local country regulators.[23] The

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[18] Alexander, Kern, et al, *Global Governance of Financial Systems: The International Regulation of Systemic Risk*, Oxford: Oxford University Press (2006)
[19] Alexander, Kern, 'Reforming European financial supervision and the role of EU institutions,' *Amicus Curiae*, Issue 82 (2010) p 2
[20] EU High Level Group on Financial Supervision in the EU, *'The De Larosiere Report,'* Brussels (2009)
[21] Alexander, op cit. at 19, p 5
[22] Committee of Wise Men, *'Final Report of the Committee of Wise Men on the Regulation of European Securities Markets,'* Brussels (2001) p 37

ESAs have powers to draft technical standards, investigate national competent authorities, take action against them where allowed by treaty, and in emergency situations that threaten financial stability they can also ban regulated activities or products. These authorities now interpret international conventions for the EU and require Member State regulators to implement them into national law. Their aim is not to replace national regulators, but to co-ordinate them better, and provide arbitration where necessary.[24] Their powers represent significant reform to the supervision of European MNEs. To support them, the ESRB was also established at the same time. The ESRB is designed to operate without any legally binding powers, and yet it occupies a pivotal position in the reinforced EU financial supervisory architecture to provide a better oversight of systemic risks.[25] However, its effectiveness has yet to be seen, and it is questionable as to whether it can be effective, given that it is operating in areas in which earlier attempts by SSBs failed.[26] Attempts to strengthen financial services regulatory architecture help to establish more robust control frameworks within MNEs, and the flexibility that recommendations and guidelines offer when responding quickly to the need for effective regulatory development,[27] (albeit that this is not always the case)[28] is well established in the EU's high level principles and risk-based processes structure of

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[23] The Committee of European Banking Supervisors (CEBS); the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS); and the Committee of European Securities Regulators (CESR)

[24] Barnier, Michel, *'The date of 1st January 2011 marks a turning point for the European Financial Sector,'* Brussels: Speech at European Commission, (January 2011)

[25] Ferran, Eilis, and Kern Alexander, 'Can soft law bodies be effective? The special case of the European Systemic Risk Board,' *European Law Review* (2010) p 751

[26] Ibid. p 758

[27] Boyle, Alan, 'Some Reflections on the Relationship of Treaties and Soft Law' *48 I.C.L.Q.* (1999) pp 901-903

[28] McCreevy, Charlie, European Commissioner for Internal Market and Services Keynote Address at *'Financial Reporting in a Changing World,'* Conference, Brussels (May 2009)

financial services supervision.[29] The influence of G20 and EU regulations in the UK is much stronger now that the ESAs and ESRB are in place, and this comprehensive legislative framework provides EU country regulators common and effective ways of tackling future bank crises.[30] To implement reform well in the UK, supervision from the BoE in balancing micro and macro-prudential regulation, defining responsibilities and managing the transition to the new regulatory structure will be key. The move to establish the ESAs and the ESRB demonstrates that Europe is upholding its international commitments and is working with other authorities across the world, which appears to be a major step forward in better global supervision of MNEs.[31]

1.3 Markets in Financial Instruments Directive

The Markets in Financial Instruments Directive[32] (MiFID) was introduced as a harmonising directive in November 2007. It amended, and in some Member States, increased regulatory expectations. Following this, MiFID II[33] aims to introduce a binding pan-European rulebook with the intention of ensuring consistent application across all Member States, as,

> "The need to adapt regulation to serve a more complex market reality characterised by increasing diversity in financial instruments and methods of trading is reflected in all major recent EU reforms in the financial services area."[34]

Importantly, the MiFID II proposal states that in an emergency situation (without defining what an "emergency" situation may be) the ESAs can take direct control of

[29] Financial Services Authority, *'Principles-based Regulation: Focusing on the outcomes that matter,'* London (2007)
[30] Trichet, Jean-Claude,*'The Future of Risk Management and Regulation: Smarter regulation, safer markets,'* Frankfurt: Speech at European Central Bank Frankfurt Main Finance Summit (23 March 2011)
[31] Barnier, op. cit. at 14, p 64
[32] Directive 2004/39/EC
[33] Amendments to MiFID in consultation and review.
[34] European Commission, Directorate General Internal Market and Services, *'Public Consultation, Review of the Markets in Financial Instruments Directive (MiFID),'* Brussels (December 2010)

national regulation of EU Member States. In view of the novelty of the ESAs, it can be expected that the individuals charged with the above responsibilities will need time to develop them in terms of policy and approach, and unless an event deemed to be an emergency occurs to accelerate it, their establishment may be slow. These EU initiatives effectively strengthen regulatory controls, encouraging the enactment into local country law elements of the agreement at the G20 Seoul Summit in 2010, which advocates taking action:

> "… at the national and international level to raise standards, and ensure that our national authorities implement global standards developed to date, consistently, in a way that ensures a level playing field, a race to the top and avoids fragmentation of markets, protectionism and regulatory arbitrage. In particular, we will implement fully the new bank capital and liquidity standards and address too-big-to-fail problems."[35]

1.4 SSBs: Gaps and Overlaps

Other SSBs, such as the International Organisation of Securities Commissions (IOSCO), use their influence to create un-enforceable multi-jurisdictional standards. This has:

> "…a hard impact in a number of areas, including prudential banking regulation…because…(they have) been adopted and implemented into the domestic legal and regulatory regimes of most countries with functioning financial markets."[36]

Historically, SSBs have independently established their regulatory parameters, and IOSCO identifies several areas of law that make up the legal framework of securities regulation, within which the instruments of financial regulation reside.[37] These include disclosure, company law, contract law, banking law, taxation law, bankruptcy

[35] G20 Seoul Summit 2010, *'The Seoul Summit Document,'* Seoul (November 2010) p 22
[36] Alexander, Kern, 'Rebuilding international financial regulation,' *Journal of International Banking & Financial Law*, Volume 26/Issue 8 (September 2011) p 489
[37] International Organisation of Securities Commissions, *'Objectives and Principles of Securities Regulation,'* (2003) p 68

law and the law of dispute resolution, which also embraces enforcement of court orders and arbitration awards. However, IOSCO is just one of the SSBs,[38] and by virtue of operating individually their work can overlap with other SSBs, or leave gaps in regulation,[39] which does not help MNEs to establish effective regulatory controls.

1.5 Co-ordinating the Efforts of International SSBs

To help remedy this, the G20 summit held at Cannes in November 2011 addressed several areas of law and regulations,[40] including the means of enhancing supervision of the implementation of their decisions at national level, the oversight of systemically important financial institutions, crisis resolution regimes and the shadow banking sector.[41]

> "The G20 leaders asked the FSB to work in collaboration with the OECD and other international organisations to explore…options for advancing financial consumer protection through informed choices that include disclosure; transparency and education; protection from fraud, abuse and errors; along with recourse and advocacy."[42]

However, cross border regulation is still a major impediment to implementing effective regulatory controls in MNEs, acknowledged by the FSB:

> "Internationally, impediments to cross-border resolution derive from major differences in national resolution regimes, absence of mutual recognition and agreements for joining up home and host regimes, and lack of planning for handling stress and resolution."[43]

Steps to minimise the effect of this were made at the G20 Cannes Summit when members agreed to strengthen the FSB's capacity, resources and governance. Also in

[38] The standard setting bodies include national regulators as well as international standard setting bodies.
[39] Turner, Lord Adair, *'Macro-prudential policy in deflationary times,'* Manchester: Speech during Financial Policy Committee Regional Visit (20 July 2012)
[40] Bremer, Katherine, *'Key Outcomes of G20 Cannes Summit,'* New York: Reuters (4 November 2011)
[41] G20 Cannes Summit, *'a snapshot of steps taken and progress made 2008 – 2011,'* Cannes (2011)
[42] Organisation for Economic Co-operation and Development, *'G20 High Level Principles on Financial Consumer Protection,'* Paris (2011) p 3
[43] Financial Stability Board, *'Reducing the moral hazard posed by systemically important financial institutions, FSB Recommendations and Time Lines,'* Basel (2010) p 3

2011, the FSB announced policy measures to address the systemic and moral hazard risks of global systemically important financial institutions, including a new international reference standard for national resolution regimes, detailing the responsibilities, instruments and powers they should have.[44] As a result, a revised FSB charter was presented to the G20 Los Cabos Summit in June 2012, with the aim of FSB co-ordinating SSBs at an inter-governmental level,

> "In order to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies…and help coordinate the alignment of the activities of the SSBs to address any overlaps or gaps and clarify demarcations in light of changes in national and regional regulatory structures."[45]

