



U.S. QFC Resolution Stay Final Rules

Maria Douvas

2018 Quadrilateral Presentation

June 2018

Agenda

U.S. QFC Resolution Stay Rule Overview	3
Compliance Timeline	4
U.S. ISDA Protocol	5
Appendix - U.S. QFC Resolution Stay Rule Summary	8

U.S. QFC Resolution Stay Rule Overview

- **Background.** To address “too big too fail” concerns arising out of the financial crisis, including the Lehman bankruptcy, U.S. prudential regulators have implemented U.S. Qualified Financial Contract (“QFC”) resolution stay rules
- **Purpose.** The purpose of these QFC rules is to allow for the orderly liquidation of global systemically significant U.S. bank holding companies and their affiliates and U.S. branches of foreign banks (collectively, “G-SIBs”)
- **Rule Requirements.** (See Appendix for further detail)
 - **Special Resolution Regimes.** Under these rules, QFCs (including over-the-counter and listed derivatives, foreign exchange, repo, stock loan and cash securities transactions) must limit transfer and default rights against a covered entity for up to 48 hours, if a special resolution regime (including the U.S. Orderly Liquidation Authority) is invoked
 - During this stay period, the FDIC may transfer all of the QFCs to a third-party financial institution (which, if transferred, permanently removes the ability to exercise defaults due to bankruptcy of the covered entity)
 - **Cross Defaults.** QFC agreements may not allow the exercise of any cross-default against a covered entity based on an affiliate’s entry into ordinary insolvency proceedings, so long as the covered entity continues to pay/perform and has not itself entered an insolvency proceeding
 - This permanent stay may be reduced to up to 48 hours in the case of cross defaults tied to a guarantor’s insolvency via the ISDA Protocol

Compliance Timeline

- **Phase-In.** The final rules provide a phased-in approach to compliance, depending on counterparty type:
 - **Phase 1:** January 1, 2019 for QFCs with other G-SIBs subject to the rule
 - **Phase 2:** July 1, 2019 for QFCs with other “financial counterparties” (which includes asset managers, pension plans and hedge funds)
 - **Phase 3:** January 1, 2020 for QFCs with community banks and all other end-user counterparties
- **Impact.** Any QFC transactions executed by G-SIB affiliates with Phase 2 or 3 counterparties on or after January 1, 2019, which is the rule’s effective date (“Effective Date), triggers a remediation requirement:
 - Any QFC trades executed on or after the Effective Date brings all QFCs between the G-SIB’s affiliates and the counterparty and its consolidated subsidiaries in scope (regardless of the date such QFCs were executed)
 - As a result, if any QFC trades are executed on or after the Effective Date but prior to the applicable phase-in date, then all QFC trades (regardless of the date such trades were executed) must be unwound

