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Financial Regulation?

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Between Law and Markets: Is There a Role for Culture and Ethics in Financial Regulation?

Dan Awrey, William Blair, and David Kershaw^{*}

Abstract: The limits of markets as mechanisms for constraining socially suboptimal behavior are well documented. Simultaneously, conventional approaches toward the law and regulation are often crude and ineffective mechanisms for containing the social costs of market failure. So where do we turn when both law and markets fail to live up to their social promise? Two possible answers are culture and ethics. In theory, both can help constrain socially undesirable behavior in the vacuum between law and markets. In practice, however, both exhibit manifest shortcomings. To many, this analysis may portend the end of the story. From our perspective, however, it represents a useful point of departure. While neither law nor markets may be particularly well suited to serving as “the conscience of the Square Mile”, it may nevertheless be possible to harness the power of these institutions to carve out a space within which culture and ethics – or, combining the two, a more ethical culture – can play a meaningful role in constraining socially undesirable behavior within the financial services industry. The objective of this article is to explore some of the ways which, in our view, this might be achieved. This exploration takes place across two dimensions. In the first dimension, we hold constant the core internal governance arrangements – corporate objectives, directors’ duties, board composition, committee structures and remuneration policies – within financial institutions. We then examine how the law and markets might be leveraged to engender a more ethical culture in two important areas: bilateral counterparty arrangements and socially excessive risk-taking. More specifically, we examine how ‘process-oriented’ regulation – backed by a credible threat of both public enforcement and reputational sanctions – might be employed with a view to reframing personal ethical choices and fostering a more ethical organizational culture within financial services firms. Intuitively, we would expect the success of this strategy to be a function of the incentives generated by existing internal governance arrangements. Lamentably, however, many of these arrangements give primacy to the financial interests of shareholders and managers over those of other stakeholders including, perhaps most

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importantly, society. In the second dimension, therefore, we examine how we might cultivate a more ethical culture through reforms of the core governance arrangements of financial institutions.

INTRODUCTION

The limits of *markets* as mechanisms for constraining socially suboptimal behavior and outcomes are numerous and well documented. Simultaneously, conventional approaches toward the law and regulation are often crude and ineffective mechanisms for containing – let alone preventing – the social costs of market failure. So where do we turn when both law and markets fail to live up to their social promise? Two possible answers are *culture* and *ethics*.¹ In theory, both can play an important role as extra-contractual/extra-legal gap fillers: helping to constrain socially undesirable activities in the vacuum between law and markets. In practice, however, the impact of culture as a constraint on socially undesirable behavior is often muted where market participants are numerous, autonomous and dispersed, and where the interests of market actors diverge. The internal and subjective nature of ethics, meanwhile, renders their normative content notoriously difficult to reconcile at the individual level – let alone build meaningful consensus around. We might thus predict that both culture and ethics would prove to be relatively impotent mechanisms for constraining opportunistic behavior, excessive risk-taking and other socially undesirable activities within the financial services industry. Indeed, this prediction is supported not only by logic, but also experience. From Bankers Trust² and Enron³, to ABACUS⁴, Libor⁵ and

¹ The distinction between ‘cultural’, ‘commercial’ and other norms, on the one hand, and what is often referred to as personal ‘ethics’, on the other, is examined in [Part III](#).

² See BT Securities Corp., Exchange Act Release No. 33-7124, 34-35136, SEC Docket 1145 (Dec. 22, 1994); BT Securities Censured and Fined \$10 Million for Antifraud and Reporting Violations Relating to the Sales of Derivatives, SEC News Digest 94-243 (Dec. 22, 1994), [available at http://www.sec.gov/news/digest/digarchives/digarch1994.shtml](http://www.sec.gov/news/digest/digarchives/digarch1994.shtml); BT Securities Corp., CFTC No. 95-3, 1994 WL 711224 (Dec. 22, 1994); Kelley Holland, Linda Himmelstein, & Zachary Schiller, *The Bankers Trust Tapes*, BUSINESSWEEK, Oct. 16, 1995, [available at http://www.businessweek.com/1995/42/b34461.htm](http://www.businessweek.com/1995/42/b34461.htm).

³ See FRANK PARTNOY, *INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED FINANCIAL MARKETS* (Times Books, 1st ed. 2003); BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* (Penguin 2004).

⁴ See Litigation Release, SEC, The SEC Charges Goldman Sachs with Fraud in Connection with the Structuring & Mktg. of a Synthetic CDO, Litigation Release No. 21489 (Apr. 16, 2010), [available at http://www.sec.gov/litigation/litreleases/2010/lr21489.htm](http://www.sec.gov/litigation/litreleases/2010/lr21489.htm); Press Release, SEC, Goldman Sachs to Pay Record \$550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (July 15, 2012), [available at http://www.sec.gov/news/press/2010/2010-123.htm](http://www.sec.gov/news/press/2010/2010-123.htm); Press Release, FSA, FSA Fines Goldman Sachs Int'l £17.5 Million for Weaknesses in Controls to Provide FSA with Appropriate Info. (Sept. 9, 2010), [available at http://www.fsa.gov.uk/library/communication/pr/2010/141.shtml](http://www.fsa.gov.uk/library/communication/pr/2010/141.shtml).

⁵ See Press Release, FSA, Barclays Fined £59.5 Million for Significant Fin relation to LIBOR & EURIBOR (June 27, 2012), [available at http://www.fsa.gov.uk/library/communication/pr/2012/070.shtml](http://www.fsa.gov.uk/library/communication/pr/2012/070.shtml); Press Release, CFTC, CFTC Orders Barclays to Pay \$200 Million Penalty for Attempted Manipulation of & False Reporting Concerning LIBOR & Euribor Benchmark Interest Rates (June 27, 2012), [available at http://www.cftc.gov/PressRoom/PressReleases/pr6289-12](http://www.cftc.gov/PressRoom/PressReleases/pr6289-12); Press Release,

the breaches of U.S. money laundering regulations by HSBC and Standard Chartered,⁶ recent financial history is replete with examples of what regulators, politicians, business and religious leaders have all recognized as,⁷ at least in part, cultural and ethical failures.

To many, this analysis may portend the end of the story. From our perspective, however, it represents a useful point of departure. While neither law nor markets may be particularly well suited to serving as “the conscience of the Square Mile”⁸ (or Wall Street, Frankfurt or Hong Kong), it may nevertheless be possible to harness the power of these institutions to carve out a space within which culture and ethics – or, combining the two, a more *ethical culture*⁹ – can be fostered and come to play a meaningful role in constraining undesirable conduct and practices within the financial services industry. The objective of this article is to explore some of the ways in which, in our view, this might be achieved.

This exploration takes place across two dimensions. In the first dimension, we hold constant the core internal governance arrangements – corporate objectives, directors’ duties, board composition, shareholder rights and remuneration policies – within financial institutions. We then examine how regulation and markets might be leveraged to help engender a more ethical culture in two important areas: (1) bilateral counterparty arrangements and (2) socially excessive risk-taking. More specifically, we examine how so-called ‘process-oriented’¹⁰ regulation – backed by a credible threat of both public enforcement and market-based reputational sanctions – might be employed with a view to reframing personal ethical choices and fostering a more ethical organizational culture within financial services firms.

Intuitively, however, we would expect the success of this strategy to be a function of the incentive structures generated by the existing constellation of internal governance arrangements. Put simply, for ethical frameworks to have traction within organizational culture and decision-making they must be given

U.S. Dep’t of Justice, Barclays Bank PLC Admits Misconduct Related to Submissions for the London Interbank Offered Rate & the Euro Interbank Offered Rate & Agrees to Pay \$160 Million Penalty (June 27, 2012), available at <http://www.justice.gov/opa/pr/2012/June/12-crm-815.html>.

⁶ See *HSBC’s Grilling: What Comes Out in the Wash*, THE ECONOMIST, July 21, 2012, available at <http://www.economist.com/node/21559349>; Jessica Silver-Greenberg, *British Bank in \$340 Million Settlement for Laundering*, N.Y. Times, Aug. 14, 2012, available at http://www.nytimes.com/2012/08/15/business/standard-chartered-settles-with-new-york-for-340-million.html?pagewanted=all&_r=0.

⁷ See *infra* note 111. See also *Money and Morals* THE FINANCIAL TIMES, OCTOBER 24, 2009, available at <http://www.ft.com> and Jonathan Sacks, *Has Europe lost its soul to the markets?* TIMES OF LONDON, DECEMBER 12 2011, available at <http://www.thetimes.co.uk>. See generally, William Blair, *Standards and the Rule of Law After the Global Financial Crisis* in MARIO GIOVANELLI AND DIEGO DEVOS, INTERNATIONAL MONETARY AND FINANCIAL LAW: THE GLOBAL CRISIS (OXFORD UNIVERSITY PRESS, 2010).

⁸ Howard Davies, Chairman, Fin. Servs. Auth., *Are Words Still Bonds: How Straight is the City?*, Address Before the Securities Institute Ethics Committee: 3rd Annual Lecture (Nov. 2, 1998), available at <http://www.fsa.gov.uk/library/communication/speeches/1998/sp18.shtml>.

⁹ As described in greater detail in *Part III*, our use of the term ‘ethical culture’ is motivated by the inherent ‘chicken and egg’ problem vis-à-vis culture and ethics.

¹⁰ The definition of process-oriented regulation and its application to the financial services industry are canvassed in *Part IV*.

room to breathe. Yet existing governance arrangements in many jurisdictions directly or indirectly (to differing degrees) give primacy to the financial interests of shareholders and, thereby, create incentive structures which reward opportunistic behavior and socially excessive risk-taking. These incentive structures are likely to crowd out efforts to foster the formation of a more ethical culture. In the second dimension, therefore, we examine how we might cultivate a more ethical culture through reforms of the core governance arrangements of financial institutions.¹¹

This article proceeds as follows. Part II maps out the limits of both law and markets as governance mechanisms in respect of the financial services industry. Part III then draws out the important distinction between cultural, commercial and other norms, on the one hand, and personal ethics, on the other, and examines the circumstances in which, in theory, each is likely to act as a meaningful behavioral constraint. It also articulates the substantive content – essentially a norm of ‘other regarding’ behavior – animating the more ethical culture we seek to foster. Building on this examination, Part IV explores how it may be possible to generate more powerful cultural and ethical constraints within the context of bilateral counterparty relationships. The springboard for this examination will be the U.K.’s ‘Treating Customers Fairly’ (TCF) Initiative, a process-oriented regulatory mechanism designed to influence organizational culture surrounding the provision of retail financial services. Part IV also examines the merits and potential drawbacks of expanding the TCF Initiative to encompass transactions involving more sophisticated market counterparties. Part V then examines whether it may be possible to employ similar process-oriented mechanisms to cultivate constraints on socially excessive risk-taking. As we shall see, the collision of culture, ethics and systemic risk raise a host of unique and difficult to navigate questions. Finally, and moving from the first dimension of our exploration to the second, Part VI examines why it might be necessary to reconfigure core internal governance arrangements as a pre-condition to the emergence of meaningful cultural and/or ethical constraints within financial services firms and, then, how we might go about doing so.

Ultimately, this paper does not profess to have all the answers. Rather, it aspires to ask some important (and too often neglected) questions about the role of culture and ethics in financial regulation and to offer up a framework for more serious and rigorous discussion.

¹¹ There is a third dimension, albeit one which resides beyond the scope of this paper, dealing with structural reforms such as ring fencing and narrow banking.

I THE LIMITS OF LAW AND MARKETS

A. THE LIMITS OF MARKETS

Markets are good at a great many things. Most importantly, the price mechanism aggregates and conveys valuable information to market participants about the prevailing supply and demand dynamics for a given asset (along with available substitutes). This information then influences how these market participants allocate scarce resources and, through their decisions, the direction of the broader economy. Where markets are complete and perfectly competitive, the prevailing view is that the frictionless operation of the price mechanism can be expected to yield a Pareto-efficient equilibrium.¹² This is the essence of Friedrich Hayek's 'spontaneous ordering'.¹³ It is also the theoretical foundation of arguments which view free and unfettered markets as the optimal means of allocating society's resources.

In reality, of course, complete and perfectly competitive markets are the creatures of textbooks. Markets have limits. These limits (or market failures) are encountered where information is costly and asymmetrically distributed; competition is imperfect; the existence of public goods results in underinvestment; or where markets generate negative externalities, imposing costs on third parties. Perhaps nowhere are these limits more clearly reflected than in the circumstances and events which culminated in the recent global financial crisis (GFC). In many cases, the complexity of modern financial markets overwhelmed the powerful incentives of even the most sophisticated market participants to ferret out and trade on new information.¹⁴ As Gary Gorton has observed, for example, many market participants did not fully understand how the unique structure of sub-prime mortgages (i.e. their short duration, step-up rates and pre-payment penalties) made the MBS and CDOs into which they were repackaged particularly sensitive to volatility in underlying home prices.¹⁵ Along a similar vein, Coval, Jurek and Stafford have demonstrated how ratings agencies and other market participants failed to perceive both (1) how the structure of CDOs (and so-called CDO²) amplified initial errors with respect to the calculation of default risk on

¹² See Kenneth Arrow & Gerard Debreu, *Existence of an Equilibrium for a Competitive Economy*, 22 *ECONOMETRICA* 265 (1954). An allocation of resources among two or more parties is said to be 'Pareto efficient' where no party can be made better off without making at least one party worse off.

¹³ See FRIEDRICH AUGUST HAYEK, *INDIVIDUALISM AND ECONOMIC ORDER* (Univ. of Chicago Press, 1st ed. 1948).

¹⁴ See, e.g., Robert Bartlett, III, *Inefficiencies in the Information Thicket: A Case Study of Derivatives Disclosures During the Financial Crisis*, 36 *J. CORP. L.* 1 (2010) (demonstrating how high information costs and low salience of information lead market participants to overlook valuable trading opportunities).

¹⁵ See Gary Gorton, *The Panic of 2007*, at 20-34 (Aug. 4 2008) (prepared for the Federal Reserve Bank of Kansas City Jackson Hole Conference), available at <http://www.kc.frb.org/publicat/sympos/2008/gorton.08.04.08.pdf>.

underlying assets, and (2) the systematic interconnections between these assets.¹⁶ Perhaps more importantly, however, socially excessive private risk-taking – driven by, *inter alia*, information problems¹⁷, the status of financial stability as a public good¹⁸, and the moral hazard and competitive distortions created by the so-called ‘too big to fail’ (TBTF) subsidy¹⁹ – generated huge negative externalities, the effects of which are still reverberating through the global economy. It should come as no surprise, therefore, that much of the post-GFC policy debate can be distilled down to a single question: what should we do when markets fail to function effectively?

B. THE LIMITS OF FINANCIAL LAW AND REGULATION

Naturally, when markets fail we reach for the regulatory tool box to directly address the identified failings. If counterparties were uninformed we seek to ensure that they are informed; if certain activities are associated with excessive risk-taking we seek to separate those activities from core banking functions; if the governance of components of the credit market such as Libor are broken we seek to fix them. However, we need to be cognizant of the limits of conventional approaches to financial law and regulation as a means of directly addressing these market failures.

As a preliminary and general matter, both public choice and regulatory capture theory predict that the law may be shaped by powerful vested interests with little or no regard for broader social welfare.²⁰ Indeed, to many, these predictions have considerable explanatory power in the context of the pre- and post-crisis regulation of the financial services industry.²¹ At the same time, we

¹⁶ See Joshua Coval, Jakub Jurek & Erik Stafford, *The Economics of Structured Finance*, 23 J. of Econ. Persp. 3 (2009).

¹⁷ See *infra* notes 14, 15 and 16.

¹⁸ Dirk Schoenmaker, *The Financial Trilemma* (Tinbergen Inst. Discussion Papers, Working Paper No. TI 11-019/DSF 7, 2011) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1340395. In turn, we would expect this to lead to underinvestment in the development of risk management infrastructure by both public and private actors.