1.6 The Basel Accords

In banking supervision, successive Basel Accords proposed improved capital adequacy requirements for banks. Basel I[46] was simplistic in its capital adequacy ratings. Basel II[47] was more developed but still looked only at the banking book, which contains longer term assets for capital adequacy. Before the financial crisis, markets held the global financial optimism of Harry Markowitz, whose portfolio diversification theory allegedly results in lower capital risk and greater reliability of returns.[48] MNE banks are essential players in financial services transactions, and they, their regulators and sovereigns held:

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[44] Financial Stability Board, *'Policy Measures to Address Systemically Important Financial Institutions,'* Basel (November 2011) section 4 i)
[45] Financial Stability Board, *'Report to the G20 Los Cabos Summit on Strengthening FSB Capacity, Resources and Governance,'* Basel (June 2012) Appendix 1, Article 1, p 2
[46]Basel Committee on Banking Supervision, '*International Convergence of Capital Measurement and Capital Standards: A Revised Framework,'* Basel: Bank for International Settlements (July 1988)
[47] Basel Committee on Banking Supervision, *'Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework,'* Basel: Bank for International Settlements (November 2005)
[48] Markowitz, Harry, '*The Rand Corporation,'* New York: Journal of Finance (1952) p 77

> "…the erroneous belief that financial markets were inherently stable, and that the Basel II capital adequacy regime would itself ensure a sound banking system."[49]

This encouraged the MNEs to underplay risk, and was the basis for capital adequacy calculations for banks in Basel II, which does not provide for counter-cyclical capital requirements.[50] Indeed,

> "Basel II embodied some of the major weaknesses with the current international financial standard setting approach… (which) disproportionately focused on the risk facing the individual firm, and not the risk facing the firm in a malfunctioning financial system…Essentially, Basel II embodied the failure of financial policymakers and regulators to incorporate systemic risks into the design of regulatory institutions and of risk management."[51]

The proposals in Basel III[52] amount to a series of measures for banks to promote the build-up of capital buffers in good times that can be drawn upon in a down-turn, to ensure that banks are considerably more resilient, and robust enough so that a bank's demise should not inflict social damage, backed up by a more intrusive regulatory approach. Basel III covers liquidity, credit risk and mortgage risk, and the measures proposed increase the ratio of equity capital to risk weighted assets in banks from 2% to 7%, including the requirement that banks hold sufficient capital to endure a period of stress. This figure is even higher when combined with the changes to the definition of equity, the increase in some risk weights and the changes to the numerator, ratio and denominator,[53] yet it is still less than half that proposed as "ideal" by David Miles

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[49] Financial Services Authority, *'The Failure of the Royal Bank of Scotland,'* London (December 2011) p 11

[50] Alexander, Kern, '*Summary Report, Central Bank Governors Meeting,'* Limassol Cyprus: Commonwealth Finance Ministers Meeting (2009) p 2

[51] Alexander, op. cit. at 36, p 493

[52] Basel Committee on Banking Supervision, *'Basel III: A global regulatory framework for more resilient banks and banking systems'* Basel: Bank for International Settlements (December 2010, revised June 2011)

[53] Turner, Lord Adair, '*Leverage, Maturity Transformation and Financial Stability: Challenges beyond Basel III,'* London: Speech at Cass Business School (2011)

of the BoE Monetary Policy Committee.[54] The impact on large and MNE banks of increased capital adequacy requirements are judged to be minimal,[55] and without a negative social impact, but whether they are sufficient to minimise the impact of a future financial crisis is unlikely as they appear to be more of a transitional step than a goal. And indeed, Basel III only strengthens:

> "…prudential regulation in limited ways…this fails to address the externality problem posed by financial institutions which requires a more holistic approach to regulation."[56]

1.7 Informational Intermediaries

The change in regulation of informational intermediaries is an important step towards the establishment of effective regulatory controls, as under-pricing of financial risk can give rise to systemic failures once the market correction is realised. For individual countries it may be seen as a disempowering move with a high sovereignty cost,[57] but from a macro-prudential point of view, it is a cost effective way of better managing pricing risk to the benefit of financial stability, and for the effectiveness of controls in MNE banks. This is because an element in financial risk is pricing, and the credit rating agencies contributed to the financial crisis by underestimating the risk that issuers of financial instruments may not repay their debts and changing ratings too slowly as market conditions worsened.[58]

1.8 Clearing Houses

[54] Miles, D., Yang, J. and Marcheggiano, G. '*Optimal Bank Capital*,' External MPC Unit, Discussion Paper No 31 (2011)
[55] Anat Admati, Peter Demarzo, Martin Hellwig and Paul Pfleiderer, *Fallacies, Irrelevant Facts and Myths in the Discussion of Capital Regulation, Why Bank Equity is Not Expensive*, Max Planck Society (2010) p 41
[56] Alexander, op. cit. at 36, p 494
[57] Danner, Allison M., and Beth Simmons, 'Sovereignty Costs, Credible Commitments, and the International Criminal Court,' *Yale Law School*: New Haven, Connecticut (2007)
[58] Regulation (EU) No 513/2011 of the European Parliament and of the Council of 11 May 2011

The regulatory push for banks to move derivative contracts to clearing houses is causing a new risk to MNEs, as the large banks themselves own the clearing houses with the aim of minimising both the cost of capital and the burden on their monitoring requirements. This produces concentration risk, as if the clearing house fails so do all of the large banks that operate through it, and it is unlikely that any government would be able to produce sufficient funds to bail out a clearing house, heightening rather than minimising the impact of a future crisis on the depositors and taxpayers of the countries involved. Now that multi-national banking services are common, sensitivity to systemic risk is caused by their interconnected nature.

1.9 Regulatory Harmonisation

The financial crisis could prove to be an important catalyst in harmonising international financial services regulation for MNEs, offering them potentially improved regulatory controls. However, enforceable hard law developments are unlikely to come from any inter-governmental institution, as international SSBs have not received the necessary support of their members to formalise guidelines at an inter-governmental level, rather:

> "…the focus has been on reforming the soft law system to make it more effective and more representative of those states subject to its standards. Despite the various imperfections and limitations of softer methods in international financial regulation, policymakers appear to have concluded that no better option is realistically available in the immediate future and that a soft law-based approach can meaningfully promote regulatory objectives."[59]

Another catalyst of regulatory harmonisation is cross-fertilisation of regulatory experience across major markets, such as Martin Wheatley returning to UK regulation after five years as Chief Executive Officer of Hong Kong's Securities and Futures

[59] Alexander, op. cit. at 36, p 491

Commission.[60] In a speech to launch the Wheatley Review into failings of governance around Libor,[61] he said,

> "It is only by utilising the expertise from across the financial sector and across the globe that we can effectively solve the problems before us for Libor. My goal is to ensure that Libor is reformed in a way that ensures credibility and trust – both in our financial system and for consumers that rely on us."[62]

If the SSBs are to work more closely together, especially if some, such as the ESRB, have hard-edged soft powers,[63] communications to create good understanding will be essential:

> "…so that they do indeed complement each other and do not become embroiled in debilitating turf wars."[64]

Also, improved communications and the potential improvement of trust via familiarity with other SSBs could result in the more consistent implementation of soft law conventions into local regulations.

1.10 Politically Driven Reform

Politics contribute to changes in regulatory architecture, as they did in the UK when the FSA was brought into being by the new Labour government, gaining its powers from the Financial Services and Markets Act 2000[65] (FSMA) and replacing nine financial services regulatory authorities[66] to form a single

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[60] Financial Services Authority, Board Members List, July 2012

[61] The London Interbank Offered Rate (Libor) is a daily reference rate based on the interest rates at which banks borrow unsecured funds

[62] Wheatley, Martin, '*Wheatley Review – the Future of Libor,*' Speech by Martin Wheatley, Managing Director, FSA at Bloomberg, 10 August 2012

[63] Ferran and Alexander, op. cit. at 25

[64] Ibid. p 773

[65] Financial Services and Markets Act 2000 c. 8

[66] These include the Personal Investment Authority, the Investment Management Regulatory Organisation and the Life Assurance and Unit Trust Regulatory Organisation

financial services regulator. In the foreword to its launch document in October 1997, Chairman Howard Davies was quite sure that the FSA would enhance consumer protection.[67] It would do this by being a single micro-prudential regulator able to offer consistency across industry sectors, and prevent areas of financial services from dropping through the gaps between its predecessors. Writing after the financial crisis, one might wish to challenge whether this was successfully achieved, as areas of "underlap"[68] were acknowledged in the Turner Review.[69] However, the FSA:

> "…remains a sophisticated, expert organization that has been operating at the highest levels in an intensely demanding field."[70]