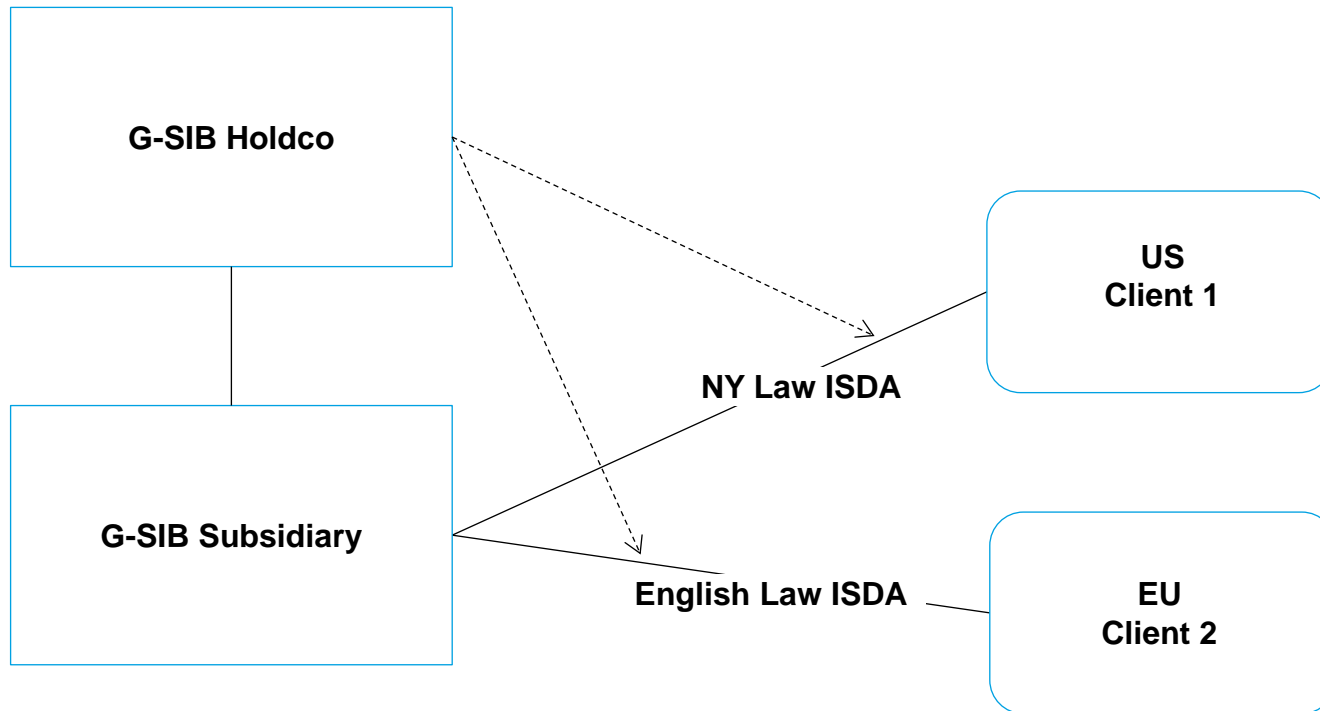
U.S. ISDA Protocol

- **Protocol v. Bilateral Amendment.** Compliance may be achieved either by bilateral amendment or through adherence to the U.S. ISDA Jurisdictional Modular Protocol (“ISDA JMP”) Protocol. (See Appendix for ISDA JMP scenarios)
 - For the cross default section of the QFC rules, adherence to the ISDA JMP provides counterparties with certain creditor protections in an ordinary resolution or insolvency of the G-SIB. These creditor protections include:
 - An up to 48 hour stay of cross defaults to an affiliate guarantor, in order to allow time for the bankruptcy court to either (A) elevate the guarantee above the senior unsecured creditors or (B) transfer the guarantor’s assets to a 3rd party (in which case the cross default to the guarantor is permanently stayed)
 - Under the terms of the QFC rules, creditor protections under the ISDA JMP are not available to bilateral amendments of QFC agreements
- **G-SIBs & 2015 Protocol.** ISDA JMP is drafted and substantively mirrors the 2015 ISDA Universal Resolution Stay Protocol (adjustments reflect changes in the final rules, and allow for more tailored adherence by funds represented by asset managers)
 - G-SIBs adhered to the 2015 ISDA Universal Resolution Stay Protocol, which covers ISDAs and certain repurchase agreement and stock loan industry master agreements
- **ISDA JMP Timing.** Publication is expected in June, although the additional platform tool for tracking and managing adherence will be available three to five months after ISDA’s publication