¹⁹ Translating into the failure of TBTF institutions to fully internalize the costs of their risk-taking; see FSA, *THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS* 95-96 (Mar. 2009), available at http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

²⁰ See George Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3(1971); JAMES BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT* (Univ. of Michigan Press, 1962); KENNETH ARROW, *SOCIAL CHOICE AND INDIVIDUAL VALUES* (Yale Univ. Press, 1951); Duncan Black, *On the Rationale of Group Decision-Making*, 56 J. POL. ECON. 23 (1948).

²¹ Similarly, ostensibly desirable regulation is susceptible to being diluted over time by industry lobbying; see, e.g., Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683 (2011) (describing the gradual dismantling of section 23A of the U.S. Federal Reserve Act); Sebastian Mallaby, *Sombre Spanish Lessons of Fighting Credit Bubbles*, FIN. TIMES, June 14, 2012 (describing how Spanish dynamic provisioning was watered down in response to industry lobbying), available at <http://www.ft.com> (search title). See also SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN (Random House, 2010) (providing an account of how the industry successfully captured lawmakers in the period leading up to the GFC); John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated*

must not assume the omniscience of public actors. Public actors often face acute asymmetries of information and expertise vis-à-vis private actors. As the GFC has made clear, these asymmetries limit the ability of public actors to effectively identify and monitor the location, nature and extent of potential risks, or design and implement the appropriate regulatory response.²² As a result, we should maintain a healthy degree of skepticism respecting the policy choices of public actors.

Then there is the structure of law itself. It would be extremely costly in most cases, if not entirely impossible, to articulate legal rules which envisioned the entire universe of potential future states of the world. These costs invariably give rise to gaps between what the law *says*, on the one hand, and what its drafters (freed from the shackles of imperfect information, bounded rationality and other constraints) would have *wanted it to say*, on the other. Simultaneously, legal rules – once established – are often viewed as inflexible. They are also often over- or under-inclusive. This rigidity generates opportunities for creative compliance and regulatory arbitrage by actors whose incentives are not aligned with regulatory objectives.²³ There is also the prospect that prescriptive legal rules will be rendered anachronistic (or perhaps even harmful) by subsequent developments.²⁴ Although broader standards may address some of these problems, their very generality may portend their ineffectiveness – particularly when interpreted by actors whose incentive structures are not aligned with regulatory objectives.²⁵

Two examples will help illustrate the limits of conventional legal approaches. Consider first the regulatory strategies typically used to combat potential opportunism stemming from the asymmetries of information and expertise which pervade modern financial markets. The law has historically been utilized in one of three (progressively more invasive) ways to address this problem. The first strategy is to mandate disclosure in an effort to level the informational playing field.²⁶ The

and *Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019 (2012) (observing similar ‘downsizing’ in connection with the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law No. 111-203 (2010) [hereinafter Dodd-Frank Act]).

²² Dan Awrey, *Complexity, Innovation and the Regulation of Modern Financial Markets*, 2 HARV. BUS. L. REV. (forthcoming 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1916649.

²³ Doreen McBarnet, *After Enron Will “Whiter than White Collar Crime” Still Wash?*, 46 BRIT. J. CRIMINOLOGY 1091, 1092 (2006).

²⁴ See, for example, SEC rules requiring U.S. domiciled money market funds to only hold debt instruments rated by an NRSRO; SEC, 17 CFR § 270.2a–7 *Money market funds*.

²⁵ See Mark W. Nelson, *Behavioural Evidence on the Effects of Principles- and Rules- Based Standards*, 17 ACCT. HORIZONS 91 (2003).

²⁶ Consider, for example, some of the disclosure obligations introduced under the Dodd-Frank Act. The Dodd-Frank Act requires, for example, that a swap dealer or major swap participant must disclose to any counterparty “information about the material risks and characteristics of the swap” and any conflicts of interest the swap dealer may have; s. 731. The Dodd-Frank Act also provides for disclosures by credit rating agencies in relation to credit ratings by authorizing SEC rules requiring filings containing information on, for example, “the assumptions underlying the credit rating procedures and methodologies” and the “data that was relied on to determine the credit rating”; s. 932. The SEC’s Release on Asset Backed Securities issued in 2010 provides that in relation to structured finance products the sale agreement for a non-registered private placement gives the purchaser the right to disclosures from the seller that would be available if the offering were registered (on form S-1 or Form SF-1 under

second strategy is to impose a duty on financial intermediaries to act to a greater or lesser extent in the interests of the other (less informed) party.²⁷ Strategies falling into this category include both fiduciary duties and suitability requirements. The third and final strategy involves regulating the mode of sale of certain financial products or, if necessary, altogether prohibiting them.²⁸

While disclosure may be a *necessary* condition for efficient private contracting, it is often not *sufficient*. This is due in no small measure to the complexity of modern financial markets.²⁹ As Robert Bartlett has observed, accurately valuing even a single CDO, for example, demands a multi-faceted analysis of an enormous volume of legal and financial data.³⁰ The information costs associated with valuing a portfolio of these instruments; Citigroup's balance sheet; or the vast array of intricate and constantly evolving counterparty exposures within the shadow banking system, are clearly orders of magnitude higher.³¹ Viewed from this perspective, what matters is not just the *availability* of information in a strictly technical sense, but also the amount and complexity of this information and, consequently, the human capital and other endowments necessary to *process* it in any meaningful way.³² Ultimately, it is the asymmetrical distribution of these

the Securities Act of 1933, as am. Pub. Law 112-106); see SEC, Asset-Backed Securities, Exchange Act Release No. 34-61,858, para. VI.B.3).

²⁷ In the U.K., see FSA, Conduct of Business Sourcebook (COBS), §§ 3 (Client categorization) & 9 (Suitability) (2007), available at <http://fsahandbook.info/FSA/html/handbook/COBS> [hereinafter COBS]. With regard to suitability requirements in the United States see, generally Kathleen C. Engel and Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending* (2002) TEXAS L. REV. 1255, and Frederick M. Gedicks, *Suitability Claims and Purchases of Unrecommended Securities: An Agency Theory of Broker-Dealer Liability* (2005) 37 ARIZONA STATE L.J. 535.

²⁸ This could include: (1) prohibiting the sale of more complex financial products and services to certain informationally disadvantaged parties; (2) mandating simplicity in the structure of these products or services; see David Scharfstein & Adi Sunderam, *The Economics of Housing Finance Reform*, (Harvard Bus. Sch. & NBER, Working Paper, August 2011), available at http://www.people.hbs.edu/dscharfstein/Economics_of_Housing_Finance_Reform_Brookings.pdf; or (3) implementing ex ante product approval requirements designed to, inter alia, screen out unnecessary complexity; see Saule T. Omarova, *License to Deal: Mandatory Approval of Complex Financial Products*, 90 WASH. U. L. REV. (forthcoming 2012); available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1996755.

²⁹ See Awrey *supra* note 22.

³⁰ See Bartlett *supra* note 14.

³¹ Broadly speaking, the shadow banking system includes: (1) non-bank financial *institutions*, such as finance companies, structured investment vehicles, securities lenders, money market mutual funds, hedge funds and U.S. government sponsored entities, and (2) financial *instruments*, such as repurchase agreements, asset-backed securities, collateralized debt obligations and other derivatives, insofar as these institutions and instruments perform economic functions (i.e. maturity, credit and liquidity transformation) typically associated with more 'traditional' banks; see Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System*, Brookings Papers on Econ. Activity (2010), available at http://www.brookings.edu/~media/projects/bpea/fall%202010/2010b_bpea_gorton; Zoltan Pozar et. al., *Shadow Banking*, Fed. Reserve Bank of N.Y. Staff Report No. 458 (2010), available at http://www.ny.frb.org/research/staff_reports/sr458.pdf.

³² See Awrey *supra* note 22 at 8-30. See also the statement of an employee of Paulson & Co. in relation to Goldman Sachs's structuring of the ABACUS transactions: "It is true that the market is not pricing the subprime RMBS wipeout scenario. In my opinion this situation is due to the fact that rating agencies, CDO managers and underwriters have all the incentives to keep the game going, while 'real money' investors have neither the analytical tools nor the institutional framework to take action before the losses that one could anticipate

endowments which render disclosure, in and of itself, a relatively ineffective strategy for addressing opportunism within the context of bilateral counterparty relationships.³³

The limits of duty-based strategies such as suitability requirements stem from the fact that they conflict with the basic tenets of freedom of contract: that individuals make their own investment decisions which reflect their (unobservable) preferences. In so doing, such strategies may undermine the allocative efficiency of markets by (1) restricting individual choice and (2) eroding investor incentives for information and price discovery. Ultimately, while the resulting costs may be justified where there are significant asymmetries of information and expertise (e.g. in the retail context³⁴), such strategies are more difficult to justify in contexts involving more sophisticated market participants.

The limits of product regulation, meanwhile, are threefold. First, defining *ex ante* the class of parties deemed to be at an informational disadvantage in respect of a given product or service is a difficult and arbitrary task. While the resulting rules may protect less sophisticated parties in many cases, they may also be over-inclusive in their application: impeding the development and spread of new markets for useful products and services.³⁵ Second, the very asymmetries of information and expertise these requirements are designed to ameliorate may render the public actors who design and implement them poorly equipped to identify which products pose the greatest risk.. Finally, the market distortions generated by these types of requirements have a history of generating unintended (and sometimes adverse) consequences.³⁶

The limits of conventional approaches toward financial law and regulation can also be observed in the current strategies used to address socially excessive risk-taking. Bank capital ratios, for example, have been at the forefront of the post-crisis regulatory response. Yet the crisis itself has revealed the profound limitations of capital regulation – limitations that some leading regulators are

based [on] the ‘news’ available everywhere are actually realized.” Compliant at ¶ 17, *SEC v. Goldman Sachs & Co.*, No. 10-CV-3229 (S.D.N.Y. 2010) (emphasis added), available at <http://www.sec.gov/litigation/complaints/2010/comp21489.pdf>.

³³ *Id.* at 52-55.

³⁴ In the U.K., see COBS, *supra* note 27, at §§ 9.2.1 & 9.2.2. Note also that FSA rules provide an ‘appropriateness regime’ in relation to non-recommended/advised services which is again structured around client knowledge and sophistication. See also COBS, *supra* note 27, at § 10. In the U.S., see SEC Rules 15b10-3 & 15c2-5(a)(2)(b) (focusing on the counterparty’s financial situation and needs). *Padgett v Dapelo*, 826 F.Supp. 99, 100 (S.D.N.Y. 1993); *Rolf v Blyth Eastman Dillon & Co.*, 424 F.Supp. 1021, 1026-27 (S.D.N.Y. 1977). For a detailed discussion of these provisions, see, ENGEL & MCCOY, *supra* note 27. See also Jonathan R. Macey et. al., *Helping Law Catch Up to Markets: Applying Broker-Dealer Law to Subprime Mortgages*, 34 J. CORP. L. 789 (2009) (observing that “today, like in the 1930s, most actions against broker dealers for suitability and suitability-like violations involve sad stories of elderly and/or inform individuals swindled by unscrupulous broker dealers”).

³⁵ Simultaneously, of course, they may be *under-inclusive*: failing to capture the entire universe of parties in need of protection.

³⁶ See Arnold Kling, *Not What They Had in Mind: A History of Policies That Produced the Financial Crisis of 2008* (Mercatus Fin. Mkts. Working Grp., Working Paper No. 1474430, 2009), available at <http://mercatus.org/uploadedFiles/Mercatus/Publications/NorWhatTheyHadInMind.pdf>.

beginning to publicly acknowledge.³⁷ First, the rigid risk weightings employed under the Basel II framework were susceptible to arbitrage by financial institutions using structured finance techniques and their own internal risk models.³⁸ While Basel III has removed some of this rigidity³⁹, banks are still able to rely on their own models in assessing asset quality. As a result, arbitrage opportunities still exist.⁴⁰ Yet the obvious alternative is to substitute banks' internal risk assessments for those of regulators: a strategy which was employed in Basel I and subsequently rejected as both inflexible and inaccurate. Capital regulation can thus be viewed as involving a choice between two second-best strategies. Second, and partially as a result, reported regulatory capital levels are not always an accurate reflection of underlying bank solvency.⁴¹ Just 15 days prior to entering bankruptcy, Lehman Brothers reported a Tier 1 capital ratio of 11% – 7% higher than the minimum requirement under Basel II.⁴² Similarly, Northern Rock was, on paper at least, the best capitalized major U.K. bank just prior to its demise.⁴³

Looking forward, it seems likely that post-crisis reforms such as the U.S. 'Volcker Rule',⁴⁴ the U.K.'s retail ring-fence,⁴⁵ and the EU's Liikanen ring-fence proposal (if implemented)⁴⁶ will face similar problems of regulatory arbitrage. Both the Volcker Rule and ring-fencing seek to insulate deposit-taking institutions from the risks associated with more speculative investment banking and proprietary trading activities involving, for example, positions in OTC derivatives. At the same time, however, both contemplate that these institutions will still be

³⁷ See Brooke Masters, *Haldane Calls for a Rethink of Basel III*, FIN. TIMES, Aug. 31, 2012), available at <http://www.ft.com> (search title). Andrew Haldane is the Executive Director for Financial Stability at the Bank of England.

³⁸ See David Jones, *Emerging Problems with the Basel Capital Accord: Regulatory Capital Arbitrage and Related Issues*, 24 J. BAN. & FIN. 35 (2000) (describing how financial institutions utilized structural subordination (i.e. tranching); remote origination (i.e. structured investment vehicles), and indirect credit enhancement (e.g. structured liquidity facilities) to lower their regulatory capital requirements without reducing the underlying economic risk).

³⁹ Basel Comm. on Banking Supervision (BCBS), *Basel III: A Global Regulatory Framework for More Resilient Banks & Banking Systems*, at 29-54 (Dec. 2010, rev. June 2011), available at <https://www.bis.org/publ/bcbs189.pdf>.

⁴⁰ See Brooke Masters et. al., *Fears Rise Over Banks Capital Tinkering*, FIN. TIMES, Nov. 13, 2011 (reporting that "concern is growing that banks in Europe and elsewhere are moving to meet new tougher capital requirements by tinkering with their internal models to make their holdings appear less risky"), available at <http://www.ft.com> (search title); see also Brooke Masters, *Investors Lose Faith in Banks' RWA Models*, FIN. TIMES, May 23, 2012, available at <http://www.ft.com> (search title).

⁴¹ The other distortion being that Basel II (unlike Basel III) did not measure liquidity.

⁴² See Candemir Baltali & Joseph Tanega, *Basel III: Dehybridization of Capital*, 8 N.Y.U. J. L. & BUS. 1, 15 (2011).

⁴³ *Id.* at 15.

⁴⁴ §619 Dodd-Frank Act.

⁴⁵ HM TREASURY, *BANKING REFORM: DELIVERING STABILITY AND SUPPORTING A SUSTAINABLE ECONOMY* (2012) available at http://www.hm-treasury.gov.uk/d/whitepaper_banking_reform_140512.pdf.

⁴⁶ EU HIGH-LEVEL GROUP ON REFORMING THE STRUCTURE OF THE BANKING SECTOR: FINAL REPORT 100-03 (2012), available at http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf. Whether or not this proposal will be implemented is unclear at the time of writing.

able to utilize these instruments for risk management (i.e. hedging) purposes. However, articulating a comprehensive legal definition of proprietary trading – and distinguishing such trading from acceptable hedging activity – is not straightforward. For a salient example, one need look no further than JP Morgan's recent trading loss – estimated to be in the range of \$2-\$5 billion dollars⁴⁷ – on what was, ostensibly at least, a hedging transaction.⁴⁸

Much of the financial regulatory tool box deployed in response to the GFC is therefore limited in its likely effectiveness. Perhaps as importantly, it is limited in its outlook. These conventional responses share a common approach to regulation which attempts to dictate or directly influence how market participants act. They do not, however, attempt to mold how people think when they act. More specifically, the current regulatory tool box does not seek to engender the formation of cultural norms or to frame personal ethical decisions as a means of conditioning behavior. We now turn to the question of whether culture and/or ethics can help fill the gap inevitably left by law and markets, and whether regulation can be used to enhance the formation and effectiveness of these behavioral constraints.⁴⁹

II THE ROLE AND LIMITS OF CULTURE AND ETHICS IN FINANCE

A. MAKING SENSE OF CULTURE AND ETHICS

As a preliminary matter, we are sympathetic to the view – reflected in Andrew Hill's statement “when I hear the words corporate culture, I reach for my pistol”⁵⁰ – that culture is an inherently slippery concept. Ethics, if anything, is even more elusive. Framing policy debates around seemingly inchoate concepts like culture and ethics is thus often, and understandably, viewed as somewhat impractical.⁵¹

⁴⁷ Lisa Pollack, *Oh, So Now It's a \$5bn Loss?*, FIN. TIMES BLOG (May 21, 2012, 1:39 PM), <http://ftalphaville.ft.com/blog/2012/05/21/1008231/oh-so-now-its-a-5bn-loss/>.