To ignore this in the current politically-driven reforms in the UK regulatory architecture would squander the past successes of the FSA, and may take financial services regulation through the instability of institutional reform only to establish an inferior regulatory outcome for MNEs.[71] However, in establishing the new institutions of the (micro-prudential) Prudential Regulatory Authority (PRA) and Financial Conduct Authority (FCA), and the (macro-prudential) Financial Policy Committee (FPC) the UK has adopted the global financial reforms proposed at the international level by the G20, and implemented them into the UK's regulatory architecture via EU Directives, the ESAs and the ESRB, which contributes towards hardening soft laws and establishing greater consistency in regulatory controls for MNEs. The FPC has a clear remit to focus on the big picture and address the risk that areas of regulated activities may fall between the PRC and FCA, although it is too

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[67] Financial Services Authority, *'Financial Services Authority: an outline,'* London (1997) p 2
[68] Gaps in policy and supervision.
[69] Financial Services Authority, *'The Turner Review: A Regulatory Response to the Global Banking Crisis,'* London (March 2009) para. 2.6
[70] Ferran, Eilis, 'The break-up of the Financial Services Authority,' *Oxford Journal of Legal Studies* (2011) p 458
[71] Ibid. p 479

early to see whether they are effective.[72] In addition, there are concerns that the BoE's greatly increased responsibilities will be too much for the corporate governance they themselves have in place.[73]

1.11 Conclusion

Greater activity of international SSBs is already having an impact on the establishment of effective regulatory controls in the EU, and the Basel III rules on capital and liquidity may result in an era of improved financial stability, reducing the severity of pro-cyclical market movements and improving stability for MNEs. The shift in regulatory focus that is taking place from micro-prudential to macro-prudential regulation (which goes way beyond controlling the level of bankers' bonuses)[74] has the aim of countering the effect of pro-cyclicality in free market movements, where interplay between confidence and contagion[75] fuels booms and exacerbates busts.[76] Countries are enacting new laws to include for the first time macro-prudential matters,[77] to better protect and enhance the stability of the financial system,[78] and to improve protection to depositors and investors,[79] in an attempt to control systemic risk in MNEs and control excessive financial risk-taking in the globalised financial markets.[80] As financial stability is an essential pre-condition of sustainable economic growth,[81] one might hope that the measures being taken are

[72] Turner, op. cit. at 53
[73] Financial Times: London (23 May 2011) p 1
[74] Huertas, Thomas, Director Banking Sector, FSA Alternate Chair, European Banking Authority, *'Bankers' bonuses: what regulation can and can't do,'* London: Speech to The Policy Exchange (2011)
[75] Turner, op. cit. at 53, p 4
[76] HM Treasury, *'A new approach to financial regulations: building a stronger system,'* London: The Stationery Office Ltd. (2011) p 18
[77] Financial Services Act 2010, c. 28, Section 1
[78] Financial Services Authority, *'Implementing aspects of the Financial Services Act 2010,'* London (2010)
[79] Banking Act 2009 c. 1
[80] Alexander, op. cit. at 36
[81] HM Treasury, op. cit. at 76, p 19

radical enough[82] to minimise the social impact of any future financial crisis, and offer MNEs the opportunity to develop their businesses in a more effectively controlled financial services regulatory environment.

[82] Turner, Lord Adair, *'Reforming finance: are we being radical enough?'* Cambridge: Clare Distinguished Lecture in Economics and Public Policy (2011)

Chapter 2

Corporate Governance and Risk Management in Multi-national Enterprises

2.1 Introduction

This chapter explores the link between corporate governance and risk management in MNEs, giving examples where the "tone from the top"[83] affects the risk profile of the company, its investment and services. It also explores corporate governance and risk management as essential elements in sustainability of MNEs and the financial systems in which they operate, the distorting effect of high executive compensation packages, and how regulatory failings help to perpetuate illegal activity in MNEs.

2.2 Failure of Risk Management in MNEs

It is well documented that before and during the financial crisis, management and boards at MNEs failed to govern their organisations in a responsible manner. This includes the choice of strategy and the assessment of risks to which the MNE would be exposed. In 2012 the G30 noted:

> "…the history of financial crises, including the 2008-2009 crisis, is littered with firms that collapsed or were taken to the brink by a failure of risk governance."[84]

For example, in the UK alone, the failure of risk management leading up to and during the financial crisis led to negative externality costs of rescuing banks such as Royal Bank of Scotland and Northern Rock,[85] funded by the UK taxpayer, and the ensuing government-initiated Walker Review identified that:

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[83] "Tone from the top" here refers to the perception of corporate stance on adherence to laws and regulations given from the board of directors to the workforce in an MNE

[84] Working Group on Corporate Governance, Group of Thirty, '*Toward Effective Governance of Financial Institutions,*' Washington (2012) p 14

[85] Grice, Andrew, '*£850bn: official cost of the bank bailout,*' London: The Independent (4 December 2009)

> "…serious deficiencies in prudential oversight and financial regulation…accompanied by major governance failures… contributed materially to excessive risk taking in the lead up to the financial crisis."[86]

2.3 Maximising Earning Potential

Incentivising directors to achieve short term goals has become a concern of public law because of these negative externalities[87] to society, which extend further than those to individual investors.[88] As a result, board remuneration has come under scrutiny. In 2005, the Association of British Insurers' guidance recommended that:

> "…annual bonuses, payable in cash, can provide a useful means of short term incentivisation."[89]

However, following the financial crisis, a report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System, noted that:

> "…while markets are at the center of every successful economy, markets only work well when private rewards are aligned with social returns. Incentives matter, but when incentives are distorted, we get distorted behavior."[90]

Action has been taken at European level to address this, and the Capital Requirements Directive[91] contains remuneration rules which EU Member States must enact into local country law. Accordingly, in 2011 the FSA introduced their Remuneration Code,[92] recommending that bonuses are paid in instalments to high earners, encouraging sustainability by lowering the propensity of directors to maximise short term

[86] Walker, Sir David, *'A review of corporate governance in UK banks and other financial industry entities,'* London: HM Treasury (2009) p 9

[87] "Negative externalities" occur in finance where the cost of risks that financial services firms take are passed on to society, and not incurred by the firms themselves.

[88] Alexander, op. cit. at 36, p 490

[89] Association of British Insurers, *'Principles and Guidelines on Remuneration,'* London (2005) p 5

[90] Stiglitz, Joseph E., *The Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System: Principles for a New Financial Architecture*, New York (2009) Section 1.2

[91] EU Capital Requirements Directive 2010/76/EU (CRD3)

[92] Financial Services Authority, *'Revising the Remuneration Code,'* London (2010)

opportunities. It has been identified that unintended consequences of greater disclosure in executive pay may occur with the new proposals, though, including negatively affecting those jurisdictions which implement them most rigorously.[93]

2.4 Corporate Governance and its Theories

The term "corporate governance" has been defined in several ways, with the now classic definition provided by the Cadbury Report in 1992:

> "Corporate governance is the system by which companies are directed and controlled…"[94]

It is concerned with a series of relationships between a company's management, board of directors, shareholders and other stakeholders, providing the structure through which the objectives of the company are set, and it provides the framework for monitoring performance against those objectives. Currently, the interests and development of employees do not form part of the corporate governance paradigm, and arguably their inclusion would be helpful in implementing corporate governance. The UK Combined Code 2010 states,

> "The board's role is to provide entrepreneurial leadership[95] of the company within a framework of prudent and effective controls which enables risk to be assessed and managed".[96]

The board also has to see shareholders' orders implemented through management and employees, and maintain external relationships with regulators and auditors.