ISDA JMP – Section 1: Special Resolution Regime

Example 1: G-SIB Holdco is taken over under a U.S. Special Resolution Regime

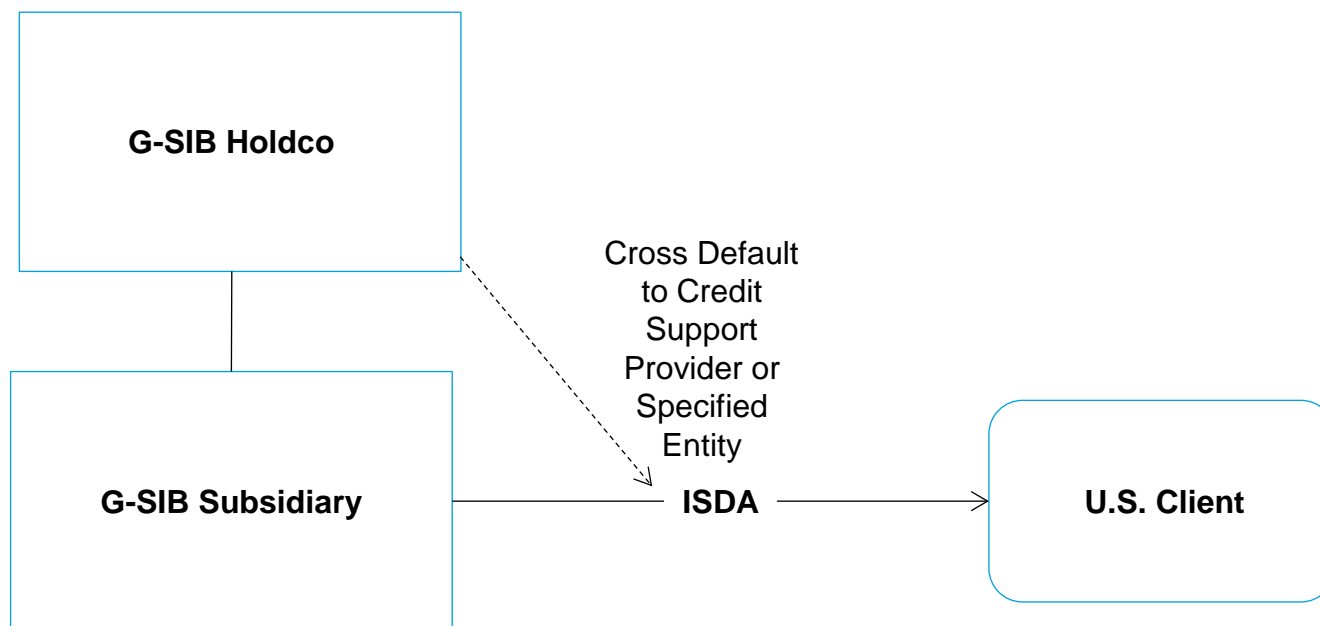
1. G-SIB Holdco enters into insolvency proceedings under the Orderly Liquidation Authority, a U.S. Special Resolution regime
2. EU client must adhere to the ISDA JMP. US client does not have to adhere to the ISDA JMP
3. Both clients 1 and 2 may not terminate their QFC master agreements with G-SIB subsidiary (regardless of the governing law of their agreement) for up to 48 hours provided G-SIB subsidiary (i) is performing and (ii) has not declared bankruptcy



ISDA JMP – Section 2: Chapter 11 Insolvency & Cross Defaults

Example 3: Cross-Default to Affiliate in U.S. Insolvency Proceedings

1. G-SIB Holdco files for Chapter 11 bankruptcy proceeding
2. Client has a cross default to G-SIB Holdco under its ISDA with G-SIB Subsidiary
3. If cross default is tied to G-SIB Holdco's guaranty, client is stayed for up to 48 hours (or permanently if guarantee is elevated in the bankruptcy or assets are transferred to a 3rd party), provided G-SIB Subsidiary continues to pay/perform and is not insolvent
4. If cross default is tied to G-SIB Holdco but Holdco is not a guarantor, client is permanently stay, provided G-SIB subsidiary continues to pay/perform and is not insolvent



Appendix

U.S. QFC Resolution Stay Rule Summary

KEY PROVISIONS

- Requires contractual provisions that opt into the temporary stay-and-transfer rule (“U.S. Special Resolution Regimes”) unless QFC contract governed by U.S. law and with U.S. counterparty
- Prohibits the exercise of cross default provisions in QFCs related to an affiliated party’s insolvency (except in the case where counterparty has signed the ISDA JMP, which provides certain creditor protections for guarantor-related cross defaults)

COVERED ENTITIES / QFC SCOPE

- Covered Entities: U.S. GSIBs, subsidiaries of U.S. GSIBs and U.S. operations of foreign GSIBs
- National banks subsidiaries of G-SIBs are covered by substantively identical OCC rules
- Adopts Dodd-Frank Act’s definition of QFC: includes derivative contracts, repo, securities lending, futures contracts and commodities contracts

EXCLUSIONS

- QFCs with a counterparty domiciled in the U.S. and governed by U.S. law do not have to remediate the stay-and-transfer provisions of the U.S. Special Resolution Regimes
- QFCs that do not provide default rights or transfer rights (QFCs with transfer rights but no default rights are in scope)
- Investment advisory contracts with “retail” customers with no default rights but with transfer restrictions mandated by the Investment Advisor’s Act
- QFCs with central clearing counterparties and financial market utilities