⁴⁸ See *JP Morgan Faces Fresh Probe*, FIN. TIMES, SEPTEMBER 6, 2012 (reporting the statement from Senator Carl Levin that the “enormous loss” was “just that latest evidence that what banks call hedges are often risky bets”). See also *Standard Chartered Bank v. Ceylon Petroleum Corp.*, [2011] EWHC (Comm) 1785 (Eng.) (illustrating how difficult it can be to distinguish between ‘speculation’ and ‘hedging’, even following a trial); upheld on appeal: *Standard Chartered Bank v Ceylon Petroleum Corporation* [2012] EWCA 1049. In 2011, an arbitral tribunal reached a different conclusion on similar facts on a claim by Citibank: see the judgment of the Court of Appeal at [9] onwards.

⁴⁹ See Letter from Paul Volcker to U.S. Treasury Dep't, Fed. Reserve Bd., Fed. Deposit Ins. Corp. (FDIC), SEC, & CFTC, at 2 (Feb. 14, 2012) (recognizing the importance of organizational culture in filling this gap).

⁵⁰ Andrew Hill, *Culture Questions for Goldman's Blankfein*, FIN.TIMES BLOG (Mar. 14, 2012, 1:05 PM), <http://www.ft.com> (search title).

⁵¹ See Sebastian Mallaby, *Woodrow Wilson Knew How to Beard Behemoths*, Fin. Times, July 6, 2012 (observing that “[w]hen policy debates are dominated by the c-word, you know we are out of practical ideas”), available at <http://www.ft.com> (search title).

Nevertheless, we also know that culture and ethics are important determinants of human and organizational behavior. As a starting point, therefore, what is required is some degree of definitional precision. Specifically, what do we mean in the present context by ‘culture’ and ‘ethics’? And, importantly, on what basis should we distinguish between these two seemingly intertwined (and yet often muddled) concepts?

Robert Ellickson provides us with a useful framework for thinking about these questions.⁵² Ellickson draws a distinction between first, second and third-party behavioral constraints.⁵³ First-party constraints are imposed by an actor on him or herself. This is the domain of *personal ethics*.⁵⁴ Second-party constraints are those which flow from systems of reward and punishment within the context of bilateral relationships between promisors and promisees. This, in turn, is the domain of *contract*.⁵⁵ Third-party constraints, meanwhile, are imposed and administered by actors (i.e. organizations and governments) or social forces (i.e. norms) which, in a strictly technical sense, reside outside the perimeter of such contractual relationships.⁵⁶ Culture – understood as the body of non-legal norms, conventions or expectations shared by actors when operating in social or institutional settings – can thus be viewed as one subspecies of third-party behavioral constraints.⁵⁷

The substantive content of cultural norms and ethics (or, indeed, the law⁵⁸) may be identical. Indeed, culture, ethics and the law can all be viewed as mechanisms – empty vessels – through which various substantive norms are generated, monitored and enforced. The prohibition against the taking of human life, for example, exists across all three dimensions. But equally, cultural and legal norms may conflict with personal ethics. The key distinction for our purposes, as

⁵² See ROBERT ELICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* (Harvard Univ. Press, 1994).

⁵³ Or, employing Ellickson’s own terminology, “controllers.” *Id.* at 126-27.

⁵⁴ *Id.* at 126.

⁵⁵ *Id.*

⁵⁶ *Id.* at 127. Although even this distinction is incomplete insofar as membership in many organizations, and with membership the obligation to adhere to organizational rules, is often contractual in nature.

⁵⁷ We deviate from Ellickson’s framework slightly in that we henceforth include constraints generated by private (i.e. non-state) organizations as falling into the category of ‘norms’, whereas Ellickson categorizes them as ‘organizational rules’. This change is merely to facilitate exposition and not to deny the importance of broader questions surrounding what institutions should or should not be understood as sources of the law. Moreover, this approach is consistent with that employed in the economic literature exploring the generation, monitoring and enforcement of norms by groups of private actors; see [Part III.C](#) below. Note also that this distinction between first party and third party constraints has an affinity with sociological and legal sociological approaches that posit the radical separation between individual norms and rules and collective or systemic rules and constraints. See, e.g., EMILE DURKHEIM, *THE RULES OF SOCIOLOGICAL METHOD AND SELECTED TEXTS ON SOCIOLOGY AND ITS METHOD* (Steve Lukes ed., Free Press 1982) (distinguishing between individual and collective representations); NIKLAS LUHMANN, *Meaning as Sociology’s Basic Concept*, in *ESSAYS ON SELF REFERENCE* (Columbia Univ. Press 1990) (distinguishing between psychic and communicative systems); Gunther Teubner, *How the Law Thinks: Toward a Constructivist Epistemology of the Law* (1989), 23 L. & SOC’Y REV. 727 (distinguishing between ‘psychic intentions’ and ‘social communication’).

⁵⁸ Although, as we have seen, the law can be an inflexible tool for articulating this content.

we have seen, is the *source* of the behavioral constraint and, ultimately, the impact this has on its potential efficacy. In the case of culture (and the law), the constraint is an *external* (or exogenous) one. In the case of personal ethics, in contrast, it is *internal* (or endogenous).⁵⁹

This, of course, raises an important set of questions: to what extent can cultural norms (or the law) be understood as simply reflecting ‘shared ethics’? Conversely, what impact do external behavioral constraints such as cultural norms or the law have on our internal ethical perspective? Put differently: to what extent do law and culture mold our ethical identity? In the discussion which follows we largely bracket these questions, preferring instead to utilize the term ‘ethical culture’ where possible to signify that culture and ethics can be employed as symbiotic, mutually re-enforcing constraints. Before we articulate the substantive content of this ‘other regarding’ ethical culture, however, it is useful to first canvas the role and limits of both ethics and culture as potential drivers of human and organizational behavior.

B. THE ROLE AND LIMITS OF ETHICS

The source of ethical constraints is endogenous to each individual actor: part of that individual’s identity. Ultimately, it is this internal orientation – along with the inherent subjectivity and unobservability of first-party enforcement – which renders the behavioral impact of ethics difficult to either model in theory or measure in the real world.⁶⁰ For some, ethics may provide a powerful guide for personal and professional conduct. For others, it may be dominated by other competing influences. For others still, it may – like Oliver Wendell Holmes’ “bad man”⁶¹ – not play the slightest role. Moreover, even within these (somewhat artificial⁶²) categories, there are likely to exist substantial problems of interpersonal and inter-temporal comparison. This, in turn, makes it difficult to identify ‘shared ethics’. It also raises the prospect that, even at the individual level, ethical perspectives may vary over time and across contexts.⁶³

The internal nature of ethics also raises a problem for regulation: namely, how can the law influence internal ethical perspectives and decision-making? Here,

⁵⁹ Ultimately, of course, it is difficult to unpack which factors are exogenous/endogenous when attempting to identify the determinants of behavior. Moreover, while something like culture might be exogenous to an individual, it can be seen as endogenous to the organization or group of which that individual is a member.

⁶⁰ Although this is precisely what the field of neuro-ethics attempts to do. See also EDWARD O. WILSON, *THE SOCIAL CONQUEST OF EARTH* (Liveright, 1st ed. 2012) (espousing theories of evolutionary ethics).

⁶¹ Mr. Justice Oliver Wendell Holmes, of the Supreme Judicial Court of Mass., Address at the Dedication of the New Hall of the Boston University School of Law: The Path of the Law (Jan. 8, 1897), *reprinted in* 10 HARV. L. REV. 457, 459, 469, 474 (1897).

⁶² Both in the sense that (1) the influence of ethics on the behavior of individual actors is perhaps best measured along a spectrum and (2) we might expect actors to fall into different groups at different times and in different contexts.

⁶³ See MICHAEL SANDEL, *WHAT MONEY CAN’T BUY: THE MORAL LIMITS OF MARKETS* (Farrar, Strauss & Giroux, 1st ed. 2012) (providing a contemporary discussion).

ongoing work in the fields of cognitive and social psychology offers some potentially valuable insights. First, the moral intensity (or salience) of an ethical problem can be an important determinant of ethical decision-making.⁶⁴ As Thomas Jones explains, the moral intensity of a problem is a function of, *inter alia*, the magnitude of the potential consequences; the probability that they will occur; their concentration; temporal immediacy; social consensus and, importantly, proximity.⁶⁵ Proximity is a measure of the physical, psychological, social or cultural distance between a decision-maker and those whom their decisions affect.⁶⁶ Thus, for example, the anonymity within large, complex organizations; technologies enabling ‘faceless’ communication across great distances, and the commoditization of business transactions and relationships might all be expected to decrease moral intensity. The potential upshot, however, is that by reconfiguring financial institutions and markets with a view to reducing physical or psychological distance, for example, it may be possible to enhance ethical decision-making.⁶⁷

Importantly, the factors identified by Jones as contributing to moral intensity are characteristics of the ethical problem itself, not of decision-makers.⁶⁸ This, in turn, introduces the prospect that we might be able to *reframe* elements of the problem so as to highlight their ethical dimensions. The trolley (or footbridge) problem is a paradigmatic example.⁶⁹ In the classical formulation of this problem, individuals are asked to participate in a thought experiment in which a train is speeding toward five people tied to the tracks. Participants are then told that, by pulling a switch, they can redirect the train onto a second track to which a single person is tied. In both cases, the person(s) tied to the tracks in the path of the train are certain to perish. Participants are then asked to consider a second hypothetical in which they are told that the runaway train can be stopped by pushing a man from a footbridge onto the tracks. Notably, while the welfare implications are identical in each case, experimental evidence suggests both that participants (1) experience a stronger emotional response to the second hypothetical and (2) are far less likely to push the man in front of the train than they are to pull the switch.⁷⁰ The implication, in the view of many, is that by

⁶⁴ Thomas M. Jones, *Ethical Decision-Making by Individuals in Organizations: An Issue-Contingent Model*, 16 ACAD. MGMT. REV. 366 (1991). Consistent with the relevant cognitive science literature, the terms ‘moral’ and ‘ethical’ (and their various derivations) are used interchangeably in this section.

⁶⁵ *Id.*

⁶⁶ *Id.* at 376. Linked to moral intensity is the concept of normative focus: the notion that social or personal norms will only influence behavior if salient *at the time of decision-making*. See Carl Kallgren et. al., *A Focus Theory of Normative Conduct: When Norms Do and Do Not Affect Behavior*, 26 PERSONALITY & SOC. PSYCHOL. BULL. 1002 (2000).

⁶⁷ Jones, *supra* note 64. See also STANLEY MILGRAM, OBEDIENCE TO AUTHORITY (Harper & Row 1974).

⁶⁸ Jones, *supra* note 64, at 371.

⁶⁹ See JUDITH JARVIS THOMSON, RIGHTS, RESTITUTION, AND RISK: ESSAYS IN MORAL THEORY (William Parent ed., 1986); Philippa FOOT, *The Problem of Abortion and the Doctrine of the Double Effect*, in VIRTUES AND VICES: AND OTHER ESSAYS IN MORAL PHILOSOPHY (1978).

⁷⁰ See Piercarlo Valdesolo & David DeSteno, *Manipulations of Emotional Context Shape Moral Judgment*, 17 PSYCHOL. SCI. 476; Joshua D. Greene et al., *An fMRI Investigation of Emotional Engagement in Moral Judgment*,

forcing people to directly confront the ethical dimensions of their decisions, it may be possible to make ethics a more powerful influence on behavior.

The second important insight is that contemplation or reflection can enhance ethical decision-making.⁷¹ Cognitive scientists distinguish between two types of cognitive processes: *intuitive* processes in which judgments are made rapidly and automatically (System 1) and *controlled* processes in which judgments are slower and more deliberative (System 2).⁷² Several scholars have proposed that utilitarian or consequentialist moral judgments take place within System 2.⁷³ This view finds empirical support in a recent study by Gunia et. al. in which test subjects were given 3 minutes to consider a right-wrong decision – i.e. whether to tell the truth or lie for personal gain – and instructed to “think very carefully” before making their decision.⁷⁴ The authors of the study found that subjects in this contemplation condition were 5 times more likely to tell the truth than subjects asked to make an immediate decision.⁷⁵ In the view of some scholars, this apparent link between intuitive processes and self-interested decisions reflects deeply engrained evolutionary motives.⁷⁶ Moreover, these motives may dominate in environments – such as finance – where a premium is placed on quick thinking and decisiveness.⁷⁷ Contemplation, in contrast, allows individuals to consciously weigh ethical considerations against self-interest.⁷⁸ As a result, slowing decision-

293 SCI. 2105; Natalie Gold et al., *Framing Effects in Ethical Dilemmas: Research Project in Experimental Philosophy (Experimental Ethics)*, <http://www.le.ac.uk/psychology/amc/ahrc.html> (last visited Sept. 26, 2012). See also RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* (2008) (framing effects more generally).

⁷¹ Brian Gunia et al., *Contemplation and Conversation: Subtle Influences on Moral Decision Making*, ACAD. MGMT. J. (forthcoming 2012); Keith Murnighan et al., *Bounded Personal Ethics and the Tap Dance of the Real Estate Agency*, in *ADVANCES IN QUALITATIVE ORGANIZATIONAL RESEARCH* (John Wagner et al. eds., 2001); Lawrence Kohlberg, *Stage and Sequence: The Cognitive Development Approach to Socialization*, in *HANDBOOK OF SOCIALIZATION THEORY AND RESEARCH* (David A. Goslin ed., 1969). Others, meanwhile, suggest that reflection and reasoning simply serve to generate *ex post* rationalizations of *ex ante* moral intuitions. See, e.g., Jonathan Haidt, *The Emotional Dog and Its Rational Tail: A Social Intuitionist Approach to Moral Judgment*, 108 PSYCHOL. REV. 814 (2001). Ultimately, however, Haidt’s social intuitionist model is grounded in right-wrong decisions designed to evoke disgust (e.g. incest) on the part of test subjects. We submit that the vast majority of ethical decisions within the business context do not evoke similar emotions.

⁷² See Daniel Kahneman, Nobel Prize Lecture: Maps of Bounded Rationality: A Perspective on Intuitive Judgment and Choice (Dec. 8, 2002) (transcript available at http://www.nobelprize.org/nobel_prizes/economics/laureates/2002/kahnemann-lecture.pdf). See also, Shane Frederick, *Cognitive Reflection and Decision Making*, 19 J. ECON. PERSPECTIVES 25 (2005); Daniel Kahneman and Shane Frederick, *Representativeness Revisited: Attribute Substitution in Intuitive Judgment*, in *HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT* (Thomas Gilovich et al. eds., 2002); Keith E. Stanovich & Richard F. West, *Individual Differences in Reasoning: Implications for the Rationality Debate?*, 22 BEHAV. & BRAIN SCI. 645 (2000); Seymour Epstein, *Integration of the Cognitive and Psychodynamic Unconscious*, 49 AM. PSYCHOLOGIST 709 (1994).

⁷³ Joshua D. Greene, *Why are VMPFC Patients more Utilitarian?: A Dual-Process Theory of Moral Judgment Explains*, 11 TRENDS IN COGNITIVE SCI. 322 (2007); Joshua D. Greene et al., *The Neural Bases of Cognitive Conflict and Control in Moral Judgment*, 44 NEURON 389 (2004); Greene, *supra* note 67.