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[93] Turner, Katharine, and Andrew Marshall, *Corporate governance and remuneration in the financial services sector*, London: Written evidence submitted to the Treasury Select Committee by Towers Watson (June 2012) section 3.15

[94] Cadbury, Sir Adrian, *The Financial Aspects of Corporate Governance: A Report of the Committee on Corporate Governance*, London: Gee & Co (1992)

[95] Lippitt, G L, 'Entrepreneurial leadership: A performing art' 21 *The Journal of Creative Behaviour* (1987) p 264 (Entrepreneurial leadership qualities include the ability to take risks, innovate, focus, take responsibility and have economic orientation)

[96] Financial Reporting Council '*The UK Corporate Governance Code,*' London (2010) p 9

In his book entitled "The Wealth of Nations" (1776) Adam Smith articulated the risks of directors caring more for their own ends than shareholder value, in that the directors of companies, acting as managers of other people's money, will not be as prudent with it as they are with their own.[97] The argument is that the directors want to maximise benefit to themselves, in an arrangement where directors are agents and shareholders are principals, and it is noted that in the lead up to the financial crisis:

> "…executive compensation contributed to excessive risk-taking at banks and other financial firms, while institutional shareholders failed to exercise an effective stewardship role to curb the excessive risk taking of senior management at leading financial institutions."[98]

A major risk to the company in this theory comes from the directors themselves, which elevates the importance of director accountability[99] and transparency as risk minimisers in MNEs, to avoid further decisions and actions being taken that lead, "…to terrible outcomes for employees, shareholders and the wider economy."[100]

In contrast to agency theory, stewardship theory takes the view that directors are good guardians of the investments of shareholders, and the UK Stewardship Code 2010:

> "…aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities."[101]

Good stewardship by way of internal control and risk management is recommended in the Turnbull Report to the Financial Risk Council:

> "A company's system of internal control has a key role in the management of risks that are significant to the fulfilment of its business objectives. A

[97] Smith, Adam, *An Inquiry Into The Nature And Causes Of The Wealth Of Nations,* Pennsylvania: Pennsylvania State University Electronic Classics Series (2005) (first published 1776)
[98] Alexander, op. cit. at 36, p 490
[99] Not only to shareholders, but to the general public in the current expectations of the community
[100] Working Group on Corporate Governance, Group of Thirty, op. cit. at 84, p 32
[101] Financial Reporting Council, '*The UK Stewardship Code,*' London (2010) p 1

> sound system of internal control contributes to safeguarding the shareholders' investment and the company's assets."[102]

2.5 Risk Management

It is important to note that there are four categories of risk: foreseen, unforeseen, foreseeable and unforeseeable, and that not all risks are controllable. Exercising good stewardship, a responsible and informed board will foresee all the foreseeable risks, and discover as many unforeseen risks as possible during their monitoring of operations, tracking of management information and engaging with all stakeholders, reducing unforeseen and even some unforeseeable risks by their knowledge, skills and diligence.[103]

However well corporate governance is embedded in a banking MNE, and despite legislation, governments themselves may contribute towards systemic risk and introduce moral hazard, an unintended consequence of which is to incentivise some directors into excessive risk taking. Where a bank's failure might precipitate a financial crisis, its directors well know their accountability is limited as the country's central bank or the International Monetary Fund (IMF) will take ex post action to protect it from collapse. [104] This protects the financial system and economy of the countries involved in the short term, but at the same time it encourages directors to take greater risks, and MNEs to under-price risk, thereby undermining systemic stability.[105]

> "The Financial Stability Forum observed in an April 2008 report (before Lehman Brothers collapsed) that the 2007 credit crunch was the result of

[102]Financial Reporting Council '*Internal Control: Revised Guidance for Directors on the Combined Code'* London (2005) p3
[103] Cadbury, op cit. at 94 (see also Companies Act 2006)
[104] Herring, Richard, *'The Central Role of Resolution Policy in Dealing with SIFIs,'* Basel: Presentation by International Association of Deposit Insurers (2011)
[105] Alexander, et al, op. cit. at 18, p 31

> massive failings in risk management in some of the largest and most sophisticated financial institutions. "[106]

Bailing out global systemically important financial institutions (G-SIFIs) encouraged reckless behaviour in undervaluing risk,[107] and raised the likelihood of further default,[108] as well as totally undermining financial services control frameworks in MNEs.[109] According to Sir David Walker:

> "Governance failures contributed materially to excessive risk taking in the lead up to the financial crisis."[110]

This exposed financial institutions to high risk strategies that caused negative externalities in the form of catastrophic losses to investors, and incurred a large social cost in the interest of maximising profit.[111] As a response from the United States of America (US), the enactment of the Dodd-Frank Act of 2010[112] makes it legally impossible for the US government to again bail out failing banks on an individual basis.

2.6 Risk of Fraudulent Malpractice

Regulatory progress by SSBs seeks to minimise the risk of malpractice, but an example of repeat occurrence is the fraudulent investment scheme structure pioneered by Charles Ponzi in the 1920's, where returns were made to existing investors from funds contributed by new investors in the US.[113] Although measures were taken to stop Ponzi schemes, during the 1990's in the UK principles based regulatory framework, Equitable Life:

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[106] Alexander, op. cit. at 36, p 490
[107] Financial Stability Board, op. cit. at 44
[108] Rajan, Raghuram, *Too Big to Save? Bailouts hurt capitalism. How we can keep from needing them in the first place,* New York: Time Business (19 January 2012)
[109] Alexander, et al, op. cit. at 18, p 31
[110] Walker, op. cit. at 86
[111] Grice, op. cit. at 85
[112] Dodd–Frank Wall Street Reform and Consumer Protection Act Pub.L.111-203
[113] 280F.193;1922 US (Ponzi)

> "…embarked on an aggressive marketing campaign, drawing in funds from hundreds of thousands of new policyholders in order to pay out bonuses far in excess of earnings to members departing the fund. A Ponzi scheme in all but name." [114]

Also, more recently, it was found that Bernard Madoff was running, "The biggest dollar Ponzi scheme of all time." [115] Assisted by globalisation, it affected investors in multiple jurisdictions whilst operating in the US rules based regulatory framework. These examples show that even with jurisdictional regulatory advances, whether rules or principles based, given insufficient rigour in applying regulatory constraint, directors may abandon risk minimisation in favour of profit maximisation.

2.7 Regulatory Supervision of MNEs

The effect of weak regulatory response to MNE activity in evading financial services regulatory controls compounds inconsistent governmental actions, and in the UK, the FSA received considerable criticism for weaknesses in oversight that contributed to the financial crisis, sparking their reform of enforcement to the "credible deterrence"[116] approach of more intrusive supervision. Weak regulation has again been highlighted in the choice of strategy and assessment of money laundering risk adopted by HSBC as revealed to the US Senate Subcommittee for Investigations.[117] Rather than applying a standard that satisfied the soft law international codes of the SSBs, HSBC's London based head office operated its subsidiary network by exploiting the advantages of regulatory arbitrage. HSBC's de-centralised, entity

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[114] Beale, M. et al *ICA Diploma in Compliance: Course Manual,* Birmingham (England): International Compliance Training Ltd (2009) p 6

[115] Lex Team, *'Madoff with ya money,'* London: Financial Times (12 December 2008) (also see: Madoff. 586 F. Supp. 2d 240 2009)

[116] Cole, Margaret, Director of Enforcement, Financial Services Authority, *'Delivering Credible Deterrence,* London: Speech at Annual Financial Crime Conference (April 2009)

[117] Levin, Carl, Opening statement, *'U.S. Vulnerabilities to Money Laundering, Drugs and Terrorist Financing: HSBC Case History,'* U.S. Senate Permanent Subcommittee on Investigations, Homeland Security and Governmental Affairs Committee, (July 2012)

based corporate structure, together with indefensible risk analysis of anti-money laundering (AML) inaccurately minimised risk in its jurisdictions, products and services. The HSBC in-house AML risk assessment placed Mexico, standing at 100 out of 183 countries on the Transparency International Corruption Perceptions Index 2011, as “low risk” for AML controls, at the same time as HSBC was allowing billions of US dollars of drugs money to be laundered from Mexico through its US outlets, “…playing fast and loose with U.S. banking rules.”[118] Here both the MNE board and management required affiliates not to carry out their own due diligence on the potential risks of transactions, but to accept the “low risk” classification as applied by head office. This active failure of HSBC to control the risk of being used as a vehicle through which to launder the proceeds of crime and actually to enable it, continued for a number of years. During this time HSBC had the attention of regulators regarding its operations in the US and Mexico: in 2003 HSBC was in enforcement with the Federal Reserve and the New York State Banking Department to improve its AML arrangements. Again in 2010, HSBC was in enforcement with the Office of the Comptroller of the Currency (OCC), and was served with a Cease and Desist order requiring a second revamp of its US AML programme. In addition to this, it has been found that HSBC at the same time was circumventing requirements of the US Treasury Department’s Office of Foreign Assets Control.[119] This catalogue of HSBC senior management’s deliberate failure to comply with AML and counter terrorist financing requirements was in part enabled by the OCC’s failure of AML oversight of HSBC in the US (HBUS), when they issued weak supervisory letters,[120] tolerating:

[118] Levin, op. cit. at 117, p 1
[119] Ibid., p 4
[120] Ibid., p 326-330

> "…the mounting AML problems at HBUS for five years, without taking any formal or informal enforcement action."[121]

In this example, weakness on the part of the OCC allowed HSBC to manoeuvre around regulatory requirements and jeopardise their own achievement of risk mitigation. Now, HSBC has noted the importance of acknowledging international best practice to imply credibility by saying it will:

> "…adopt and enforce adherence to a single standard globally that is determined by the highest standard we must apply anywhere."[122]

Perhaps this MNE would have benefited from better oversight and stronger regulatory sanction at an early stage, as its senior management may then have followed agency theory and illegal activity with less vigour, changed the tone from the top, and attended more to establishing effective financial services regulatory controls as guardians in a stewardship role.