SCOPE OF COVERED ENTITIES

- Covered Entities: U.S. GSIBs, subsidiaries of U.S. GSIBs and U.S. operations of foreign GSIBs
- Defines covered entity subsidiary by reference to the Bank Holding Company Act “control” standard rather than GAAP “consolidated subsidiary” approach
- Does carve out certain specified covered entity subsidiary companies (e.g., merchant banking portfolio companies) but not securitizations

Uncleared Derivatives Initial Margin: Implementation Challenges for 2019- 2020

Quadrilateral Meeting of the FMLC/FMLG/FLB/EFMLG

Greg Todd, Managing Director and Associate General Counsel

Frankfurt, Germany
June 7, 2018

Disclaimer

“Bank of America Merrill Lynch” is the marketing name for the global banking and global markets businesses of Bank of America Corporation. Lending, derivatives, and other commercial banking activities are performed globally by banking affiliates of Bank of America Corporation, including Bank of America, N.A., member FDIC. Securities, strategic advisory, and other investment banking activities are performed globally by investment banking affiliates of Bank of America Corporation (“Investment Banking Affiliates”), including, in the United States, Merrill Lynch, Pierce, Fenner & Smith Incorporated and Merrill Lynch Professional Clearing Corp., which are both registered broker dealers and members of FINRA and SIPC, and, in other jurisdictions, by locally registered entities.

Investment products offered by Investment Banking Affiliates: Are Not FDIC Insured * May Lose Value * Are Not Bank Guaranteed.

These materials have been prepared by one or more subsidiaries of Bank of America Corporation for the client or potential client to whom such materials are directly addressed and delivered (the “Company”) in connection with an actual or potential mandate or engagement and may not be used or relied upon for any purpose other than as specifically contemplated by a written agreement with us. These materials are based on information provided by or on behalf of the Company and/or other potential transaction participants, from public sources or otherwise reviewed by us. We assume no responsibility for independent investigation or verification of such information (including, without limitation, data from third party suppliers) and have relied on such information being complete and accurate in all material respects. To the extent such information includes estimates and forecasts of future financial performance prepared by or reviewed with the managements of the Company and/or other potential transaction participants or obtained from public sources, we have assumed that such estimates and forecasts have been reasonably prepared on bases reflecting the best currently available estimates and judgments of such managements (or, with respect to estimates and forecasts obtained from public sources, represent reasonable estimates). No representation or warranty, express or implied, is made as to the accuracy or completeness of such information and nothing contained herein is, or shall be relied upon as, a representation, whether as to the past, the present or the future. These materials were designed for use by specific persons familiar with the business and affairs of the Company and are being furnished and should be considered only in connection with other information, oral or written, being provided by us in connection herewith. These materials are not intended to provide the sole basis for evaluating, and should not be considered a recommendation with respect to, any transaction or other matter. These materials do not constitute an offer or solicitation to sell or purchase any securities and are not a commitment by Bank of America Corporation or any of its affiliates to provide or arrange any financing for any transaction or to purchase any security in connection therewith. These materials are for discussion purposes only and are subject to our review and assessment from a legal, compliance, accounting policy and risk perspective, as appropriate, following our discussion with the Company. We assume no obligation to update or otherwise revise these materials. These materials have not been prepared with a view toward public disclosure under applicable securities laws or otherwise, are intended for the benefit and use of the Company, and may not be reproduced, disseminated, quoted or referred to, in whole or in part, without our prior written consent. These materials may not reflect information known to other professionals in other business areas of Bank of America Corporation and its affiliates.