⁷⁴ Gunia et al., *supra* note 71, at 18-19.

⁷⁵ *Id.* at 23. See also, Joseph Paxton et al., *Reflection and Reasoning in Moral Judgment*, 36 COGNITIVE SCI. 163(2012).

⁷⁶ Murnighan et al., *supra* note 71.

⁷⁷ Gunia et al., *supra* note 71, at 31.

⁷⁸ *Id.* at 9.

making processes down and reflecting on their ethical dimensions may yield socially desirable behavioral effects.

Finally, morally-oriented conversations can promote more ethical decision-making in the context of right-wrong decisions pitting values such as honesty against self-interest.⁷⁹ Gunia et. al., for example, found that test subjects having even a brief, anonymous and electronic morally-oriented conversation were 4 times more likely to tell the truth than subjects having a self-interested conversation.⁸⁰ In effect, conversation can be utilized to highlight the ethical dimensions of problems, enhance moral intensity (or normative focus) and, thereby, put ethical considerations on firmer footing within group decision-making processes.⁸¹ Simultaneously, however, these conversations must be about more than simply allowing individuals and groups to construct *ex post* explanations which reinforce their *ex ante* intuitions.⁸²

Ultimately, of course, the insights of cognitive and social psychology must be approached with caution as potential drivers of public policy. Many strands of this research are still in their theoretical and experimental infancy. Moreover, most of the relevant empirical work has been confined to the laboratory: the real world may prove very different. Organizational and other environmental factors may, similarly, interfere with strategies designed to enhance ethical decision-making. Nevertheless, as we explore further below, this research may help us better understand ways in which regulation can counteract the emergence of ‘bad apples’ and ‘bad barrels’ within organizations.

C. THE ROLE AND LIMITS OF CULTURE IN FINANCE

Few would argue that cultural, commercial and other extra-legal norms are not capable of exerting a profound influence on human and organizational behavior. Moreover, such norms theoretically offer a number of potential advantages vis-à-vis other behavioral constraints – e.g. the law – in terms of, *inter alia*, their responsiveness, adaptability, and the relatively low costs of monitoring and enforcement. In markets, these norms can also help overcome the adverse selection and coordination problems which inhibit the development of efficient markets.⁸³ Perhaps not surprisingly, therefore, a significant body of scholarship has emerged dedicated to exploring the circumstances in which privately generated

⁷⁹ *Id.*

⁸⁰ *Id.* at 24.

⁸¹ AMITAI ETZIONI, *THE MORAL DIMENSION: TOWARD A NEW ECONOMICS* (Free Press 1988). This, of course, works in both directions: conversations which emphasize self-interest may have the opposite effect. Rebecca K. Ratner & Dale T. Miller, *The Norm of Self-Interest and Its Effects on Social Action*, 81 J. PERSONALITY & SOC. PSYCHOL. 5 (2001).

⁸² Gunia et al., *supra* note 68; Haidt, *supra* note 71.

⁸³ See, e.g., Dan Awrey, *The Dynamics of OTC Derivatives Regulation: Bridging the Public-Private Divide*, 11 EUR. BUS. ORG. L. REV. 155 (2010) (describing how the contractual norms developed by the International Swaps and Derivatives Association helped overcome coordination problems inhibiting the development of OTC derivatives markets).

norms arise and when they can be expected to yield Pareto improvements over both law and markets. The majority of this scholarship has centered around homogeneous and geographically proximate groups of market actors – ranchers⁸⁴, diamond merchants⁸⁵ and cotton merchants⁸⁶, for example – engaged in long-term, repeat play interactions. Broadly speaking, this scholarship supports the intuition that the most successful norms – i.e. those generating binding behavioral constraints – will be those where: (1) violations are easily observable; (2) news of violations is easily disseminated within the relevant group, and (3) the group possesses both the capacity and incentives to impose immediate and meaningful sanctions on violators.⁸⁷ These factors provide a framework for thinking about the formation of cultural norms not only in the context of market interactions, but also *within* individual firms.

The financial services industry has produced numerous ‘codes of conduct’, ‘codes of ethics’ and ‘principles of best practice’ which purport to articulate various cultural and commercial norms. Prominent examples include the Chartered Financial Analyst (CFA) Institute *Code of Ethics and Standards of Professional Conduct*⁸⁸; the Chartered Institute for Securities and Investment *Code of Conduct*⁸⁹, and the Alternative Investment Management Association *Guides to Sound Practices*.⁹⁰ The salient question, however, is whether these norms generate meaningful behavioral constraints within the financial services industry. Ultimately, this is an important empirical question which resides beyond the scope of this paper. Nevertheless, there exist a number of reasons to suggest that – in a great many cases – the real world impact of these norms may be very limited.

First, as we have already observed, the complexity of modern financial markets is often the source of acute asymmetries of information and expertise.⁹¹ These asymmetries undermine the ability of market participants with lower tolerances for complexity to detect violations of any relevant norms, either by their

⁸⁴ Ellickson, *supra* note 52.

⁸⁵ See Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992).

⁸⁶ See Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms and Institutions*, 99 Mich. L. Rev. 1724 (2001).

⁸⁷ Avner Greif, *Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders’ Coalition*, 83 AM. ECON. REV. 525 (1993); Ellickson, *supra* note 52; Bernstein, *supra* note 85; Bernstein, *supra* note 86. In viewing diffusion mechanisms as key to the enforcement of norms, we adopt an individualist rather than institutionalist approach to norm formation. Contrasting individualist and institutionalist approaches to norm formation. See Michael Hechter & Elizabeth Borland, *National Self Determination: The Emergence of an International Norm*, in SOCIAL NORMS 186 (Michael Hechter & Karl-Dieter Opp eds., 2001).

⁸⁸ See CFA Institute, *Code of Ethics & Professional Conduct* [hereinafter *Code of Ethics*], <http://www.cfainstitute.org/ethics/codes/ethics/Pages/index.aspx> (last visited Sept. 27, 2012).

⁸⁹ See Chartered Institute for Securities & Investments (CISI), *Promoting Professionalism*, <http://www.cisi.org/bookmark/genericform.aspx?form=29848780&URL=ethics> (last visited Sept. 27, 2012).

⁹⁰ See Alternative Investment Management Association (AIMA), *Guides to Sound Practices*, http://www.aima.org/en/knowledge_centre/sound-practices/guides-to-sound-practices.cfm (last visited Sept. 27, 2012).

⁹¹ See text to notes 32-36.

own counterparties or in the marketplace more generally.⁹² This is especially problematic given that it is precisely these market participants which are – almost by definition – most at risk. In June 2012, for example, the U.K.’s Financial Services Authority (FSA) completed a review which found evidence of widespread mis-selling of complex interest rate hedging products to relatively unsophisticated small and medium sized enterprises.⁹³ Previous FSA reviews have also uncovered extensive mis-selling of, *inter alia*, payment protection insurance⁹⁴ and sub-prime mortgage products.⁹⁵ The U.S. has, similarly, experienced a spate of mis-selling claims in the wake of the GFC.⁹⁶ Importantly, this behavior emerged and persisted despite the existence of numerous industry codes and institutional pronouncements stating, in effect, that the customer *always* comes first.⁹⁷ It did so, at least in part, because the market participants which it targeted were poorly positioned to detect it.

Second, even where violations are observable, there is often no credible threat of enforcement. The CFA Institute *Code of Ethics* provides an illustrative example. The CFA is arguably the most prestigious designation for financial services professionals. The *Code of Ethics* stipulates that CFA members must act with integrity, diligence, competence, respect, and in an ethical manner. In the context of advisory relationships, it also imposes duties of loyalty, fair dealing, suitability and disclosure of conflicts of interest. These important ethical objectives have much in common with those articulated in other professional contexts such as law and accountancy.⁹⁸ The CFA Institute has established a disciplinary procedure to address violations of the *Code of Ethics*, with its most powerful sanctions being to

⁹² Awrey, *supra* note 83.

⁹³ See Press Release, FSA, FSA Update, Interest Rate Hedging Products: Information About Our Work and Findings (June 2012), available at <http://www.fsa.gov.uk/static/pubs/other/interest-rate-hedging-products.pdf>. The regulatory structure of banks and financial services in the UK is in the process of being reformed. By the close of 2013, the role of the FSA in relation to conduct in financial markets will be taken over by the Financial Conduct Authority and its current prudential regulation function will be carried out by the Bank of England. See further http://www.fsa.gov.uk/about/what/reg_reform/background.

⁹⁴ Press Release, FSA, The Sale of Payment Protection Insurance: Results of Thematic Work (Nov. 2005), available at http://www.fsa.gov.uk/pubs/other/ppi_thematic_report.pdf; Competition Commission, *Payment Protection Insurance Market Investigation Order 2011* (Mar. 24, 2011), available at <http://www.competition-commission.org.uk/> (search title). As of May 2012, £4.8 billion has been paid out in refunds and compensation for mis-sold payment protection insurance. See FSA, *Monthly PPI Refunds and Compensation*, http://www.fsa.gov.uk/consumerinformation/product_news/insurance/payment_protection_insurance/latest/monthly-ppi-payouts (last visited Sept. 27, 2012).

⁹⁵ See Press Release, FSA, FSA Finds Poor Practices by Intermediaries and Lenders within Sub-prime Market (July 4, 2007), available at <http://www.fsa.gov.uk/library/communication/pr/2007/081.shtml>.

⁹⁶ See Tom Braithwaite et al., *Banks Sued Over Mortgage Deals*, FIN. TIMES, Sept. 3, 2011, available at <http://www.ft.com> (search title).

⁹⁷ See for example Goldman Sach’s 14 principles, the first of which states simply: “Our clients’ interests always come first.”

⁹⁸ See, e.g., Solicitors Regulation Authority, *Solicitors Regulatory Authority Handbook* (Oct. 6, 2011), <http://www.sra.org.uk/handbook/>; Financial Reporting Council, *Ethical Standards for Auditors* (2006-11), <http://www.frc.org.uk/Our-Work/Codes-Standards/Audit-and-assurance/Standards-and-guidance/Standards-and-guidance-for-auditors/Ethical-standards-for-auditors.aspx>.

suspend or revoke a violator's membership.⁹⁹ However, as an organization whose reputation and financial resources are derived from its ability to attract and retain its members, the CFA Institute's incentives to vigorously pursue enforcement action are relatively weak. This is reflected in the CFA Institute's own enforcement statistics, which report an average of 2.42 suspensions and 0.92 expulsions per year from 2000-2011 from a total membership of over 98,000.¹⁰⁰ This data suggests either that CFA members almost never violate the *Code of Ethics* or, perhaps more likely, that the probability of detection and subsequent enforcement is extremely low.

Theoretically, the violation of norms can also be enforced within the marketplace itself via the imposition of reputational sanctions.¹⁰¹ Once again, however, high information costs can be expected to impede the process by which news of violations is disseminated within the marketplace and, thus, undermine the potency of this market-based enforcement mechanism. Indeed, even where information costs are relatively low, the mobility (and resulting transience) of personnel within the financial services industry can make it difficult to effectively target reputational sanctions.¹⁰² Concomitantly, it is not uncommon for market participants to make significant relationship-specific investments in the financial services firms with which they do business. This, in turn, increases the costs of 'exit' in response to the violation of a norm recognized as existing within the context of that relationship and, as a corollary, increases the likelihood of *private* re-negotiation (as opposed to *public* litigation) as a means of compensating the aggrieved party for any loss. Each of these factors is likely to have a dilutive impact on any market discipline which might have otherwise been brought to bear on those market participants perceived to have violated a cultural or commercial norm.

While markets may not provide fertile ground for the formation of cultural norms, the structure of the firm arguably holds out greater promise. The frequency of interactions within a firm will often render violations of firm-specific

⁹⁹ It can also issue, *inter alia*, cautionary letters, private reprimands and public censures.

¹⁰⁰ See CFA Institute, Disciplinary Statistics (2000-2012), http://www.cfainstitute.org/ethics/Documents/Professional%20Conduct%20Program%20Documents/mem_discipline_stats.pdf.

The figures over the same period for cautionary letters, private reprimands and censures are, respectively, 16.25, 5.83 and 1.17 per year.

¹⁰¹ See John Armour et al., *Regulatory Sanctions and Reputational Damage in Financial Markets* (Oxford Legal Studies Research Paper No. 62/2010, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1678028; John Graham et al., *Corporate Misreporting and Bank loan Contracting*, 89 J. Fin. Econ. 44 (2008); Cindy R. Alexander, *On the Nature of the Reputational Penalty for Corporate Crime*, 42 J. L. & ECON. 489 (1999); Jonathan M. Karpoff et al., *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANTITATIVE ANALYSIS 581 (2008); Gregg Jarrell & Sam Peltzman, *The Impact of Product Recalls on the Wealth of Sellers*, 93 J. POL. ECON. 512 (1985); Benjamin Klein & Keith Laffler, *The Role of Market Forces in Ensuring Contractual Performance*, 81 J. POL. ECON. 615 (1981).

¹⁰² How, for example, do you impose effective reputational sanctions in the circumstance where the violation was committed by a team at financial institution 'A', but where all members of the team are now dispersed among institutions 'B', 'C' and 'D'? And what if the senior management team at 'A' at the time of the violation – who might have notionally been responsible for overseeing the team's activities – have themselves moved on? Where, in this case, is the appropriate *locus* of the sanction?

norms (relatively) observable.¹⁰³ Violations of these norms can then be disseminated easily up the firm's hierarchy through formal complaint and compliance procedures; management information systems, as well as by word of mouth. There also exists a range of firm-level disciplinary mechanisms which provide relatively low cost means of sanctioning non-compliance. These mechanisms include, *inter alia*: dismissal; demotion; promotion (or the denial thereof); quality of work flow and, of course, remuneration.

Indeed, the key question for firms is not how to promote cultural formation but, rather, how to foster a more ethical culture. While codes of ethics can be drafted and held up as reflective of best practice, the cultural norms these codes purport to reflect may be overpowered by other countervailing cultural norms. Indeed, there is significant anecdotal evidence of such countervailing norms within many financial firms. These norms resemble what Dale Miller has characterized as 'the norm of self-interest'¹⁰⁴: a norm reinforced by existing incentive structures.¹⁰⁵ Self-interest here may encompass the interests of individual employees, teams, divisions¹⁰⁶ or even the entire institution¹⁰⁷, generating pressure to exploit counterparties interests and ignore the societal impact of their risk-taking. Indeed, a prominent diagnosis of recent events, including the Libor, mis-selling and money-laundering scandals, has been that dysfunctional firm cultures were the primary driver of these failings.¹⁰⁸

D. TOWARD A MORE ETHICAL CULTURE IN FINANCE

So what is the substantive content of the ethical culture this paper aspires to cultivate? As stated at the outset, our dual objectives are to explore ways in which the law and markets might be utilized to engender cultural and ethical constraints on both (1) opportunism in the context of bilateral counterparty arrangements and (2) socially excessive risk-taking. The common theme underlying both of these objectives is the desire to promote what can best be characterized as a norm of

¹⁰³ Although, especially within financial services firms, there may be ample scope for agents to hide their non-compliant behavior. This reality is driven home by the 'rogue trader' scandals such as Nick Leeson's trading activities at Barings plc.

¹⁰⁴ Miller, *supra* note 81.

¹⁰⁵ For anecdotal evidence supporting this view that a culture of individualism is readily enforced within the firm, see Grant Woods, Letter, *Barclays Culture Discouraged Staff from Raising Concerns*, FIN. TIMES, July 10, 2012, available at <http://ft.com> (search title) (observing that "[t]he culture at Barclays in 2006-07, when I worked there, discouraged staff from raising concerns; in some instances, their loyalty and commitment were questioned, should they do so. There was also the unsaid threat that it could adversely affect any potential bonus or, worse, undermine their job security.")

¹⁰⁶ See Gillian Tett, *Insight: Anthropological Insights into Banking Behaviour*, FIN. TIMES, Jan. 17, 2008 (referring to "warring . . . tribal cultures" in Citibank and Merrill Lynch), available at <http://www.ft.com> (search title).