2.8 Soft Law into Hard Law

A telling trend that marks a shift from the voluntary guidance of stewardship theory to the controls of agency theory is that the principles of corporate governance are increasingly enacted into local country law and regulation, following international OECD and IOSCO[123] guidelines. The essential legal duties of directors under the Companies Act 2006 are a duty of trust, where directors are required to exercise care to protect the financial interests of shareholders, and a duty of care towards stakeholders, including employees, but not customers. The MNE trying to establish financial services regulatory controls into its UK operations will find that the directors' duty of maximising shareholder value is already at odds with the FSA's principle of treating

[121] Levin, op. cit. at 117, p 6
[122] Levey, Stuart, (Chief Legal Officer, HSBC Holdings plc) '*Written Testimony for Senate Permanent Subcommittee on Investigations,*' (July 17, 2012) p 7
[123] International Organisation of Securities Commissions, op. cit. at 37

their customers fairly,[124] given by Section 5 of FSMA. This is an example of greater legislation and regulation being enacted in a move away from the “comply or explain” culture of voluntary codes of conduct, at the same time causing conflicting overlap between SSBs. These controls are made with the benefit of different stakeholder groups at heart, and the conflicting results increase the risk of non-compliance for an MNE when faced with multiple regulatory requirements amongst the jurisdictions in which they do business.

Country based voluntary codes of conduct, such as that of the UK Institute of Directors,[125] are still important in the development of corporate governance, as where there is a comply or explain expectation, code compliance can be instrumental in forming new laws. Codes also give MNEs the opportunity to adhere to corporate governance standards, without forcing them to submit to costly laws. Sanctions imposed by institutions such as the UK Listing Authority are serious, as they can inflict reputational damage, and ultimately can mean exclusion from continuing operations in their country and industry. However, compliance to codes may be hampered by lack of willingness to adhere to best practice in MNEs, damaging implementation of good corporate governance, as in the case of HSBC, above.

2.9 Impact of Share Ownership

A potential risk minimising element that may help MNEs in achieving effective financial services regulatory controls, which is not included in current corporate governance guidelines is that of preventing directors from also being shareholders.

[124] FSA Principle for Business 6, London: FSA Handbook, Release 127 (July 2012)
[125] Institute of Directors Chartered Director Committee, ‘*Chartered Director Code of Professional Conduct,*’ London: Institute of Directors (February 2012)

This could remove the conflict of interests that director/shareholders have when on one hand they are responsible for profit maximisation and on the other embedding the principles of sound corporate governance, and put them more in the stewardship position of disinterested parties. Where directors have too great an interest in the firm by being shareholders also, there is the potential that their responsibilities for embedding good governance and minimising the risks to the company will be overshadowed by their self-interest in profit maximisation by way of bonuses as well as shares and dividends, to the extent of taking increased risks to maximise profits for themselves. However, the lack of personal interest that may result from neutrality should directors be prohibited from being shareholders may dilute both their interest and diligence in embedding effective regulatory controls. In this way, the very mechanism created to enable them to exercise disinterested diligence removes their impetus to do so, reducing the incentive for them to be good stewards unless their remuneration is increased substantially to engage them.

The logic that says personal interest leads to greater involvement and diligence is that in which employee share purchase schemes is encouraged. Employee loyalty, personal buy-in and diligence at work are improved by having personal interest in the profitability of the company. Employees then bring their knowledge and experience of business risks into the boardroom as enlightened shareholders, with first-hand knowledge of where effective controls may be lacking. This democratic approach towards employee participation leads to stability and loyalty, which are both important pillars of corporate governance and risk minimisation in MNEs. An organisation in which employees have an interest as principal in the firm, although not an MNE, is the UK based John Lewis Partnership. Since the 1920's, the beneficial owners of John Lewis have been the employees whose shares are held in trust.[126]

The occurrence of share ownership over the last 50 years, fuelled by technological advances notably in the clearing system, has given rise to 2 large groups of shareholders: institutional investors and private investors. Institutional investors, holding large tranches of the shares of listed companies, can make real demands as principals and affect the course of the MNE's progress. They can influence the board of directors, their agents, to carry out their demands by removing their investment to another vehicle and adversely affecting the share price. Institutional shareholders seek stability as well as profitability, and pressure from them might be sufficient to influence the directors to improve financial services regulatory controls, improving also stability and long term growth. However, the large amount of share ownership by small investors, for example those investing in funds of funds[127] without a depth of knowledge of the market or industry, does not fully support the Financial Reporting Council's code of conduct guideline that boards of directors carry out orders from shareholders,[128] as there is little likelihood that these shareholders will know enough about the business to minimise its risks and implement effective financial services regulatory controls.[129]

The stakeholder group that has the greatest opportunity to benefit the organisation by its enlightenment is the board of directors. A democratically run responsible and

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[126] John Lewis Partnership, *'The Constitution of the John Lewis Partnership, Introduction, Principles and Rules,'* London (April 2012) p 5
[127] A fund of funds invests in other mutual funds, and does not invest selectively in any single holding.
[128] Financial Reporting Council '*The Combined Code on Corporate Governance*' London (2003)
[129] UN Global Compact and the International Finance Corporation '*Corporate Governance: The Foundation for Corporate Citizenship and Sustainable Businesses*' (2009)

informed board, having relevant diverse knowledge and skills to set the strategic aims and risk appetite of the organisation, without exposing it (and the economies in which it operates) to unacceptable levels of risk will, with appropriate culture, remuneration structure, soft law, as well as local legislation and independent judicial arrangements, be helpful in implementing effective regulatory controls. Their diligent attendance to relevant management information can greatly reduce operational risks. This is encouraged in UK financial services by the FSA's Treating Customers Fairly initiative, a lynchpin of which is the management information review by relevant Approved Persons, including directors.[130]

The UK's FSA puts the onus of accountability onto Significant Influence Function Holders, senior managers who hold decision making responsibility. Principle for Business 2 is fully in balance with the Companies Act 2006, when it states, "A firm must conduct its business with due skill, care and diligence."[131] Further to this, Principle 3 requires a regulated firm, "to organise and control its affairs responsibly and effectively, with adequate risk management systems."[132] The appreciation of "risk" as referred to by regulators, is in connection with the risk that the firm in question poses to its ability to achieve its own objectives, which, for the FSA, currently are:

> "…maintaining confidence in the UK financial system,…contributing to the protection and enhancement of stability of the UK financial system, …securing the appropriate degree of protection for consumers, and… reducing the extent to which it is possible for a regulated business to be used for a purpose connected with financial crime."[133]

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[130] Financial Services Authority, *'Treating Customers Fairly – guide to management information,'* London (July 2007)
[131] Financial Services Authority, *'Principles for Business, Principle 2,'* London: FSA Handbook, Release 127 (July 2012)
[132] Financial Services Authority, *'Principles for Business, Principle 3,'* London: FSA Handbook, Release 127 (July 2012)
[133] Financial Services and Markets Act 2000 c. 8, section 2

As a result of international regulatory debate following the financial crisis, the FSA took on a statutory objective under the Financial Services Act 2010, to "contribute to UK financial stability."[134] This is noteworthy, as much criticism was levelled at FSA for not achieving this objective leading up to the financial crisis, when it did not at that time have the financial stability statutory objective in place.

2.10 Transparency

For the integration of effective multi-national financial services regulation to occur within an MNE, there must first be transparency and the willingness of directors to abide by the international codes. Ideally, the offices of Chairman and Chief Executive are held by different people on a unitary board, and their executive management team, which is responsible for the day to day running of the company, is separate from the board of directors, whose main function is to minimise risks by maximising the opportunity to foresee risk. Their horizontal power structure at board level enables full utilisation of the various skills and knowledge of each individual director, and brings greater breadth of understanding of a broad range of risks, thus minimising the risks inherent in the company's operations. Effective corporate governance depends largely on the tone from the top. The input of effective non-executive directors is also very important in embedding corporate governance and risk minimisation,[135] as they bring to the board political neutrality and independent judgement in managing risks.

The responsibility of management in minimising risks is one primarily of control implementation, monitoring and remediation, and whereas management of the company's operations by its employees is vertical in structure, the ideal horizontal

[134] Financial Services Authority, op. cit. at 49, p 3
[135] Cadbury, op. cit. at 94

board structure gives each director, equally and severally, responsibility and similar duties, deriving their power from company law. The link from the board to the executive management team is then hierarchical, creating a master/servant relationship, where the board that takes instructions from the shareholders, delegating activities to the management. It could be argued that by using Germany's two-tier board structure in large and public companies better transparency and effective participation of employees is achieved by bringing them closer to the board and their decisions,[136] better enabling MNEs to establish effective regulatory controls.