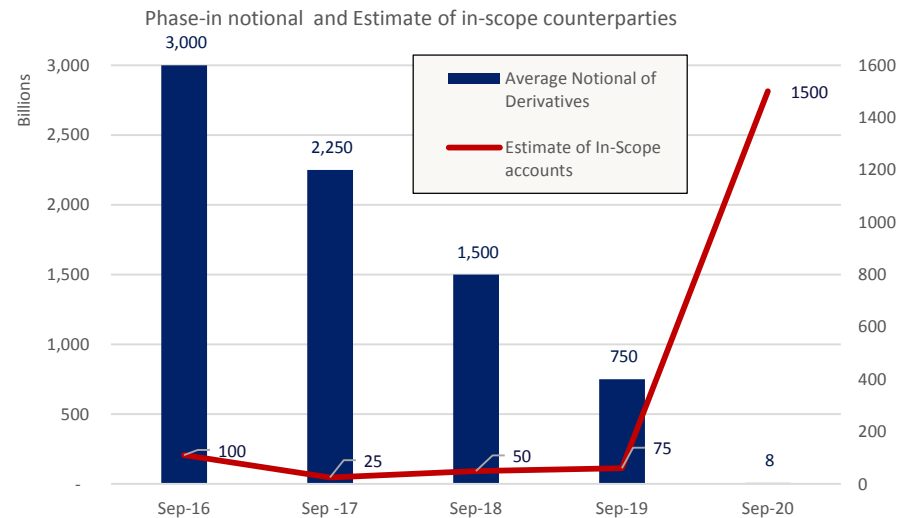
Bank of America Corporation and its affiliates (collectively, the “BAC Group”) comprise a full service securities firm and commercial bank engaged in securities, commodities and derivatives trading, foreign exchange and other brokerage activities, and principal investing as well as providing investment, corporate and private banking, asset and investment management, financing and strategic advisory services and other commercial services and products to a wide range of corporations, governments and individuals, domestically and offshore, from which conflicting interests or duties, or a perception thereof, may arise. In the ordinary course of these activities, parts of the BAC Group at any time may invest on a principal basis or manage funds that invest, make or hold long or short positions, finance positions or trade or otherwise effect transactions, for their own accounts or the accounts of customers, in debt, equity or other securities or financial instruments (including derivatives, bank loans or other obligations) of the Company, potential counterparties or any other company that may be involved in a transaction. Products and services that may be referenced in the accompanying materials may be provided through one or more affiliates of Bank of America Corporation. We have adopted policies and guidelines designed to preserve the independence of our research analysts. The BAC Group prohibits employees from, directly or indirectly, offering a favorable research rating or specific price target, or offering to change a rating or price target to a subject company as consideration or inducement for the receipt of business or for compensation and the BAC Group prohibits research analysts from being directly compensated for involvement in investment banking transactions. We are required to obtain, verify and record certain information that identifies the Company, which information includes the name and address of the Company and other information that will allow us to identify the Company in accordance, as applicable, with the USA Patriot Act (Title III of Pub. L. 107-56 (signed into law October 26, 2001)) and such other laws, rules and regulations as applicable within and outside the United States.

We do not provide legal, compliance, tax or accounting advice. Accordingly, any statements contained herein as to tax matters were neither written nor intended by us to be used and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on such taxpayer. If any person uses or refers to any such tax statement in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to any taxpayer, then the statement expressed herein is being delivered to support the promotion or marketing of the transaction or matter addressed and the recipient should seek advice based on its particular circumstances from an independent tax advisor. Notwithstanding anything that may appear herein or in other materials to the contrary, the Company shall be permitted to disclose the tax treatment and tax structure of a transaction (including any materials, opinions or analyses relating to such tax treatment or tax structure, but without disclosure of identifying information or, except to the extent relating to such tax structure or tax treatment, any nonpublic commercial or financial information) on and after the earliest to occur of the date of (i) public announcement of discussions relating to such transaction, (ii) public announcement of such transaction or (iii) execution of a definitive agreement (with or without conditions) to enter into such transaction; provided, however, that if such transaction is not consummated for any reason, the provisions of this sentence shall cease to apply. Copyright 2013 Bank of America Corporation.

Background

New In-scope Counterparties (NICS) in 2019 and 2020

- **Initial Margin Phases in Through 2020:** Uncleared derivatives margin rules phase in initial margin requirements will continue to phase in as notional thresholds drop to USD/EUR 8 billion in 2020-global dealers expect 1200 to 1500 client relationships to become subject to initial margin requirements in Sept. 2020. Typical number of in-scope accounts encountered by a large dealer are shown below:



- **Variation Margin Implementation Experience of Limited Value:** initial margin presents new challenges in funding, operations, calculation concepts, setup and monitoring for counterparties who are largely unfamiliar with initial margin concepts
- **Timing and Scale of Preparation Are Key Drivers:**
 - NISCs will most likely converge in timing of their final preparations for go-live so that their efforts occur concurrently, typically six months before relevant phase-in dates.
 - In preparation for go-live, NISCs will demand attention from key infrastructure components (e.g. banks, custodians, middleware vendors, and consultants) at the same time, congesting industry resources and creating bottlenecks.