¹⁰⁷ *Id.*

¹⁰⁸ Editorial, *Shaming the Banks into Better Ways*, FIN. TIMES, June 28, 2012 (referring to the "rotten culture at Barclays"), available at <http://www.ft.com> (search title).

‘other regarding’ behavior¹⁰⁹ within financial services firms, one which – to the fullest extent possible – attempts to induce these firms to take into account the private and social costs of their decisions. These objectives should not, in our view, be controversial given the enormous social impact of the GFC and the questionable conduct and practices which it has brought to light. Moreover, as described above (and in further detail below) ‘other regarding’ norms are already reflected in many of the codes of conduct, principles of best practice and other guidance produced by various professional bodies and other organizations. Our objective in this article is to explore whether it might be possible to enhance the impact of these norms as behavioral constraints.

III WHO IS MY CLIENT? CARVING OUT A ROLE FOR A MORE ETHICAL CULTURE IN BILATERAL COUNTERPARTY RELATIONSHIPS

Financial policymakers are well aware of the important role which culture can play within financial services firms. The Basel Committee on Banking Supervision, for example, has observed that “a demonstrated corporate culture that supports and provides appropriate norms and incentives for professional and responsible behavior is an essential foundation of good governance.”¹¹⁰ Many senior figures within the financial services industry have, similarly, signaled that they are receptive to the idea that culture can play a meaningful role in firm governance.¹¹¹ From the perspective of many policymakers, however, the objective of fostering meaningful cultural and/or ethical constraints on socially undesirable behavior is, at best, aspirational.¹¹² As a result, whilst we have seen post-crisis calls for financial services firms to take culture and ethics more seriously, we have not seen substantive policy proposals which would seek to actively promote a more ethical culture in finance.

¹⁰⁹ It is noteworthy in this regard that ‘other regardingness’ is the touchstone used in much of the cognitive science literature as a proxy for ‘ethical’ decision-making and conduct; see Gunia et. al., *supra* note 71.

¹¹⁰ See Press Release, Basel Committee on Banking Supervision (BCBS), *Principles for Enhancing Corporate Governance* 8, 22 (Oct. 4, 2010) (“Sound corporate governance is evidenced, among other things, by a culture where senior management and staff are expected and encouraged to identify risk issues as opposed to relying on the internal audit or risk management functions to identify them. This expectation is conveyed not only through bank policies and procedures, but also through the ‘tone at the top’ established by the board and senior management.”), available at <http://www.bis.org/publ/bcbs176.pdf>.

¹¹¹ See, e.g., STEPHEN GREEN, *GOOD VALUE: REFLECTIONS ON MONEY, MORALITY AND AN UNCERTAIN WORLD* 198 (Allen Lane 2009) (observing that “[e]veryone knows about the importance of truth and honesty for a sustainable business”); see also the lecture given by Bob Diamond (former CEO of Barclays Bank plc) in which he stressed the importance of trust and culture (reported in Editorial, *Shaming the Banks into Better Ways*, FIN.TIMES, June 28, 2012).

¹¹² See, e.g., Davies, *supra* note 8; *City’s Ethics Awareness Lessons Must Percolate Down* FIN. TIMES, October 4, 2010 (observing that Hector Sants, former CEO of the UK’s FSA, “was told on arrival at the FSA that the regulator ‘does not do ethics’”), available at <http://www.ft.com> (search title).

A. THE TCF INITIATIVE

Nevertheless, there are precedents. One such precedent is an ostensibly modest scheme implemented by the U.K.'s FSA prior to the crisis, known as the 'Treating Customers Fairly' (or TCF) Initiative.¹¹³ As its name implies, the objective of the TCF Initiative is to compel financial services firms to treat retail clients fairly. The first incarnation of the TCF Initiative was introduced in 2001 in response to a raft of mis-selling claims involving various financial products.¹¹⁴ Notably, however, the legal obligation on U.K. financial services firms to treat customers fairly predates the TCF Initiative. The E.U. Markets in Financial Instruments Directive (MiFID), for example, mandates that member states require a financial services firm to "act honestly, fairly and professionally in accordance with the best interest of its clients".¹¹⁵ These requirements are reflected in the FSA's Principles for Business, which include, *inter alia*, the requirement to act honestly and with integrity; to treat customers fairly, and to communicate with clients in a way that is fair and not-misleading.¹¹⁶ What distinguishes the TCF Initiative from these broader regulatory pronouncements, however, is that firm processes and culture are the *target* of regulation.

The TCF Initiative falls under the umbrella of a diverse collection of regulatory strategies often described as 'process-oriented' regulation.¹¹⁷ Process-oriented regulation proceeds from the acknowledgement that 'top-down', prescriptive regulation is often ill-suited to heterogeneous and fast-paced industries such as finance, where entrenched asymmetries of information and expertise pervade the relationships between regulators and regulated actors.¹¹⁸ The hallmark of process-oriented regulation is that it seeks to leverage the superior information and expertise of regulated actors by granting them the flexibility to design bespoke organizational processes, systems and controls with a view to achieving a set of broad regulatory objectives (or outcomes) articulated by the

¹¹³ See FSA, Treating Customers Fairly, <http://www.fsa.gov.uk/doing/regulated/tcf> (last visited Sept. 28, 2012).

¹¹⁴ Sharon Gilad, *Overcoming Resistance to Regulation via Reframing and Delegation*, REGULATION & GOVERNANCE (forthcoming 2012), available at <http://law.huji.ac.il/upload/Sharon.Gilad.pdf>.

¹¹⁵ 2004/39/EC as am., Article 19(1). Notably, recently proposed amendments to MiFID would clarify that "the overarching high level principle to act honestly, fairly and professionally and the obligation to be fair, clear and not misleading should apply irrespective of [retail or professional] client categorization"; see Explanatory Notes on Proposed Directive on Markets in Financial Instruments repealing Directive 2004/39/EC (October 10, 2011), s. 3.4.8, available at ec.europa.eu/internal_market/securities/isd/mifid_en.htm.

¹¹⁶ FSA, FSA Handbook, Principles for Business (PRIN) § 2.1.1, available at <http://fsa.handbook.info/FSA/html/handbook/PRIN/2/1>.

¹¹⁷ Members of this family include systems-based regulation; enforced self-regulation; management-based regulation; principles-based regulation, and meta-regulation. See Sharon Gilad, *It Runs in the Family: Meta-regulation and Its Siblings*, 4 REGULATION & GOVERNANCE 485 (2012).

¹¹⁸ JULIA BLACK, RULES AND REGULATORS (Clarendon Press, 1997); Cass Sunstein, *Problems with Rules*, 83 CAL. L. REV. 953; *id.*

regulator.¹¹⁹ Simultaneously, however, process-oriented regulation is about more than leveraging firm-specific information to produce tailored systems and controls. It is also about incorporating the regulatory objectives (or outcomes) into firm culture.¹²⁰ As Christine Parker observes, process-oriented regulation – which she labels ‘meta-regulation’ – focuses “on the inside of corporations to constitute corporate consciences that go beyond compliance”.¹²¹

But how is the transfer of regulatory responsibility and process design intended to affect cultural change? Two ideas appear to underpin how process-oriented regulation promotes cultural change. The first is connected to the preconditions to the formation of cultural norms identified in Part III: observability; dissemination; and enforcement. Of central importance in this regard is ‘tone from the top’.¹²² More specifically, a key foundation for cultural change is that senior managers make it clear to the rest of the firm that (1) regulatory objectives matter and (2) violations will result in internal sanctions. Second, both the act of transferring *ownership* of regulatory responsibility to the firm and the firm’s *engagement* with regulatory objectives engender the formation of norms about expected and legitimate behavior.¹²³

In its *ideal form*, process-oriented regulation promotes dialogue, processes, systems and controls that generate behavioral norms that are solidified and diffused by internal enforcement mechanisms which are backed by senior management’s imprimatur. However, as Parker and Sharon Gilad point out, it is improbable that targeted cultures can be instrumentally created in this way.¹²⁴ Any attempt to foster specified normative positions takes place through agents (including senior management) that may have countervailing normative

¹¹⁹ Christine Parker, *Meta-Regulation: Legal Accountability for Corporate Social Responsibility*, in *THE NEW CORPORATE ACCOUNTABILITY: CORPORATE SOCIAL RESPONSIBILITY AND THE LAW* . 33 (Doreen McBarnet et al., eds., 2007).

¹²⁰ Report, FSA, *Treating Customers Fairly – Towards Fair Outcomes for Consumers* 2.3 (July 19, 2006) [hereinafter *Towards Fair Outcomes*], available at http://www.fsa.gov.uk/pubs/other/tcf_towards.pdf; See Julia Black, *Forms and Paradoxes of Principles-Based Regulation*, 3 *Capital Markets L. J.* 425 (2008) (identifying cultural change as one of the potential advantages of this type of regulation (which she labels principles-based regulation), while simultaneously noting some of the drawbacks of giving regulatory authority to regulated constituencies that may have incentives to interpret the outcomes in non-compliant ways); see also Parker, *supra* note 119.

¹²¹ *Supra* note 119. For Parker, borrowing from Selznick “a corporate conscience is created when values that transcend self-interest are built into the practice and structure of the enterprise” (from Philip Selznick, *The Moral Commonwealth* (1992) at 245. (quoting PHILIP SELZNICK, *THE MORAL COMMONWEALTH* 245 (1992) (“a corporate conscience is created when values that transcend self-interest are built into the practice and structure of the enterprise”).

¹²² See *supra* note 120 at [2.3] and [2.4].

¹²³ This view finds support in both organizational and sociological theory. See, e.g., Silbey et al., ‘*The Sociological Citizen’s Relational Independence in Law and Organizations*, 59 *L’Année Sociologique* 201, 218 (2009) (describing a case study in which project engagement resulted in a “perceptual and moral transformation”); see also CLIFFORD GEERTZ, *Thick Description: Toward and Interpretative Theory of Culture*, in *INTERPRETATION OF CULTURES: SELECTED ESSAYS* 3 (1975) (observing that “it is through the flow of behaviour – or more precisely social action – that cultural forms find articulation”).

¹²⁴ Christine Parker & Sharon Gilad, *Internal Compliance Management Systems: Structure, Culture and Agency*, in *EXPLAINING COMPLIANCE: BUSINESS RESPONSES TO REGULATION* (Christine Parker & Vibeke Nielson eds., 2011).

commitments and incentives and who may deploy strategies to resist cultural change.¹²⁵ A more realistic way to look at process-oriented regulation is thus as one of several complimentary strategies¹²⁶ designed to increase the probability that certain normative positions can be voiced and gain traction within the firm. Put differently, it seeks to bias the internal battleground of firm culture in favour of specified regulatory objectives.

The TCF Initiative identifies six outcomes which the FSA expects financial services firms to achieve on behalf of their retail clients. These outcomes aim to ensure that (1) fair treatment of consumers is embedded in corporate culture; (2) products and services meet the needs of identified consumer groups and are targeted accordingly; (3) sufficient information is provided to consumers before, during and after the point of sale; (4) any advice is suitable to a particular consumer; (5) products and services meet the expectations of consumers, and (6) consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim, or make a complaint.¹²⁷ The FSA has also produced extensive guidance about how firms should approach their obligations under the TCF Initiative.¹²⁸ Compliance with the TCF Initiative is then measured against the extent to which the processes designed and implemented by firms are able to deliver against these outcomes.

Consistent with the process-oriented approach to regulation, the TCF Initiative compels firms to design and evaluate their own organizational processes against desired regulatory outcomes. In giving firms the *flexibility* to design and implement firm-specific processes, the TCF Initiative also shifts at least some of the *responsibility* for meaningfully engaging with – and ultimately achieving – regulatory objectives from the FSA to financial services firms. The TCF Initiative places the onus on firms, and specifically on senior management, to promote an organizational culture which encourages meaningful internal dialogue about firm practices, their impact on retail clients, and whether or not they meet the required regulatory outcomes. Indeed, the FSA describes the TCF Initiative as “a cultural issue”¹²⁹, observing: “it is only through establishing the right culture that senior management can convert their good intentions into actual fair outcomes for consumers.”¹³⁰

At present, there exists limited empirical evidence against which to judge the success (or failure) of the TCF Initiative. Recent qualitative research conducted by Sharon Gilad, however, has examined the TCF Initiative and, specifically, the

¹²⁵ *Id.*

¹²⁶ We explore supportive incentive structures in Part VI of this article.

¹²⁷ *Towards Fair Outcomes*, *supra* note 120, § 1.2.

¹²⁸ See Gilad, *supra* note 114; FSA, TCF Library, www.fsa.gov.uk/doing/regulated/tcf/library (last visited Sept. 28, 2012).

¹²⁹ Report, FSA, *Treating Customers Fairly – Culture 2* (July 2007), available at http://www.fsa.gov.uk/pubs/other/tcf_culture.pdf; *Towards Fair Outcomes*, *supra* note 120, § 2.4 (referring as well to the goal of effecting a “cultural shift”).

¹³⁰ *Id.*

preconditions to its effective implementation.¹³¹ There are two central findings of this important work. First, enforcement matters. Gilad's findings suggest that many financial services firms were initially reluctant to engage with the TCF Initiative as, in their view, they already treated their customers fairly.¹³² Indeed, for many firms, engagement involved little more than the collection of data to demonstrate that fairness was, in fact, taken into consideration by their personnel.¹³³ However, as Gilad notes, this view changed – and more meaningful engagement ensued – following a marked increase in the number of enforcement actions brought by the FSA stemming from the failure of individual firms to treat customers fairly.¹³⁴ Importantly, the FSA also signaled that a firm's failure to meaningfully *engage* with desired regulatory outcomes – as well as the failure to *achieve* them – may trigger enforcement action.¹³⁵

The second important finding relates to the role of senior management in spearheading implementation and ongoing engagement. As described above, the TCF Initiative does not seek to compel compliance *per se*. Rather, it proceeds on the basis that compliance benefits – i.e. behavioral change leading to improved outcomes for retail clients – will flow from dialogue, process design and implementation, and ultimately, cultural formation. All of this requires clear signals from senior management that they support (indeed, *demand*) engagement with TCF Initiative by all employees.¹³⁶ To engage with the TCF Initiative purely through a compliance lens, and thereby to give a firm's compliance function primary responsibility for its implementation, would thus undermine its potential efficacy. Gilad's empirical work confirms this view: when firms viewed the TCF Initiative as the responsibility of compliance professionals, implementation was measurably slower and less effective.¹³⁷

While empirical data on the impact of the TCF Initiative may be sparse, there are several reasons for (cautious) optimism. First, the TCF Initiative articulates a relatively intelligible and non-arbitragable standard of 'other regarding' behavior:

¹³¹ Gilad, *supra* note 114.

¹³² Even when these firms were implicated in various mis-selling claims. *Id.* at 11-14.

¹³³ *Id.*

¹³⁴ *Id.* at 14-16.

¹³⁵ See *Towards Fair Outcome*, *supra* note 120, at 1.28 ("We will continue to consider enforcement action in circumstances where a firm's systems or actions leave open the potential for significant consumer detriment, or where actual significant detriment has occurred. This is much more likely to be our response where firms continue to deny that TCF has any relevance for them or have failed to take appropriate steps to work out what changes may be required and to start implementing them."); see also *id.* at [5.13].

¹³⁶ Indeed, the FSA has itself stressed that commitment on the part of senior management is crucial to the successful implementation of the TCF Initiative. In a 2006 report outlining the FSA's vision for the TCF Initiative, the role of senior management in the TCF process is referred to 32 times. See *Toward Fair Outcomes*, *supra* note 120. Indeed, in stressing the importance of managerial leadership to cultural change within firms the FSA is at one with leading managerial theories of culture and business practices. See, e.g., EDGAR H. SCHEIN, *ORGANIZATIONAL CULTURE AND LEADERSHIP* 11 (John Wiley & Sons 2004) (observing that "[i]t can be argued that the only thing of real importance that leaders do is create and manage culture; that the unique talent of leaders is their ability to understand and work with culture; and that it is the ultimate act of leadership to destroy culture when it is viewed as dysfunctional").