In a company with a hierarchical power structure at board level, such as Hyundai, the corporate structure is family-centric and paternalistic, with unfettered decision making power being held by the dominant entrepreneur, as seen in the South Korean "chaebol"[137] structure. This is quite the opposite of the recommendation of the UK Corporate Governance Code,[138] which requires firms along the lines of stewardship theory to separate out roles by the relevant ability, knowledge and skills and so share the responsibility for strategic decision amongst a diverse group bringing many informed views and experience, decreasing the risk of decision-making. Although in the chaebol structure the board of directors may be well informed, they may not be able to effectively exercise their responsibilities under the control of the dominant entrepreneur.

Where a MNE carries out a thorough risk analysis prior to making an investment overseas, including the business and country culture, it will capture local foreseeable

[136] Tricker, Bob, *Corporate Governance: Principles, Policies and Practices* Oxford: Oxford University Press (2009) p 65
[137] Ibid., p 191
[138] Financial Reporting Council, op. cit. at 96, Section A: Leadership

risks and largely enable their control by the board of directors. An indicator of whether it will be possible to implement effective corporate governance is whether transparency is present in the host country's business culture. The information required for due diligence may not exist, and if it does, a lack of transparency may prevent the MNE from gaining access to it, wholly or in part, to an extent where it is not possible to assess the risks of investment, and due diligence will be incomplete. The country's culture will also affect the participation of the board of directors, institutional and private shareholders, employees and their ability to embed good corporate governance, depending on the level of development in the jurisdiction, and the levels of democracy, accountability, fairness and transparency in the MNE. In the case of HSBC in Mexico, its decentralised governance model ideally positioned the businesses to "lean upon their US cousins,"[139] pressurising them to accept transactions that were clearly outside of regulatory boundaries.

Even if a MNE board of directors studies the IMF country profiles[140] and carries out thorough due diligence before investing in a new jurisdiction, where there is little transparency information asymmetry occurs to the detriment of the MNE investor with the effect that the whole spectrum of risks will not be visible, and some real risks such as environmental risk, legislative and regulatory risk, and judicial risk may remain. The linked principles of transparency and democracy are very important in minimising risk, as where there is no transparency there is a lack of information, increasing the amount of unforeseeable and therefore uncontrolled risks. Where public awareness is introduced, greater knowledge exists in the community and there is an increased potential for transparency to develop into a sustainable economic democracy.

[139] Levin, op. cit. at 117
[140] International Monetary Fund, '*IMF reports and publications arranged by country*'

For an MNE investing in a developing country, identification by a responsible and informed board of the areas in greatest need of development, such as education, public welfare, economic development and the wellbeing of the local environment, can help to reduce its investment risks. If the board of directors does not include these in its risk assessment and mitigation, it is courting the resentment of local people and increasing the level of risk to which the MNE is exposed. On the other hand, MNEs should also carry out their business in a transparent fashion, as they themselves are not transparent enough. For instance, in removing the references to deposits made by investors in Iran,[141] HSBC circumvented international requirements for several years, and only agreed to cease this activity upon regulatory action, incurring large fines.[142]

2.11 Harmonisation and Best Practice

The OECD has set out its guidelines to encourage MNEs to implement best practice policies which support sustainable development and promote social, economic and environmental objectives.[143] In developing countries MNEs can follow codes of corporate governance conduct and implement effective financial services regulatory controls by following the international soft law guidelines adapted to the local environment,[144] which can help to develop greater accountability and transparency, and even develop the judiciary where cases are brought in that jurisdiction.[145]

Although international soft law conventions are not binding, they offer MNEs a best practice position from which to satisfy OECD guidelines, and in those countries

[141] Levin, op. cit. at 117
[142] Ibid.
[143] 40 ILM 237 (2000) (The OECD Guidelines for Multinational Enterprises)
[144] OECD Guidelines, op. cit. at 143
[145] For example: 809 F.2d 195 (Union Carbide Gas Plant Disaster at Bhopal India, 1984)

where these have been embedded even into the guidelines for legal action, such as the US sentencing guidelines,[146] they offer protection against prosecution. This has clearly been seen in the case of Morgan Stanley,[147] where a former managing director, Garth Peterson, breached the Foreign Corrupt Practices Act.[148] Morgan Stanley were protected by having evidence of good governance controls in place, constituting a robust compliance programme, which acted as an effective defence,

> "Recognizing that a compliance program is not available as a formal affirmative defense, it is clear that Morgan Stanley was able to use not only their written compliance program but its ongoing maintenance, communication and due diligence aspects to shield the employer from liability."[149]

All MNEs are bound by the principles of international law. If they are contracting in a foreign jurisdiction they work under the principles of international law, which are very clear, and include a preamble to explain the contract, its purpose and the obligations of the MNE. This clarifies to both parties the extent and limits of expectations, which can be very important when an MNE is contracting with a government body. State contracts carry more risks than ordinary commercial contracts as governments can change legislation and nationalise assets, as happened to Inchteck Tyres Ltd in 1984.[150] However, as this is the last occurrence of such a nationalisation, it does not pose a real risk to 21st Century MNEs.

There has to be buy-in with integrity to soft international law for it to provide effective controls, and it is via the MNEs that the corporate governance initiatives of

[146] United States Sentencing Commission, *'2011 Federal Sentencing Guidelines Manual,'* Washington: Office of Legislative and Public Affairs (2011)
[147] U.S. v Peterson. 12-cr-00224
[148] The Foreign Corrupt Practices Act of 1977, as amended, 15 U.S.C. §§ 78dd-1, et seq. (FCPA)
[149] Fox, Thomas, *'Morgan Stanley Gets Thumbs Up From DOJ & SEC For Best Practices Compliance Program,'* Dallas: Corporate Compliance Insights (May 2012)
[150] The Tyre Corporation of India Limited (Disinvestment of Ownership) Act, 2007

organisations such as the OECD and IMF among others spread the reach of their codes into the practices of developing nations. They aim to protect the interests of the local community and environment whilst still allowing the MNE to fulfil its primary purpose of maximising profits for its shareholders. Although, where corporate governance has given way to profit maximisation, the local criminal community may also be benefitted by the MNE's activities, as in the case of HSBC, above.

Control of risk is essential to sustainability, and within an MNE the concept of risk minimisation when linked to investor returns may show that a low risk profile equates to low returns, but the risk minimisation associated with corporate governance is linked with the thorough identification and analysis of risks to the organisation, to minimise risks whilst maximising corporate sustainability. These include cultural influence both internally and externally to the MNE, as well as financial risks.[151] Although systemic risk, and how it manifests itself on the global financial system, has not yet been defined,[152] writing in 2001, Joseph Norton identified four areas of potential systemic risk that were already present in the international financial system, which, he suggested, could only be addressed appropriately by MNEs and international SSBs working together.[153] These are the risk of recurrence of a sovereign debt crisis, foreign exchange payment and settlement risk, money laundering and corruption risk, and cross border financial contagion risk.[154]

2.12 Conclusion

[151] Aras, Guler, and David Crowther, 'Governance and sustainability. An investigation into the relationship between corporate governance and corporate sustainability,' *Management Decision*, Vol. 46, No. 3 (2008) p 437
[152] Ferran, and Alexander, op. cit. at 25, p 770
[153] Attanasio, John, and Joseph Norton, *'A New International Financial Architecture: A Viable Approach?'* London: British Institute of International and Comparative Law (2001) p 155
[154] Ibid.

The findings in this chapter demonstrate that both individual and systemic risks, if left unchecked, can cause serious financial damage to the stability of the financial marketplace as well as the long term survival potential of MNEs, emphasising the value of embracing the guidelines of international SSBs into their risk management framework. The management of risks at both local and international level is a key factor in financial services regulatory controls, as MNEs with robust corporate governance arrangements will remain more stable in a downturn, helping to maintain the confidence of investors. Market confidence has increasingly become a critical factor in the stability of global financial markets, as multi-national linkages create a network effect, and networks require confidence and stability[155] to operate, benefitting from the consistency of the international regulatory approach. This global theme is the subject of the next chapter, but it is relevant here as the failure of risk management controls embedded in an MNE have the potential to not only cause the failure of that group of companies, but also to severely impact the operation of the financial services global network.