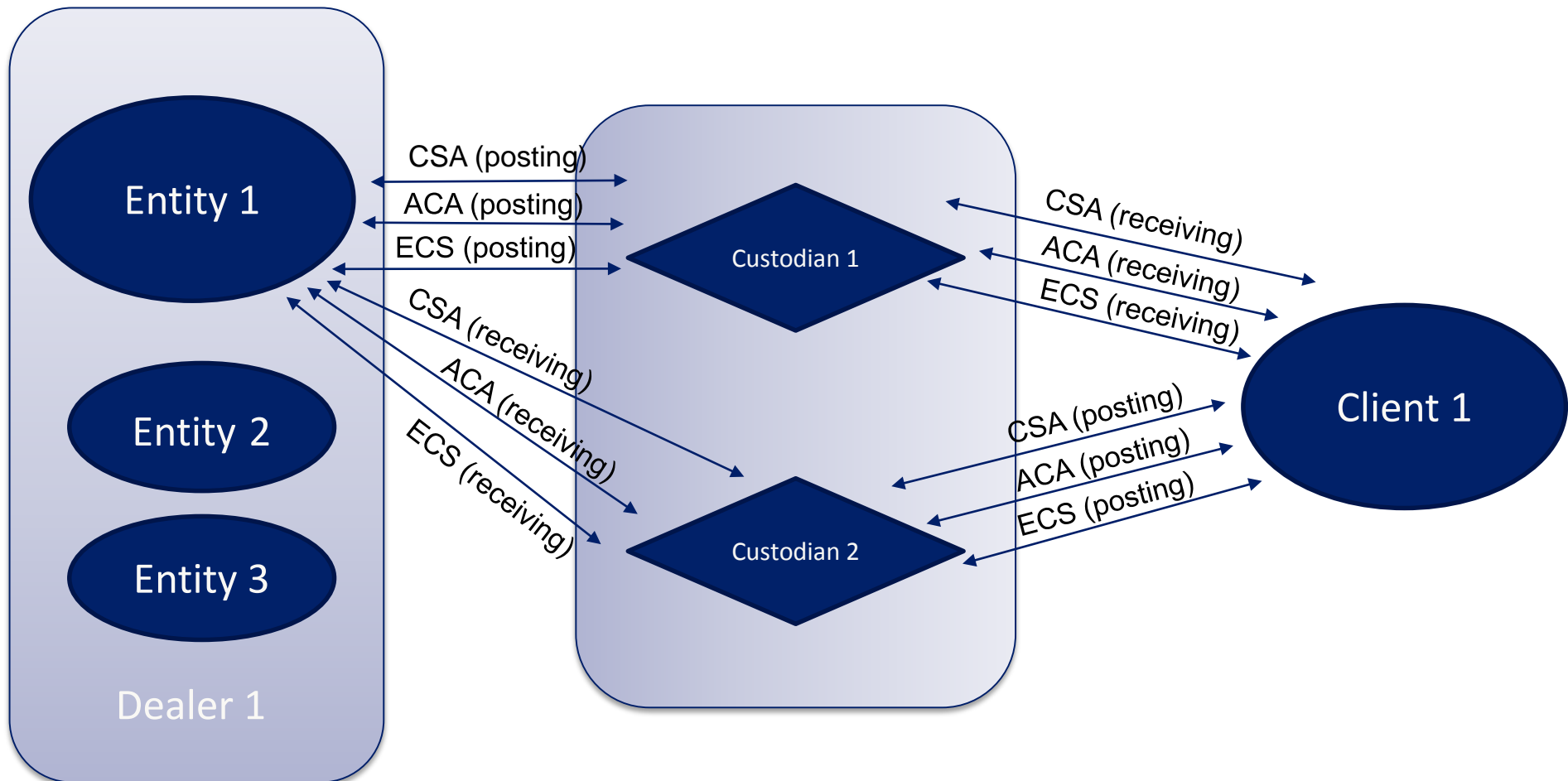
New In-scope Counterparties (NISCs)