¹³⁷ Gilad, *supra* note 114, at 20.

thus avoiding two of the principal pitfalls associated with more prescriptive rules. Second, unlike the various codes of conduct and ethics produced by the financial services industry, the credible threat of formal regulatory sanctions in response to failures – not just of *compliance* but, crucially, of *engagement* – provides powerful motivation for firms to take the TCF Initiative seriously. Simultaneously, the public disclosure of sanctions imposed for violations of the TCF Initiative reveals valuable information to the retail marketplace about a firm's propensity to treat customers fairly. This could theoretically provide the basis for enhanced market discipline.¹³⁸ If enforcement action, market discipline and managerial leadership are together able to send a clear signal that engagement with the TCF Initiative will be rewarded and non-engagement sanctioned – then the TCF Initiative will have made a notable contribution to ethical cultural formation in financial firms.

The process-oriented focus of the TCF Initiative thus provides a platform for financial services firms to promote an organizational culture of 'other regarding' behavior. To realize this potential, however, the FSA would do well to draw on the insights of cognitive and social psychology canvassed in Part III of this article. More specifically, while the TCF Initiative is designed to facilitate dialogue regarding firm practices and the outcomes they achieve for retail clients, the content and framing of these conversations can be important determinants of organizational decision-making and behavior. Reframing these conversations to highlight their ethical dimensions could therefore yield significant benefits. Thus, for example, the FSA could provide guidance to the effect that meaningful engagement with the TCF Initiative includes reviewing the results of previous FSA enforcement actions (i.e. those against other firms) – thereby highlighting the *probability* and *magnitude* of potential consequences and providing the foundations of a 'lessons learned' review of a firm's own practices. It could similarly mandate that, as part of the vetting process for new products and services, decision-makers would confirm that they would let their grandmother, parent or child purchase the product or service in question (thus enhancing *proximity*).¹³⁹

The FSA could also mandate that all new financial products and services be vetted and approved by an internal 'ethics' committee, headed by senior management and responsible for, *inter alia*, overseeing delivery of the outcomes identified by the TCF Initiative. The introduction of an ethics committee would offer at least three potential benefits in this context. First, it would signal to the lower rungs of the organization that treating customers fairly (and 'other regarding' behavior more generally) was not just a compliance issue, but also an

¹³⁸ Although, in the case of the U.K., oligopolistic competition for many financial products and services – combined with the fact that mis-selling claims have been alleged against a large cross-section of the financial services industry – is likely to have dampened its impact. Ultimately, however, the impact of market discipline in this context is an empirical question which resides beyond the scope of this paper.

¹³⁹ For these purposes, it would be useful (and perhaps necessary) to assume that the grandmother, parent or child possessed the risk preferences of the 'target' client.

important business issue.¹⁴⁰ Second, it would provide an opportunity for *reflection* – for sober second thought about the impact of business decisions on client welfare. Third, it would establish a clear channel of accountability in terms of compliance with the TCF Initiative, thus eliminating any organizational anonymity which might otherwise decrease the moral intensity of ethical decisions. The prospect of introducing an ethics committee is examined in greater detail in Part VI.

Together, these and other mechanisms could potentially enhance moral intensity within financial services firms and put ethical and business considerations on a more equal footing. Systems and processes that incorporate such mechanisms allow personal ethical commitments to be foregrounded, and their expression legitimated. As a result, they enable personal ethical commitments that are consistent with the TCF Initiative to play a more prominent role in the formation of cultural norms within financial firms.¹⁴¹

B. THE EXTENDED TCF INITIATIVE

While further evidence regarding the impact of the TCF Initiative is clearly needed, it is worthwhile exploring the potential merits (and drawbacks) of extending this process-oriented strategy beyond its current narrow focus on retail customers to encompass transactions involving ostensibly more sophisticated counterparties.¹⁴² An ‘Extended’ Treating *Counterparties* Fairly (Extended TCF) Initiative could apply to transactions in, for example, the markets for swaps and other over-the-counter (OTC) derivatives; structured finance vehicles; structured investment products, and other more exotic financial instruments.¹⁴³ Like its retail counterpart, the Extended TCF Initiative could contribute to the formation of a more ethical culture within a segment of the financial services industry in which it is widely perceived as lacking. Perhaps most importantly, it could serve to deter the design and marketing of financial products and services intended, either in

¹⁴⁰ See Gilad, *supra* note 114.

¹⁴¹ See Jones, *supra* note 64.

¹⁴² In the U.K., COBS rules currently distinguish between retail clients, professional clients and eligible (i.e. market) counterparties in accordance with, effectively, their ostensible level of financial expertise and sophistication. See COBS, *supra* note 27, at § 3. *Per se* eligible counterparties include, *inter alia*, investment firms; credit institutions; insurance companies; collective investment schemes; pension funds; governments, and central banks. *Id.* at § 3.6.2. In addition, a firm may treat a client as an eligible counterparty if, *inter alia*, the client is a body corporate (including a limited liability partnership) which, together with its parent company or subsidiaries, has called up share capital of at least £10 million. *Id.*, *supra* note 27, at § 3.6.4.

¹⁴³ We focus on primary markets for two related reasons. First, robust (i.e. transparent, deep and liquid) secondary markets can be expected to result in more accurate price discovery which, in turn, is itself a tonic against opportunism. Second, in the view of many observers, the most egregious cases of opportunism in recent years – and especially in connection with the GFC – have occurred within the primary markets for these more esoteric, complex and thinly traded instruments.

whole or in part, to extract rents from less sophisticated “sophisticated counterparties”.¹⁴⁴

As with the TCF Initiative, regulators would specify objectives to be implemented through process-oriented regulation. These objectives would be tailored to the business context in which they were applied and, necessarily, therefore, would be very different from the objectives identified in the retail context. They could include, for example: (1) that the fair treatment of counterparties is embedded in corporate culture; (2) that a counterparty discloses clearly and openly all relevant information about a product which it is marketing; (3) that a counterparty does not attempt to take any steps that could distort the interpretation or weighting of the disclosed information; and (4) that a counterparty does not market products that in its view sophisticated market participants would be unable to understand and price accurately.

The success of the Extended TCF Initiative, like the TCF Initiative, would ultimately hinge on the extent to which financial services firms (and their employees) meaningfully engage with regulatory outcomes. Once again, a credible external enforcement threat – in relation to engagement as well as outcomes – is key. So too is commitment on the part of senior management. The introduction of an ethics committee to scrutinize transactions and oversee engagement with the Extended TCF Initiative would, for the reasons discussed above, also pay potential dividends. Taking another page from cognitive and social psychology, meanwhile, the FSA could require counterparties to transact ‘face-to-face’ (i.e. either physically or via teleconference) or otherwise attempt to reduce their physical, psychological or social proximity. While such proposals might seem too costly, or unrealistic, or remnants of a bygone era, there is no denying the fact – as evidenced by the heightened emotional response to the footbridge problem¹⁴⁵ – that it is often more difficult to take advantage of your counterparty once you have shaken their hand.

However, there are a number of reasons to suggest that the Extended TCF Initiative might not be as effective as its retail counterpart. Perhaps most importantly, unlike the retail marketplace, there is arguably no underlying societal norm that sophisticated market counterparties should be treated fairly. Indeed, there is a strong countervailing norm of *caveat emptor* within many wholesale markets. More specifically, where sophisticated parties fail to fully understand the nature or extent of the risks they contract to assume, the general view is thus that they have no one to blame but themselves and should, accordingly, bear the consequences of their ignorance, incompetence and/or greed. Viewed from this perspective, extending regulatory strategies such as the TCF Initiative to ostensibly more sophisticated counterparties amounts to unwarranted paternalism. This, in turn, is likely to dilute the impact of any reputational (i.e. market-based) sanctions

¹⁴⁴ See, *supra* notes 32 and 93.

¹⁴⁵ See Valdesolo & DeSteno, *supra* note 67; Greene et al., *supra* note 70; Gold et al., *supra* note 70.

for firms which are deemed to have treated their counterparties unfairly.¹⁴⁶ Ultimately, however, such likely counterarguments are arguably missing the point. As Milton Friedman observed, efficiency demands that contractual exchange is both voluntary and, importantly, *informed*.¹⁴⁷ The Extended TCF Initiative must ultimately be judged on the basis of whether it engenders the formation of cultural norms which would promote such informed (and therefore more efficient) contracting.

IV WHO IS MY NEIGHBOR? CARVING OUT A ROLE FOR A MORE ETHICAL CULTURE IN SYSTEMIC RISK REGULATION

The GFC has driven home the reality that financial services firms frequently do not possess the incentives to take systemic risk seriously. While these firms, their shareholders and employees capture the benefits derived from their socially excessive risk-taking, they only bear a portion of the attendant costs. Indeed, of all the issues to emerge from the crisis, the fact that public resources had to be diverted to private firms to prevent the collapse of the financial system remains the most acute and controversial. The salient question thus becomes: can process-oriented regulation help constrain socially excessive risk-taking within financial services firms? Put differently: does the TCF Initiative's process-oriented approach provide a template for what we might for argument's sake call a 'Take Externalities Seriously' (or TES) Initiative?¹⁴⁸

A TES Initiative could include, for example, the following objectives: (1) to ensure that the identification and avoidance of socially excessive risk taking is embedded in corporate culture; (2) to identify and monitor potential socially excessive (i.e. systemic) risks generated by a firm's activities; (3) to better understand a firm's exposure to systemic risks; and (4) to determine how best to minimize these risks on an ongoing basis. These objectives would, *inter alia*, engage firms in the important and difficult task of developing better metrics of systemic

¹⁴⁶ In response to the loss of reputational discipline, the regulator could deploy other enforcement strategies – see *infra* the discussion of the 'fit and proper purpose regime' at text to notes 150-151.

¹⁴⁷ MILTON FRIEDMAN, CAPITALISM AND FREEDOM 13 (Univ. of Chicago Press 1962).

¹⁴⁸ For the present purposes, we bracket questions about the types of financial institutions to which the TES Initiative should apply. One argument is that the TES Initiative should apply only to systemically important firms, as it only those institutions whose failure threatens to generate the type of negative externalities unleashed by the GFC. Ultimately, however, there several arguments in favor of more general application. First, a more targeted application does not take account of the potential contagion effects of non-systemically important firms which engage in socially excessive risk-taking in herds. Second, employees from firms not subject to the TES Initiative could relocate to firms which were subject to it (and vice versa). Insofar as these employees were unfamiliar with the TES Initiative, this might be expected to undermine attempts at norm formation within systemically important institutions.

risk (something which represents an ongoing challenge for regulators¹⁴⁹). Importantly, where firm-level processes yielded significant improvements in terms of the measurement or management of systemic risk, these improvements could be disseminated by regulators in the form of industry guidance: thereby helping to overcome the inherent incentive problems arising from the fact that financial stability is a public good.

Like the TCF Initiative, the TES Initiative would make socially excessive risk-taking a business and cultural issue for firms, with compliance measured against both the delivery of desired regulatory outcomes *and* ongoing engagement. Through internal engagement and dialogue arising from the development and implementation of processes and controls – backed by managerial commitment – the TES Initiative would aim to foster the generation of a cultural norm within firms that foregrounds awareness amongst all employees that their conduct has social consequences. Awareness, of course, is not the same thing as understanding. Individual actors, no matter how intelligent, are incapable of processing the systemic implications of their financial market activity. Yet awareness that their actions may have systemic implications may generate some individual restraint, as well as encouraging engagement with the processes and controls designed to manage these risks.

In effect, the process, controls and norms generated by an effective TES Initiative would result in firms internalizing some of the social costs of their activities. On paper, therefore, the potential benefits of the TES Initiative are compelling. But are they achievable? As a preliminary matter, the conceptual problems associated with the design and implementation of the TES Initiative would be significantly greater than either the TCF Initiative or Extended TCF Initiative. While ‘fairness’ is in many respects an amorphous concept, it can readily be given more precise content in the context of the bilateral customer/counterparty relationships.¹⁵⁰ Socially excessive risk-taking, in contrast, is extremely difficult to *define* – let alone *identify* before the moment it crystallizes as a negative externality. These conceptual problems would undoubtedly render it more difficult for regulators to provide meaningful firm-specific and industry guidance. They would also make enforcement action stemming from the failure to achieve desired regulatory outcomes inherently more problematic.¹⁵¹ These

¹⁴⁹ See Dimitrios Bisias et al., *A Survey of Systemic Risk Analytics* (Office of Fin. Research, Working Paper No. 0001, Jan. 5, 2012), available at http://www.treasury.gov/initiatives/wsr/ofr/Documents/OFRwp0001_BisiasFloodLoValavanis_ASurveyOfSystemicRiskAnalytics.pdf.

¹⁵⁰ As the six outcomes identified by the TCF Initiative attest.

¹⁵¹ Any uncertainty respecting the required regulatory standard could lead to legal challenges. Moreover, *in extremis* – i.e. where the materialization of a risk will wipe out the assets of the firm – we would expect the threat of *ex post* enforcement for failing to achieve desired regulatory outcomes to have a negligible impact on *ex ante* incentives to take the risk (especially where there was no recourse to the assets of the decision-makers). This is because in states of the world where the risk materializes, the marginal costs of enforcement action would be zero.

enforcement problems would be compounded by the likely impotence of market-based (i.e. reputational) sanctions in response to socially excessive risk-taking.¹⁵²

Perhaps the most compelling response to these very legitimate concerns is that, as described above, process-oriented regulation is designed to promote firm engagement with desired regulatory outcomes and, through engagement, to promote cultural norms that deter socially undesirable behavior. In the aftermath of the crisis, it cannot be denied that there is such a thing as socially excessive risk-taking or that the externalities thereby generated are very real. Nevertheless, it is inevitable that when dealing with something as complex as socially excessive risk-taking, different firms (and even regulators) will adopt divergent perspectives respecting, *inter alia*, whether and to what extent various activities generate systemic risk and how best to address it. What process-oriented regulatory strategies such as the proposed TES Initiative attempt to do is stimulate meaningful and ongoing dialogue within firms about these important questions. It then provides firms with the flexibility to design and implement firm-specific processes which reflect the results of this dialogic process. Put simply, in a domain where there are few right answers, the objective of the TES Initiative would be to engender a culture in which firms continually questioned the impact of their activities on others. Any conceptual indeterminacy in terms of desired regulatory outcomes would be unlikely to pose a significant obstacle to such cultural formation.

Furthermore, although effective enforcement action would be more problematic than in the TCF context, it bears emphasizing that enforcement action need not be based solely on the failure to achieve outcomes, but also on the effective engagement by the firm with, and the level of commitment by senior management to, the TES Initiative. Regulators could also deploy indirect sanctions. Under a holistic¹⁵³ approved persons regime¹⁵⁴, for example, a regulator could deny approval if the candidate does not have the skills, qualities or

¹⁵² See, e.g., Armour et al., *supra* note 101 (finding that news of enforcement actions in connection with wrongdoing which harmed third parties had a weakly *positive* effect on a firm's share price).

¹⁵³ Under such a regime when presented with an approval request for a controlled function (see note below), the FSA would consider the fitness of the applicant relative to the fitness and competences of the board and management as a whole. The FSA has indicated that in considering the competence of any applicant for a controlled function the competence of other approved persons for that function will be relevant to ensure the institution has an appropriate competence as a whole. FSA, EFFECTIVE GOVERNANCE: SIGNIFICANT INFLUENCE AND CONTROLLED FUNCTIONS AND THE WALKER REVIEW 4.28 (FSA, Consult. Paper 10/3, Jan. 2010).

¹⁵⁴ Pursuant to section 59 Financial Services and Markets Act 2000, any person performing a "controlled function" of an authorised person must be approved by the FSA. Such person must be a fit and proper person. See FSA, FSA Handbook, FIT 1 & 2, available at <http://fsahandbook.info/FSA/html/handbook/FIT>. Controlled functions currently consist of governing functions (for example, director or non-executive director function), significant management functions, systems and control functions and required functions; See FSA, FSA Handbook, SUP 10.4, available at <http://fsahandbook.info/FSA/html/handbook/SUP/10/4>. Currently, the FSA has proposed broadening the range of control functions, as well as narrowing the functions for which approval is given. Although implementation has been delayed (FSA Statement 25 March 2011), once implemented this will enhance FSA's control over the financial institution personal and board structure.

commitment necessary to counteract the firm's ineffective engagement with the TES Initiative. Alternatively, regulators could designate a candidate as 'board champion'¹⁵⁵ for the TES Initiative.