[155] Alexander, Kern, *'Market Impact of (Orderly) Sovereign Default in the EU,'* Brussels: Policy Department A: Economic and Scientific Policies, Committee on Economic and Monetary Affairs, European Parliament (2009) p 3

Chapter 3

Globalisation and the Focus of Regulation

3.1 Introduction

This chapter discusses how developments in communication technology, in particular the internet, have transformed the way that financial services in securities and banking operate, giving MNEs greater opportunities in reaching potential customers without having a clear, effective, regulatory environment in which to operate.

3.2 Re-defining Identity

MNEs can develop their business by having their head office in one (usually developed) jurisdiction and creating or acquiring subsidiaries to give a "family tree" of entities across the globe. The transfer of intellectual capital from the MNE to subsidiaries in developing countries helps to build their international capability and brings them into the realm of international conventions which transcend the local political and economic power base. As MNEs buy up local entities and change their names to that of the corporate identity, even where the same individuals are employed in the entity the local perception of it and its power relations become more international, and the simple way for an MNE to implement coherent financial services regulatory controls is to adopt international soft law conventions that broadly cover local requirements. Indeed, it has been claimed in offering an explanation as to why countries tend to adhere to international soft law,

> "The modern transformation of sovereignty has remade international law, so that international law norms now help construct national identities and interests through a process of justificatory discourse."[156]

[156] Koh, op. cit. at 3, p 2602

Although this may overstate the effects of globalisation, the introduction of international enterprise blurs the bright lines of jurisdictional control, and coherence in regulatory terms includes addressing risks of the detailed "nuts and bolts" locally, as well as those risks that manifest themselves in the larger financial system.[157]

The virtuous circle arrangement of development linked to the establishment of effective financial services regulatory controls turns on itself, though, when the MNE is doing business in the developing jurisdiction to benefit from regulatory arbitrage, and lowers the threshold of the whole MNE to sub-standard practices. HSBC found that their decentralized management model, focusing on country heads did not allow international policies and procedures to be adequately implemented, resulting in the action against them in the US for allowing drugs money from Mexico to be laundered easily through their business.[158] HSBC found that while their old model served them well historically, before financial globalisation:

> "…it does not work in an interconnected world where transactions cross borders instantaneously and where weaknesses in one jurisdiction can be quickly exported to others."[159]

3.3 Regulatory Developments in Europe

In the EU, even though regulatory treaties and directives attempt to normalise local country financial services regulation across Member States, regulation has not yet embraced globalisation sufficiently to move from being country-based,[160] although the establishment of the ESRB and strengthening of European regulatory architecture has

[157] Gadbaw, op. cit. at 16, p 572
[158] Levey, op. cit. at 122
[159] Ibid., p 2
[160] Alexander, Kern, 'The Need for Efficient International Financial Regulation and the Role of a Global Supervisor' *Journal of Money Laundering Control*, 5(1) (2001) p 52

partially addressed this.[161] MNEs cannot choose to comply with the regulations of, say, the jurisdiction of their head office but have to comply with the laws and regulations of each host country in which they carry out their business, increasing many times the burden of regulatory compliance. Differences in regulatory regimes do give rise to conflicts of laws and regulatory arbitrage, because:

> "…the international regulatory agenda has not paid sufficient attention to MNCs (Multi-National Corporations). Their regulation has remained largely confined to the domestic forums. The inability of domestic law to grapple with the concept of MNCs and the failure at international law to deal effectively with it have led to regulatory gaps."[162]

These gaps are symptomatic of the vacuum in financial services regulation at an international level[163] that the FSB is now trying to address.

3.4 The Internet: Accelerator of Globalisation

Perhaps the most influential accelerator of globalisation in financial services is the internet. Globalisation is essentially an economic process, but one with political consequences, which opens up remote regions of the world to expand in trade, investment and economic opportunity. Technological developments in communications and transportation as instruments of globalisation have accelerated its pace, and as the speed and ease of communication increased, the liberalisation[164] of financial markets and linkages amongst players became easier. It is a relatively new concept that countries liaise with each other on such a speedy and constant basis.

[161] Ferran, and Alexander, op. cit. at 25, p 751
[162] Amao, Olufemi, Corporate Social Responsibility, Human Rights and the Law: Multinational Corporations in Developing Countries, London: Routledge (2011) p 275
[163] Alexander, et al, op. cit. at 18
[164] Gkoutzinis, Apostolos, *Internet Banking and the Law in Europe*, Cambridge: Cambridge University Press (2006)

Leading up to the financial crisis, regulation remained micro-prudential and enshrined in local administrative laws. National regulators had not adapted to the demands and inter-connectivity of the market, having failed as yet to fully engage with the many substantive and jurisdictional issues arising from internet securities offerings and secondary trading.[165] The network effect of the internet based international capital markets are relatively new for Europe based MNEs. Bank loans were the method of capital raising before 1988, when currency exchange controls were removed across the EU allowing investors to operate across borders and in other currencies. Bank loans do not pose the same vulnerability to contagion and pro-cyclical market movements as international capital markets.[166]

3.5 Relevance of Jurisdictional Laws in International Regulation

In the international capital markets sector of the financial services industry, securities regulation is, in effect, a private law specialised anti-fraud regime with criminal sanctions for failure to comply. If securities regulation was removed, 90% of securities regulations would still apply through criminal law. Its introduction to the legal framework aimed to remove caveat emptor[167] risk from the investor in securities and place them into a controlled environment where investor confidence would be restored after the financial frauds of the 1920s.[168] With securities regulation, the financial markets are segregated and individually studied, so local country securities regulation becomes better developed as the financial markets of a country develop. Without this, abuse of investors is almost inevitable, as corporate managers are

[165] Karmel, Roberta S., 'Regulatory Initiatives and the Internet: A new era of oversight for the Securities and Exchange Commission,' *N.Y.U. Journal of Legislation and Public Policy*, 35, (2001) p 33

[166] BIS Papers, No 1, '*Marrying the macro- and micro-prudential dimensions of financial stability,*' Basel: Monetary and Economic Department (2001) p 9

[167] Let the buyer beware

[168] Ponzi, op. cit. at 113

incentivised as agents[169] to look after their own and shareholders' interests, and not the public interest. Using their industry expertise, regulatory technocrats specify and particularise generic laws, introducing standards and tools to control this risk, and these controls have, essentially, remained in place since the 1930s.

In financial services MNEs their Information Technology (IT) network is a fundamental enabling factor of operating globally. Capital movement has increased, with the technological advances of telecommunications and the internet[170] removing barriers to international financial transactions. These began to establish during the 1990's whilst the legal and regulatory regimes governing them remained country specific,[171] blind to their attendant network effects, as SSBs and market participants themselves did not fully realize that:

> "…financial globalisation is bound up with a specialisation in financial services that makes countries much more vulnerable to each other's mishaps."[172]

Rules of international law define that the state can apply its own laws within its country. For example, it is easy if an MNE is selling US securities in the US: they have to apply US law. However, a country can also apply its laws if conducts have effects upon its jurisdiction. 50 years ago it was almost impossible to have an impact on the jurisdiction of another country in a securities offering as there was no way of communicating it effectively across borders without deliberately approaching individual investors. However, financial markets responded at every step of the

[169]Smith, op. cit. at 97
[170] Libin, Nancy, C., & James S Wrona, 'The Securities Industry and the Internet: A Suitable Match?' *Columbia Business Law Review*, Vol. 3:601 (2001) p 680
[171] Choi, Stephen J., & Andrew T. Guzman, 'National Laws, International Money: Regulation in a Global Capital Market,' *Fordham Law Review, Global Capital Market Regulation,* Vol. 65 (1997) p 1906
[172] Cecchetti, Stephen, '*Is globalisation great?'* Lucerne: Speech at Bank for International Settlements, 11th BIS Annual Conference (June 2012)

technological revolution, and in 1995 the first bank in the world offered transactional services over the internet.[173] This was very innovative, and opened the door for people all over the world with an internet connection to view a securities offering, as issuers are not prevented from posting prospectuses online. However, because of the way that securities regulation has developed offering investor protection to reduce the effect of information asymmetries, it is the responsibility of the financial services firm offering the product to control communications to the participants in the investment. The IOSCO report of 1998[174] described several applications of the internet to the securities industry, and identified the impact of securities regulation and capital markets regulation the internet on Wall Street, where later securities issuers were offering trading, purchasing and selling investments.