Compliance Requirements

CSA Negotiations	<ul style="list-style-type: none">▪ Credit Support Annexes (CSAs) incorporating initial margin rule requirements and processes need to be executed with trading counterparties.
Custodial Documents and Account Setup	<ul style="list-style-type: none">▪ Custodian Account Control Agreements (ACA) need to be executed between trading counterparties and custodians.▪ Segregated accounts for posting and collection of collateral need to be set up.
Initial Margin Calculations	<ul style="list-style-type: none">▪ ISDA SIMM (SIMM), approved internal models, or standardized schedules published in uncleared derivative margin rules (grid) need to be implemented to calculate daily initial margin posting requirements.▪ Uncleared derivative margin rules may require that firms carefully monitor model performance, ensuring that regulatory requirements (99% confidence, 10-day) are maintained. Any issues need to be reported to ISDA and/or regulators.▪ Any risk exceedences require additional margin collection based on bilateral discussions.
Operational Build-out	<ul style="list-style-type: none">▪ Identification of in-scope trades▪ Calculation and mapping of risk sensitivities into standard risk files to reconcile initial margin▪ Synchronization of initial margin calculations for operational requirements (e.g. time zone effects, collateral delivery cutoff times, T+1, etc.)▪ Dispute management processes▪ Collateral funding/management at segregated custodial accounts

Challenges for NISCs

Custodian Documentation and Account Setup



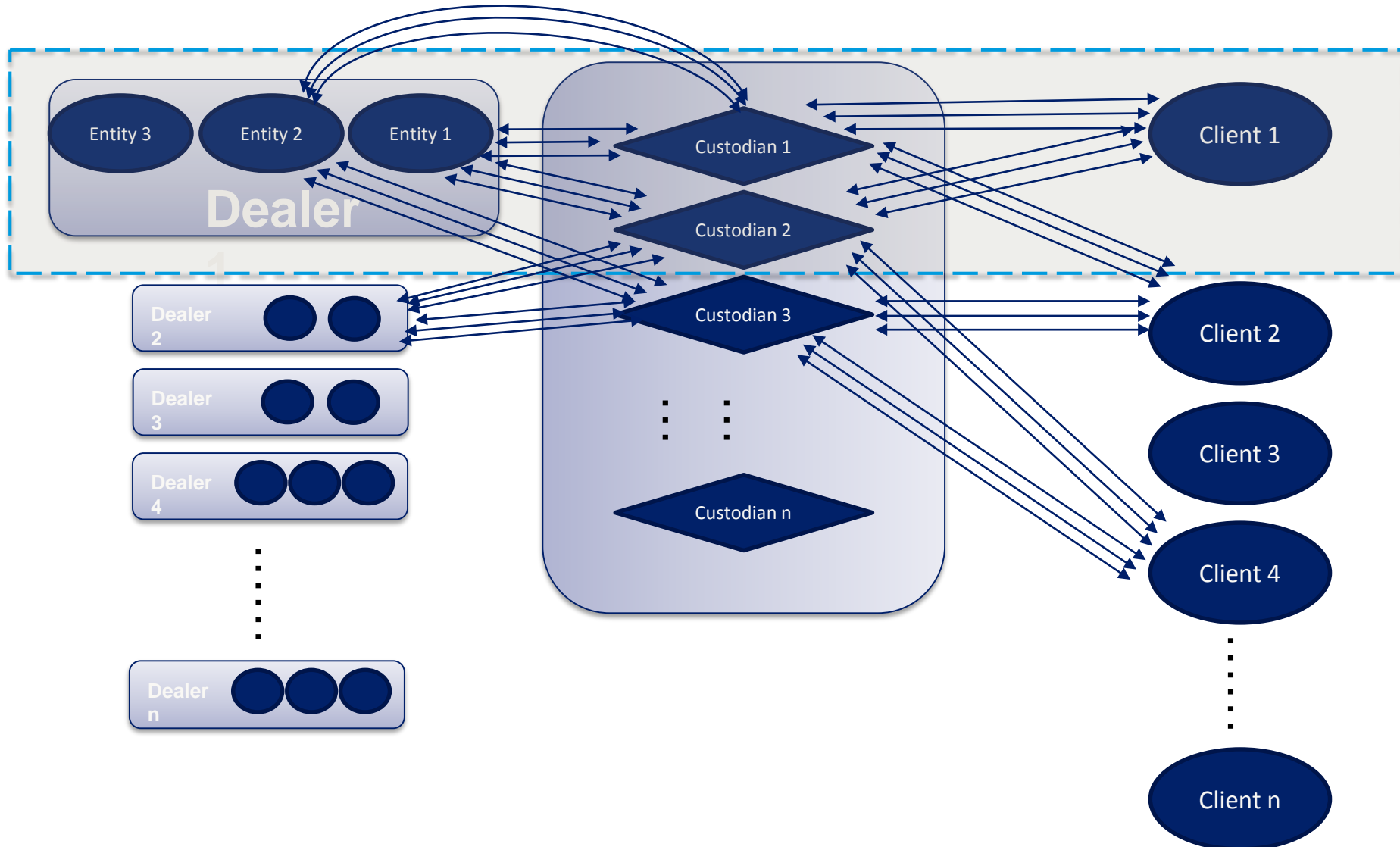
- A counterparty relationship between firms A and B may require 2 sets of custodial documents (ACA and ECS) and 2 CSAs across up to four custodial relationships to cover posting and receiving relationships.