V TREATING BANKS DIFFERENTLY: PRECONDITIONS TO THE EMERGENCE OF BINDING CULTURAL AND ETHICAL CONSTRAINTS

The objective underlying the TCF, Extended TCF and TES Initiatives is to foster a more ethical culture within financial services firms. Yet, as the GFC has illustrated, personal financial incentives will at times come into conflict with both pre-existing personal ethical commitments as well as the outcomes the TCF, Extended TCF and TES Initiatives seek to achieve. It follows that, in order for a meaningful ethical culture to form and flourish through process-oriented regulation, we must first address these countervailing incentives and connect pay and rewards of bank personnel more directly with regulatory objectives. This section explores some of the ways this might be achieved.

The FSA's experience with the TCF Initiative drives home the importance of leadership and commitment on the part of senior management as a necessary precondition to any shift toward a more ethical culture within financial services firms.

In this regard, if any stated commitment on the part of senior managers is not backed up by observable action to implement the initiatives (and then monitor and enforce compliance), it is highly unlikely that the desired 'cultural shift' will take place. Whereas employees will observe and easily interpret mixed managerial signals, regulators may struggle to differentiate between managerial word (unequivocal) and action (equivocal). Managers may, therefore, be able to creatively comply through ostensible engagement that ultimately has limited impact on the ground. Clearly, then, managerial incentives are central to the success of these cultural initiatives.

There are two key drivers of the incentive structure of financial firm managers. The first driver is personal compensation arrangements, where those arrangements are linked directly or indirectly to financial targets. The second is managers' relationship with shareholders and, therefore, shareholder value. Shareholders in financial institutions, as in other commercial institutions, have strong incentives to encourage managers to focus on value creation. However, within systemically important financial institutions, these incentives to create value also incentivize shareholders to encourage managers to take socially excessive risks. As has been argued elsewhere, where creditors do not discipline institutions

¹⁵⁵ See *Towards Fair Outcomes*, *supra* note 120, at 3.3.

which benefit from the TBTF subsidy and where the state does not demand full payment for its implicit guarantee,¹⁵⁶ shareholders, including long term shareholders, have powerful incentives to encourage managers to increase the volatility and, therefore, riskiness of the institution's asset profile.¹⁵⁷ That is, it is rational for such shareholders (thinking only about the value of their portfolio of assets) to want their managers to 'bet the bank'. Accordingly, to increase the probability that measures such as Extended TCF and TES Initiatives will succeed, managers need to be given room to resist direct or indirect shareholder pressure to focus only on shareholder value.

What, then, are the governance and remuneration tools available to create the decision-making space necessary to enable a more ethical culture – institutionalized through measures such as the Extended TCF and TES Initiatives – to flourish? Below we canvass a range of possible strategies. Some of these strategies – remuneration and corporate objective regulation, for example – may be viewed as pre-requisites. Others, meanwhile, may be more appropriately viewed as facilitative but, ultimately, optional. Certain of these optional governance strategies may be viewed as, at least in part, substitutable: the absence of one may be counterbalanced by the presence of another. Accordingly, whether any particular jurisdiction creates managerial incentive structures that provide fertile soil for our proposals must be assessed holistically. Here, however, we do not have the space to attempt close, comparative jurisdictional assessments.

A. COMPOSITION REFORMS: A BOARD LEVEL ETHICS COMMITTEE

An important question raised by the GFC is whether weaknesses in the structure and composition of the boards of financial institutions were a proximate cause of their failure. The focus to date has been on the competences of independent non-executive directors – whether they were sufficiently knowledgeable about their firms and the financial services industry¹⁵⁸ – and the role of the board in effectively managing risk. The primary regulatory response in this regard has been to insist that many financial institutions (i.e. banks and other 'credit institutions') form board-level risk committees, majority controlled by independent directors.¹⁵⁹

¹⁵⁶ JOSEPH NOSS & RHIANNON SOWERBUTTS, 'THE IMPLICIT SUBSIDY OF BANKS' FINANCIAL STABILITY (Bank of Eng., Paper No. 15, May 2012), available at http://www.bankofengland.co.uk/publications/Documents/fsr/fs_paper15.pdf.

¹⁵⁷ Christopher Bruner, *Corporate Governance Reform in a Time of Crisis*, 36 J. Corp. L. 309, 341 (2011).

¹⁵⁸ See, e.g., WALKER REVIEW, A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES: FINAL RECOMMENDATIONS (Nov. 26, 2009) [hereinafter WALKER REVIEW], available at http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf.

¹⁵⁹ See, e.g., BCBS, PRINCIPLES FOR ENHANCING CORPORATE GOVERNANCE 52 (2010) (citing, for example, the FSA rules on risk committees at High Level Standard, SYSC 21.1.5), available at <http://www.bis.org/publ/bcbs176.pdf>.

In contrast to risk management, ethics and culture have not featured in this board composition debate. In the U.K., for example, the important *Walker Review on The Corporate Governance in UK Banks and other Financial Entities* did not address ethics or a specific role for the board with regard to firm ethical culture. Nevertheless, many U.K. companies – including financial institutions – do have (and had prior to the crisis) board committees whose remit was to address firm ethics.¹⁶⁰ Two of the institutions that were perceived to have performed relatively well during the crisis, Standard Chartered and HSBC, both have ethics-related committees at board level. Standard Chartered has a board level committee on sustainability and responsibility; HSBC has a committee on corporate sustainability.¹⁶¹ Clearly, however, no causal or regulatory conclusion can be drawn from these anecdotal observations. Moreover, it is important to keep in mind the limits of board composition reforms in general. In the case of the major bank failures during the crisis, for example, it is unlikely that such reforms would have prevented the failure in question, or have altered the board composition of many of those failing banks.¹⁶²

Nevertheless, the role of an ethics committee in financial institutions is worth canvassing in the post-crisis board composition debate. An ethics committee could form a key component of an attempt to generate an ‘other regarding’ ethical culture within financial institutions. As we have seen, the process-orientated approach embodied by the TCF Initiative places significant weight on the role played by management. An ethics committee, on which executive and non-executive directors sit and to which senior management reports, would be vital in: (1) signaling to management and all employees the importance of the formation of an ethical culture; and (2) establishing effective monitoring, reporting and other mechanisms to oversee its design and implementation.

Working together with management, an ethics committee would take the lead in establishing and revising a firm’s ethical objectives consistent with applicable regulatory objectives – including those identified by the TCF, Extended TCF and TES Initiatives. More specifically, an ethics committee would be responsible for setting the firm-specific ethical outcomes and then monitoring the processes developed by management and employees, and benchmarking their effects in

¹⁶⁰ See WALKER REVIEW, A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES: CONSULTATION DOCUMENT (July. 16, 2009) available at http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf at 128 (reporting a review by Deloitte indicating that 33% of Banks (as compared to 40% of all companies) as of 2008 had a committee that dealt with issues of “CSR/Environment/Ethics/Health & safety”). The remit of such committees is, of course, considerably wider than the issues considered in this paper.

¹⁶¹ *Id.* at 166.

¹⁶² See, e.g., The Royal Banks of SCOTLAND, ANNUAL REPORT AND ACCOUNTS 2006 2 (2006) (listing the bank’s pre-crisis board of directors), available at http://www.investors.rbs.com/download/report/RBSplc_Accounts_2006.pdf.

practice and over time.¹⁶³ An ethics committee could also be responsible for putting in place and monitoring the effectiveness of ethical disciplinary procedures within the firm and for overseeing the management information systems that gather information about engagement and compliance with the processes and procedures designed engender a more ethical culture.

Because the generation of an ethical culture is both an operational and monitoring issue (the goal being to infuse ethical considerations into institutional activities), such a committee would consist of both executive and non-executive directors. However, as its key function would be to hold management to account for their leadership and engagement with the Initiatives, the ethics committee would be majority controlled by the non-executive directors.

B. REMUNERATION

The view is now widespread that one of the primary drivers of socially excessive risk-taking within financial institutions prior to the GFC were the remuneration arrangements of both executive directors and lower level bankers and traders. These arrangements incentivized decision-making that focused on short term financial gains (often unrealized in cash terms). In many instances, financial institutions appear to have remunerated managers and other employees by taking account of the short term upside of transactions, but not the potential long term downside.¹⁶⁴ In the wake of the crisis, domestic and transnational regulatory responses¹⁶⁵ have thus focused on ensuring that: (1) pay more accurately reflects both short term and longer term risks; (2) there are limits on the performance-based component of pay; (3) any performance-based component has a limited cash component, and (4) a substantial portion of performance-based pay is deferred over a significant period of time (e.g. over three to five years).¹⁶⁶

However, even where remuneration arrangements are linked to the long term value of the enterprise, these arrangements may still generate incentives to

¹⁶³ As a board-level committee it could not, however, be closely involved in the design and implementation of the processes necessary to achieve these objectives. As discussed above, of central importance to process-oriented regulation is harnessing the firm's ground-level knowledge and expertise, and making engagement with regulatory objectives a central part of a firm's ethos.

¹⁶⁴ See generally, Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers Pay* 98 Geo. L. J. 247(2010); Coffee, *supra* note 24, at 1047.

¹⁶⁵ See, e.g., COMMISSION OF THE EUROPEAN COMMUNITIES (EC), EU COMMISSION RECOMMENDATION ON REMUNERATION POLICIES IN THE FINANCIAL SERVICES SECTOR (2009), available at http://ec.europa.eu/internal_market/company/docs/directors-remun/financialsector_290409_en.pdf; Committee of European Banking Supervisors (CEBS), Guidelines on Remuneration Policies and Practices (2010), available at <http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Remuneration/Guidelines.pdf>; Federal Deposit Insurance Corporation (FDIC) Notice of Proposed Rulemaking on Incentive Based Compensation Arrangements, FIL-7-2011 (Feb. 9, 2011), available at <http://www.fdic.gov/news/news/financial/2011/fil11007.pdf>; FSA Handbook, Senior Management Arrangements, Systems and Controls (SYSC) 19A, available at <http://fsahandbook.info/FSA/html/handbook/SYSC/19A>.

¹⁶⁶ See *id.* at 19A.3.49. Note that these standards are applied on a 'firm-wide' basis and are therefore applicable to executive directors as well as bankers and traders.

cut ethical corners. To the extent that firms profit from the exploitation of asymmetries of information and expertise in relation to highly complex products, for example, such actions impose costs on their less informed and/or inexperienced counterparties, thereby generating quasi-rents. In relation to socially excessive risk-taking, meanwhile, the long term outlook of the financial institution may support an approach to risk that, from society's perspective, is clearly undesirable. If the primary objective of financial institutions, as organizations, is to generate shareholder value (which we discuss further below) then rational managers acting in the interests of their shareholders will exploit the implicit and uncosted state guarantee.¹⁶⁷ Maximizing value will continue to support an approach that promotes excessive risk-taking: ultimately transferring value from the state to shareholders. If the risks pay off shareholders win; if they do not, society loses.¹⁶⁸ Requiring employees to maximize firm value within a three to five year time frame (as the new remuneration rules and guidelines effectively require) will thus not necessarily place a break on socially excessive risk-taking.

Claw-back provisions have greater potential to alter the incentives of individual bankers. Correctly drafted claw-backs can ensure that the costs generated by socially excessive risks are borne not just by society but also by the bankers who took them. The extent to which claw-backs can have these effects, however, depends on the scope of application of the claw-back. Does it apply to paid or merely deferred remuneration? And if it applies to paid remuneration, how far is the look-back period in relation to which claw-back can be applied, and what is the extent of prior earnings which must be re-paid? Claw-back provisions, such as those set forth in the FSA's Remuneration Code,¹⁶⁹ which apply only to unvested deferred remuneration, mean that rational bank employees (unaffected by other-regarding cultural norms) will discount only the deferred benefit of the socially excessive risk-taking by the probability that the risks will be realized within the vesting timeframe. In these behavioral calculations, the bank manager or employee will also take into account the benefits of any increase in fixed (and non-recoverable) salary – as well as job security – arising from risking-taking aligned with broader institutional incentives. Simultaneously, banks may attempt to realign banker incentives by increasing fixed pay.

The Dodd-Frank Act, meanwhile, authorizes the FDIC to impose claw-backs on senior executives who are "substantially responsible" for bank failure.¹⁷⁰ On

¹⁶⁷ See Noss & Sowerbutts, *supra* note 156; see also Coffee, *supra* note 24, at 1053-55.

¹⁶⁸ See, Coffee *supra* note 24.

¹⁶⁹ FSA Handbook, SYSC 19A.3.52 providing for the reduction "unvested deferred" remuneration in the event of "employee misbehaviour", or where a business unit suffers a "material downturn in [firm] financial performance" or "a material failure of risk management", available at <http://fsahandbook.info/FSA/html/handbook/SYSC/19A/3>.

¹⁷⁰ §210(s) Dodd-Frank Act. FDIC Rule 380.7. In the event of bank bailout the FDIC would not be appointed as receiver and there remain doubts about the legality of this provision. See Dorothy Shapiro, *Federalizing Fiduciary Duty: The Altered Scope of Officer Fiduciary Duty Following Orderly Liquidation under Dodd-Frank* 17 STAN. J.L. BUS & FIN 223, 226.

one level, the FDIC claw-backs are broader than those provided for under FSA rules insofar as they apply to *all* compensation. On another level, however, they are narrower in that they (1) require personal rather than collective (business unit) responsibility (2) and only apply when the bank is in FDIC receivership. Furthermore, the FDIC rules will only apply to compensation earned within one to two years of the appointment of the FDIC as receiver. A rational manager of a U.S. bank would therefore discount the benefit of risky behavior against the probability that such risks will result in receivership in a one to two year period (as well as the probability that the FDIC will be able to establish his "substantial responsibility"). As the crisis has demonstrated, holding senior bank managers to account for bank failings is very difficult and for systemically important banks the probability of entering an insolvency proceeding even when the bank fails is low. It follows that the probability of claw-back under these rules is also low.

The personal and institutional financial interests of bankers under the reformed remuneration rules manifest the potential to crowd out the kind of process-oriented approach to cultural and ethical formation described above. In such an environment there is a risk that measures such as the TCF, Extended TCF and TES Initiatives would be reduced to ethical window dressing. That said, it has now become relatively common place for companies to include non-financial targets such as employee satisfaction, health and safety, and environmental measures alongside financial measures in executive remuneration arrangements.¹⁷¹ Indeed, the UK FSA's Remuneration Code requires that "non-financial performance metrics form a significant part of the performance assessment process". The identified non-financial risk metrics include "risk management and compliance with the regulatory system".¹⁷² Some financial institutions have voluntarily gone further than this. Morgan Stanley, for example, has recently altered the provisions in senior banker remuneration to enable claw-backs where, *inter alia*, there are violations of Morgan Stanley's ethical standards.¹⁷³ Such non-financial targets could be extended to explicitly incorporate the level of engagement, implementation and compliance with the TCF, Extended TCF and TES Initiatives. Building on the role of ethics committees noted above, and the existing role of risk committees vis-à-vis remuneration,¹⁷⁴ the ethics committee could take responsibility for setting such non-financial remuneration targets. Furthermore, by connecting remuneration to a *collective* part of the financial

¹⁷¹ PRICEWATERHOUSECOOPERS (PwC), EXECUTIVE COMPENSATION: REVIEW OF THE YEAR 2009 70 (2010), available at <http://www.pwc.co.uk/assets/pdf/executive-compensation-review-of-the-year-2009-pwc.pdf>.

¹⁷² FSA Handbook, SYSC 19A.3.37, available at <http://fsahandbook.info/FSA/html/handbook/SYSC/19A/3>.