The ease of access to information from overseas on the internet his gives rise to legislative jurisdictional problems for MNEs that issue securities, which regulatory bodies have yet to address. The Securities Act of 1933, the Securities Exchange Act of 1934 and the 2004 Transparency Directive in Europe,[175] none of these specify the territorial scope of application of the relevant rules, and this creates problems with the internet and legislative jurisdiction. Over the decades, there has not been progress in this area, and the lack of clarity in legislative jurisdiction when operating via the internet continues. Transactions in banking are well advanced and benefit from greater clarity, but listing securities by using the internet has made it impossible for MNEs to put in place effective financial services regulatory controls, creating problems in regulatory, as well as legislative and judicial terms. This is because

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[173] Gkoutzinis, op. cit. at 164
[174] IOSCO Internet Task Force Report, *'Report on Securities Activity on the Internet,'* Report from the International Organisation of Securities Commissions, Basel (1998)
[175] EU Directive 2004/109/EG (EU Transparency Directive)

securities regulators have applied the principle of technological neutrality to matters surrounding jurisdiction. The principle of neutrality says that all communications media are the same, be it letters sent through the post in paper format, or by fax, or by the internet. The issue is that the internet is not like other forms of communications in three distinct ways: firstly, in establishing regulatory jurisdiction, secondly in the application of legislative jurisdiction, and thirdly in establishing judicial jurisdiction. When a securities prospectus is put on to the internet by an issuer that is for professional investors only in, say, the US, it is immediately available by anyone with an internet connection across the globe. The issuer may include some wording to the effect that it is an offering to professional investors in the US, but private investors overseas also can view the information, which cuts across accessibility of information on securities rules in Section 5 of the Securities Act 1933. In addition to this, it is quite possible that other countries have rules to prevent information intended for high risk issues to professional investors to be made available to private investors. To implement effective controls in this regard, the MNE would have to check every securities system in the world to see whether it is legal to market those securities there, which is clearly not a viable proposition. This is a regulatory gap caused by the removal of barriers to free trade, the network effects of securities globalisation, and the paradigm shift in execution of securities trades brought about by technological advancement, in particular, the internet. These areas require considerable research before regulatory progress can be made. Perhaps some optimism can be drawn from the comments of Commissioner Daniel Gallagher of the Securities Exchange Commission, to Jack Katz' incisive call for a special study of US regulatory policy, to include:

> "…the future of the U.S. and global secondary market structure, the interaction of the equity, debt and derivatives markets nationally and internationally, and the development of a corporate disclosure system that reflects the needs of investors and the information technology of the present and future."[176]

There are securities already for which it is impossible to determine the country of issue and ownership, making a mockery of country financial services and AML regulation, so the move to a level playing field at international level is imperative. This may take decades to implement, and it gives imbalances of greater cost on smaller players, but should MNEs operating in developing countries wish to have access to international markets, increasingly they have to adopt and adhere to international standards of increased openness and transparency,[177] accountability and responsibility to address asymmetries of information[178] and avoid withdrawal of IMF funding, even though the IMF themselves operate in a, "…prevailing culture of secrecy."[179] They also have to comply with international conventions, and legislation with extra-territorial application such as the US PATRIOT Act 2001 and the UK Bribery Act 2010, and there is an argument for its regulatory framework to be international to avoid conflicts of laws issues when implementing extra-territorial laws to control risk. The consequences of increased globalisation and technological change include an increase in both risk universe and the speed of change, which necessitates forward looking and responsive action by international as well as local legislators and regulators to minimise the risks of profit maximisation by boards. Without this, hierarchical structures that prevent democracy, accountability and fairness cannot be overcome and transparency cannot be optimised to provide the

[176] Gallagher, Daniel, *'SEC Reform after Dodd-Frank and the Financial Crisis,'* Washington: Speech by US Securities Exchange Commission to the US Chamber of Commerce (2011)
[177] Stiglitz, op. cit. at 5, p 96
[178] Ibid., p xi
[179] Ibid., p 51

stepping stones towards effective minimisation of risk by way of the establishment of effective financial services regulatory controls in MNEs.

3.6 Conclusion

The globalisation of financial services offerings has outstripped by far the ability and knowledge of regulators to enact appropriate controls, and before the financial crisis it can be argued that local country regulators and international SSBs did not appreciate the full expanse of risk that existed in the internet-enabled global financial system and the impact that network effects have on it. To re-establish effective regulatory controls in financial services MNEs, a modernisation of regulation taking into account technological change and the resulting challenges to sovereignty, differences in development of countries and the driving forces of myriad local and international SSBs could hardly be more necessary.

Conclusions

Having considered whether an effective participation of a responsible and informed board of directors, shareholders and employees might be helpful in implementing effective financial services regulatory controls in MNEs, it can be seen that a fundamental requirement is pre-existing appropriate and effective legal, regulatory and institutional foundations upon which to build. Directors have the incentive of the financial system which protects them from failure and encourages them to take risks, but also the codes of conduct, legal and regulatory frameworks that aim to control the risks.

The financial crisis demonstrated how local country and international SSBs failed to provide appropriate regulatory and supervisory standards, and there is no doubt that the financial crisis:

> "…triggered intense efforts internationally, regionally and nationally to enhance the monitoring of systemic stability and to strengthen the links between macro- and micro-prudential oversight."[180]

Exacerbated by the trend to use the capital markets rather than bank loans to raise capital, systemic risk was introduced into the financial system without identifying and recommending adequate controls, although risk elements were evident and discussion was taking place as to the likely outcome being a financial crisis as far back as 2001.[181] The network effect of inter-linkages in the financial system and the destructive effect as confidence decreased during the financial crisis moved the focus

[180] Alexander, op. cit. at 36, p 7
[181] Attanasio and Norton, op. cit. at 153

of regulatory attention to strengthening fiscal controls and developing the tools of macro-prudential supervision.[182] The President of the European Central Bank[183] expects these tools to be established at the earliest around 2015,[184] and reforms demonstrate that the direction and pace of development are not set by the SSBs themselves but are essentially reactions to external influences including political, environmental, industry driven and economic factors and events, including advances in technology, the media, other regulators, governments and large firms and their shareholders.[185]

Jurisdictional development of regulatory laws will remain diverse as long as sovereignty of states to regulate holds the dominant discourse, keeping sovereignty costs low to the governments of jurisdictions in which financial services MNEs operate. Compliance with hard local legislation favours a decentralised MNE structure, with each local entity being largely responsible for its own legal and regulatory compliance programme within the MNE. By comparison, soft law arrangements favour a centralised approach, where a central policy can be implemented that is in compliance with international conventions, which is both cost effective and relatively simple to implement in that one coordinated and robust compliance programme can be put in place across all entities for the MNE. However, they are effective only to the extent that individual governments and MNEs want them to be, being non-enforceable and relatively cheap to exit,[186] although controls

[182] Trichet, op. cit. at 30
[183] Mario Draghi, former Governor of the Bank of Italy
[184] Trichet, op, cit. at 30
[185] Beale, op. cit. at 114
[186] Brummer, Chris, 'Why soft law dominates international finance – and not trade,' *Journal of International Economic Law* (2010) p 635

via the World Bank and its financial awards can be, for relevant players, a very effective way of encouraging appropriate buy-in.

In the debate on whether it is possible to establish global regulation of financial services, or whether it will always be fragmented by local country legislation and regulation, global technology is a key player as more and more banking services and capital markets products are web based and do not respect national boundaries. Although any international agreement on harmonizing financial services regulation may not be possible and may result in undesirable sacrifices of sovereignty,[187] international soft law does allow progress to occur in a practical, pragmatic and cost effective manner, at a faster pace that the enactment of hard law, which is more in keeping with the pace of change in the financial services market, crucially without incurring sovereignty costs.[188] Even where international conventions have no binding power, they are increasingly important mechanisms for promoting the convergence and harmonisation of national financial law and regulation.[189]

With all of the recent changes in financial architecture, the most notable is the move to looking outwards from the micro-prudential regulation of individual banks and other financial institutions, and towards macro-prudential issues including countering the pro-cyclical tendency of market influences, and increasing to a material extent the capital adequacy requirements of banks. The unsurprising attention that banks are receiving from legislative and regulatory bodies around the world in the wake of the financial crisis may result in a more comprehensive and flexible era of financial

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[187] Scott, H., 'The Internationalization of Primary Public Securities Markets,' *Duke Journal of Law and Contemporary Problems*, Vol. 63: 71 (2000) p 104
[188] Brummer, op. cit. at 186, p 631
[189] Alexander et al, op. cit. at 18, p 36

regulation. However, systemic risk and its components have still not yet been fully defined and the G20 appear still to be focussing on enhancing the micro-prudential areas that they know already without actually committing to identifying in detail the gaps in international financial services regulation.

The impact of international SSBs on establishing effective regulatory controls can be seen as a co-ordinating element, empowering local regulators to more confidently implement relevant regulations knowing that international conventions have been established to support them. The advantage of reducing the possibility of using regulatory arbitrage by jurisdictions adopting international soft law conventions into local regulation offers the possibility of a more consistent and predictable market place, and potential for the better establishment of robust compliance programmes and effective financial services regulatory controls in MNEs.

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