¹⁷³ Morgan Stanley, Schedule 14A: Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934, at 28-29 (Apr. 5, 2012), available at <http://www.sec.gov/Archives/edgar/data/895421/000119312512151028/d303252ddef14a.htm>. See generally, Sharlene Goff & Daniel Schafer, *Banks Ready to Claw Back More*, FIN. TIMES, Aug. 27, 2012, available at <http://ft.com> (search title).

¹⁷⁴ See, e.g., FSA Handbook, SYSC 21.1.5(f), available at <http://fsahandbook.info/FSA/html/handbook/SYSC/21/1>.

institution – for example, a product group, business unit, or division within the bank – in addition to *individual* performance, remuneration could drive peer group monitoring, thereby strengthening one of the three pillars of norm formation: the dissemination of information about the violation of cultural norms.

C. CORPORATE LAW: THE OBJECTIVE OF BANK ACTIVITY

There is a longstanding debate about in whose interests a company should be run: whose interests directors should consider when they make decisions. Many argue that directors should be required to take into account the interests of all corporate stakeholders when they act, without any legal direction to prioritize one constituency over another. This approach is referred to by commentators as a ‘pluralistic’ or ‘multiple-interest’ model of the corporation.¹⁷⁵ Several justifications have been given for this approach. Some commentators, for example, observing that the corporate form is a ‘gift’ from the state and that corporations exert enormous influence over all our lives, have argued that with great power comes quasi-public responsibility to consider the interests of all stakeholders.¹⁷⁶ Economic justifications, meanwhile, focus on the incentives for firm-specific human capital investments by employees which are generated by knowing that their interests count as much as anyone else’s.¹⁷⁷ Whether or not one is persuaded by such arguments more generally, given the stark consequences of the GFC and the necessity for publicly funded bail-outs, the case for a multiple-interest model in the context of financial institutions is compelling. At the very least, there is a powerful justification in relation to systemically important institutions for a model that gives equal priority to the interests of customers (depositors, counterparties, etc.), shareholders and the broader society.

A form of the multiple-interest model is essential for creating the conditions in which the TCF, Extended TCF and TES Initiatives can facilitate the formation of a more ethical culture. All actors, from the board down to the trader, need to know that when there is a conflict between regulatory objectives and the pursuit of value that it is lawful and legitimate to prioritize fair treatment or the avoidance of potential externalities. Managerial leadership and commitment – an essential prerequisite to the formation and enforcement of cultural norms – will manifestly be undermined if the law’s core statement of the directors’ obligations fails to take account of the ‘other regarding’ obligations that are foundational to the initiatives. Furthermore, the imposition of a legal obligation to make decisions on the basis of an ‘other regarding’ standard may assist managers in managing, and at times resisting, shareholder pressure to take excessive risks.

¹⁷⁵ See generally, DAVID KERSHAW, *COMPANY LAW IN CONTEXT: TEXT AND MATERIALS* (OUP, 2d eds. 2012), 357-378.

¹⁷⁶ E. Merrick Dodd, Jr., *For Whom are Corporate Managers Trustees*, 45 HARV. L. REV. 1145 (1932).

¹⁷⁷ Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

In most jurisdictions, this pre-requisite to ethical cultural formation is unproblematic because all corporations are subject to a multiple interest model of corporate purpose. This is the case, for example, for firms incorporated in New York, Germany or Austria.¹⁷⁸ One jurisdiction where there this is not the case is the U.K., where directors' duties require that directors act in a way in which they consider will promote shareholder interests.¹⁷⁹ The *Walker Review* rejected the suggestion that the existing duty should be amended to take account of the fact that banks are different.¹⁸⁰ However, recent remarks by a former CEO of the FSA on the subject of banking culture suggests that U.K. regulators are open to the idea of revisiting this issue.¹⁸¹

D. CORPORATE LAW: SHAREHOLDER RIGHTS

One needs to be wary of overstating the importance of the corporate purpose debate. Through an instrumental lens, even if given discretion to act in the interests of multiple constituencies, it seems probable that the constituency to whom directors and managers have to answer will be the constituency whose interests they prioritize in the case of conflict between shareholder value and other stakeholder interests. That is, the background structure of shareholder rights will continue to form decision-making within financial institutions. However, whilst in all jurisdictions shareholders have the power to appoint, remove, and (not) re-appoint directors, they are not equal when it comes to the nature and extent of shareholder rights, and, therefore, the effects those rights have on senior management and firm decision-making and behavior.

In the U.K., for example, shareholders have very powerful rights. They have the non-waivable right to remove directors without cause by passing a simple majority resolution¹⁸², along with the right to call a meeting at any time when 5% of the shareholder body instructs the board to call a meeting.¹⁸³ In the U.S., by way of contrast, although the rules vary amongst states, it is open to most financial institutions to select weaker removal rights. A firm incorporated in Delaware, for example, can elect to have a classified board where the directors have three year

¹⁷⁸ N.Y. BUS. CORP. LAW § 717(b); AUS. STOCK CORP. LAW § 70(1). In Germany, while the Stock Corporation Act is silent on the question of corporate objective, it is widely accepted that the management board should act in the interests of shareholder, employees and society at large. Wolfgang Hefermehl & Gerald Spindler, in 3 Münchener Kommentar zum Aktiengesetz 58, § 76/53 (Bruno Kropff & Johannes Semler eds., Beck, 2d ed. 2004).

¹⁷⁹ Companies Act, 2006, c. 46, § 172. Whilst the provision requires that regard is had to other stakeholders in the process of making the decision the provision is clear that the decision itself must prioritize the interests of the shareholders.

¹⁸⁰ See WALKER REVIEW, *supra* note 158, at 138.

¹⁸¹ Hector Sants, Speech to the Chartered Institute of Securities and Investments Conference: *Do Regulators Have a Role to Play in Judging Culture and Ethics?* (June 17, 2010) (stating that the corporate purpose objective must include "a stronger and more explicit obligation to wider society").

¹⁸² Companies Act, 2006 § 168.

¹⁸³ *Id.* at §§ 303-05.

terms and can only be removed with cause¹⁸⁴ during this term.¹⁸⁵ Furthermore, the shareholders only have the right to call an interim shareholder meeting where the charter or bylaws authorize them to do so.¹⁸⁶ In Germany, meanwhile, the supervisory board directors may be removed at any time without cause, but the removal threshold is a supermajority (75%), making removal difficult in practice.¹⁸⁷

Recent empirical work suggests that this predicted relationship between shareholder rights and bank behavior is very real indeed.¹⁸⁸ Ferreira, Kershaw, Kirchmaier and Schuster construct a ‘management insulation index’ (MII) and apply this index to all U.S. banks to measure the extent and variation in shareholder rights. They then, *inter alia*, regress MII index scores against data on (1) which banks were bailed-out through the U.S. Troubled Asset Relief Program (TARP) and (2) whether banks still owed TARP funds a year after the program commenced (TARP+1). TARP and TARP+1 are viewed by the authors as a proxy for pre-crisis susceptibility to bank failure and an arguable proxy for excessive risk-taking prior to the crisis. For Ferreira et. al. the relationship between bank exposure to shareholder rights (or lack thereof) and bank failure is consistent with the view that banks which are subject to stronger shareholder rights would be more likely to be receptive to shareholder pressure to take excessive risk and, therefore, more likely to fail. This generates what would be for many commentators and policymakers, a counterintuitive result: *for banks* stronger, and not weaker, shareholder rights are a problem.¹⁸⁹

For our purposes, this suggests that where conflicts arise between value generation and ethical cultural objectives, and where directors of financial institutions are subject to powerful shareholder rights, then the ethical cultural objectives are likely to be subordinated. When strong shareholder rights and pressure are combined with a corporate objective that prioritizes shareholder interests, managers’ structural incentives are clearly not aligned with the objective of fostering a more other-regarding culture. However, even when a bank is subject to a multiple-interest rule, as Ferreira et. al.’s U.S. study shows, such rights may drive behavior that disregards non-shareholder concerns. It follows that where there are more powerful shareholder rights, managers’ commitment to the implementation of the initiatives is likely to more muted, thus undermining the

¹⁸⁴ See *Campbell v. Loews, Inc.*, 36 Del. Ch. 563, 134 A.2d 852 (1957) (The ‘cause’ threshold is a high one in effect requiring some form of breach of duty or illegality).

¹⁸⁵ DEL. GEN. CORP. LAW § 141(K). Note that the ‘with cause’ removal right is itself at default rule that can be amended by amending the certificate of incorporation.

¹⁸⁶ Del. Gen. Corp. Law § 211(d).

¹⁸⁷ German Stock Corp. Act § 103.

¹⁸⁸ Daniel Ferreira, David Kershaw, Tom Kirchmaier & Edmund Schuster, “After the Crisis: Is there a Case Against Shareholder Empowerment?” (on file with the authors).

¹⁸⁹ See also Reint Gropp & Matthias Köhler, *Bank Owners or Bank Managers: Who is Keen on Risk? Evidence from the Financial Crisis* (European Bus. Sch., Research Paper No. 10-02, Feb. 23, 2010) (taking a different approach but reaching some similar conclusions), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1555663.

potential effectiveness. This suggests that to create space for norm formation through the TCF, Extended TCF and TES Initiatives regulators will need to tack against the prevailing consensus that banks should be subject to stronger, not weaker, shareholder rights. It also suggests that, *ceteris paribus*, the U.S. and Germany provide more fertile soil for the initiatives than, for example, the U.K.

E. CORPORATE LAW: THE DUTY OF CARE

Above we have considered the ways in which an ethical culture could be connected to remuneration and governance arrangements which incentivize senior managers to commit to measures such as the TCF, Extended TCF and TES Initiatives and to relieve them, to a degree, from pressures to pursue shareholder value. But as managerial leadership is central to the success of the initiatives, we also need to consider the role that the threat of liability might potentially play.

Imposing liability upon directors for failing to take due care in the implementation of the TCF, Extended TCF and TES Initiatives would be one approach to incentivizing managerial leadership. At the same time, the well-trodden debate about the duty of care in the Anglo-American context shows that regulators need to be wary of imposing care expectations on directors. Where the standards are too high, directors will be fearful that carefully taken but unsuccessful decisions, or careful supervision that failed to identify non-compliant behavior, will *ex-post* and with the benefit of hindsight be judged unfavorably. As a result, directors may either refuse to serve or take an excessively risk-averse approach to decision making, monitoring and/or controls. It is this policy concern that explicitly informs Delaware corporate law with its gross negligence standard for the duty of care.¹⁹⁰ This standard is violated only where it can be shown that directors were ‘recklessly indifferent’ to the interests of the corporation¹⁹¹ or, in relation to internal controls, that there was “a sustained or systematic failure of the board to exercise oversight-such as an utter failure to attempt to assure a reasonable information and reporting system exists.”¹⁹² Perhaps, as John Armour and Jeffrey Gordon have recently argued, the policy concerns that underpin Delaware’s duty of care jurisprudence are less weighty in economic contexts such as banking where risk-taking is necessary and socially desirable but where, simultaneously, such risk-taking threatens significant negative externalities. In such contexts, dampening executive directors’ incentives to take risks may be a laudable policy objective.¹⁹³ For our purposes, if regulators make this election in favor of a

¹⁹⁰ See, e.g., *Gagliardi v. Trifoods, Int’l, Inc.*, 683 A.2d 1049 (Del. Ch. 1996). Note further in this regard that most Delaware corporations benefit from a complete liability waiver for duty of care violations which is permitted pursuant to section 102(b)(7) of the Delaware General Corporation Law.

¹⁹¹ *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (Del. Ch. 2005).

¹⁹² *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996); *In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A.2d 106 (Del. Ch. 2009).

¹⁹³ John Armour and Jeffrey N. Gordon, *Systemic Harms and the Limits of Shareholder Value* (on file with the authors, July 2012).

more demanding standard of care, this standard could play a role in incentivizing managers to engage effectively with the TCF, Extend TCF and TES Initiatives and, thereby, help facilitate norm formation.

In the U.K., higher care standards are already in place, although the probability of their enforcement is generally thought to be very low.¹⁹⁴ The U.K. standard of care is that of a hypothetical reasonable average director where – if the *actual* director in question has above average skills and experience – the hypothetical director is imbued with those above average skills and experience.¹⁹⁵ But how would the TCF, Extended TCF and TES Initiatives be incorporated into such a general standard? In order to understand the expectations generated by the care standard, recent Australian case law – applying a reasonable average director standard¹⁹⁶ – has begun to draw on the best practice guidance set forth in both corporate governance codes and trade association guidelines. These sources are used to identify the functions, and context-specific expectations, of directors when determining whether they have taken reasonable care. For example, in *Australian Securities and Investments Commission v. Rich*¹⁹⁷ the court took into account observations on the roles of directors in U.K. reports on board composition regulation¹⁹⁸ and a report from the British Confederation of Industry on the responsibilities of the British public company. More recently, the court in *ASIC v. Healey*¹⁹⁹, in finding a violation of the duty of care, drew on materials produced by the Australian Institute for Directors respecting the director's role vis-à-vis financial statements in order to understand the role and function of non-executive directors in relation to financial reports.

Following the lead of these Australian cases, guidelines and rules about a director's function and role can be used by courts to flesh out the substantive content of the care obligation. It can be argued, therefore, that where the TCF, Extended TCF and TES Initiatives place explicit obligations on executive directors to spearhead implementation, a failure to take such duties seriously – as a reasonable average director would take them – could expose directors to personal liability. Similarly, if the non-executive directors serving on our proposed ethics committee failed to perform their oversight role with due care, they could find themselves in breach of their care obligation.

Of course, in any jurisdiction where a high standard of care is adopted, the extent to which it would incentivize executive and non-executive directors to take their obligations under the TCF, Extended TCF and TES Initiatives seriously will

¹⁹⁴ John Armour, *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* (European Corp. Governance Inst., Working Paper No. 106/2008, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1133542.

¹⁹⁵ Companies Act, 2006 § 174.

¹⁹⁶ Australian Corporations Act § 180.

¹⁹⁷ 44 A.C.S.R. 431(2003).

¹⁹⁸ DEREK HIGGS, REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS (2003), available at <http://www.ecgi.org/codes/documents/higgsreport.pdf>.

¹⁹⁹ 278 A.L.R. 618(2011).

be a function not only of the standard of care and its interaction with the initiatives, but also of the probability that any breach will be enforced by either the company, a shareholder or, as is possible in Australia, by the regulator. However, here is not the place to address these broader corporate law issues. Further, even in jurisdictions where the standard of care is demanding and the probability of enforcement high, one would not expect to see many cases where directors, whether executive or non-executive, are found personally liable.²⁰⁰ Indeed, actual director liability is very rare in all jurisdictions.²⁰¹ This does not mean, however, that the threat of liability would not influence behavior – both positively in ensuring that the TCF, Extended TCF and TES Initiatives are taken seriously but also negatively, for example, where skilled executive and non-executive directors refuse to serve.

VI CONCLUSION

There is little doubt that, for better or worse, culture and ethics play an important role in the governance of financial services firms. There is less consensus, however, surrounding the question of whether, or to what extent, the law or markets can (or should) be utilized to generate meaningful cultural and/or ethical constraints in pursuit of broader social objectives. Whilst financial markets were on a seemingly endless upwards trajectory, the question was not a pressing one. In the wake of the GFC, however, it has justifiably been the subject of renewed focus. This paper has canvassed some of the ways which we might seek to engender a more ethical culture within the financial services industry. More specifically, it has illustrated how process-oriented regulation, combined with more radical restructuring of the internal governance arrangements of financial institutions, could be leveraged to achieve this laudable objective. Ultimately, however, there are no easy answers; no quick fixes. Nevertheless, public support from across the political spectrum – along with the stated commitment of financial leaders themselves – has created the opportunity for reform, and it should be taken.

²⁰⁰ Even in Australia, where these two preconditions are arguably applicable – particularly because ASIC, the Australian financial market regulator, has power to enforce breaches of duty – we still do not see higher levels of director liability. In *ASIC v Healey* for example, although the directors were found in breach no financial penalty was imposed upon them (*ASIC v Healey (No.2)* [2012] FCA 1003).

²⁰¹ See Bernard S. Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006).