CSA: Credit Support Annex
ACA: Account Control Agreement
ECS: Eligible Collateral Schedules

Challenges for NISCs

Custodian Documentation and Account Setup

As more NISCs are brought into scope for initial margin requirements, the complexity involving signing of custodial documents and CSAs increases dramatically.



Challenges for NISCs

Defining and Managing Netting Sets

Counterparties must have a clear understanding of the portfolio of in-scope trades in their relationship to calculate initial margin. The task of identifying which trades in a trading relationship are subject to uncleared derivative margin requirements requires substantial work.

- **Individual Trade Tracking:** Building the capability to track each trade in a portfolio by product and jurisdiction will be a considerable challenge for many NISCs.
- **Overlapping Margin Regimes:** The need to calculate and collect or post the “higher-of” multiple potential netting sets where firms are subject to overlapping uncleared margin rule sets will be an additional complication.
- **Multiple CSAs under Single Master:** NISCs must also have the ability to partition trading portfolios into multiple netting sets (legacy trade and regulatory initial margin sets) to calculate initial margin. Infrastructure build to deal with these implications will be complex and time-consuming.
- **Implications for Applying Initial Margin to All Trades:** Some firms might avoid netting set complexity simply electing to apply initial margin to all trades. This potentially increases initial margin requirements significantly, especially if such firms apply the standardized grid schedule approach in lieu of SIMM.

Challenges for NISCs

Initial Margin Calculation Methodology

NISCs will need to use either standardized schedules published in the uncleared derivative margin rules (“grid methodology”) or internal models (including SIMM) to calculate initial margin.

Grid Methodology

- **Proper Netting Sets Critical:** The primary challenge for firms using the grid methodology will lie in determining proper netting sets of in-scope products.
- **Ambiguity Presents Challenges:** Participants may find the grid methodology confusing for some products where tenors and notionals do not readily apply (e.g. callable instruments, vega-quoted products).
- **Higher Initial Margin Calculations:** Firms basing calculations on the grid methodology may require substantially higher initial margins than those using risk-based methodologies such as SIMM, encumbering their trading counterparties with higher costs which may be reflected in pricing.

Challenges for NISCs

Initial Margin Calculation Methodology

Internal model / ISDA SIMM

▪ **Model Choice:**

- SIMM presents a simplified risk based model which generally results in lower initial margin requirements compared to grid-based calculations, particularly where risk offsets exist.
- SIMM support environment is well established. SIMM is well known to regulators who must often approve internal models.
- The vast majority of initial margin implementation to date has been achieved by using SIMM. It is a common model between trading counterparties helps them to resolve margin disputes and predict liquidity requirements. New industry models, if they appear, would require broad adoption and approval.
- Internal enterprise risk systems or capital models are unsuited for daily margining.

▪ **Demonstrating Proper Implementation:**

- Model inputs need to be expressed in consistent and defined data file formats for use by counterparties and middleware providers/vendors.
- Model inputs must reflect proper netting sets (in-scope products), sensitivity calculations, sensitivity mapping.
- Unit testing – There is currently no standard to reflect to a user's counterparties whether it has implemented the model correctly. ISDA may need to formulate a system where licensees are required to demonstrate that they have correctly implemented SIMM to achieve certification.

▪ **Monitoring Requirements:**

- Monitoring requirements apply to dealers subject to US rules and all market participants subject to EU and Japanese rules. Small banks and buy-side firms in the EU and Japan will struggle to roll out and manage expensive monitoring and margin remediation capabilities.
- EU and Japanese regulators will require resources to effectively supervise and interpret monitoring processes, results, and margin remediation taking place across these firms.

Challenges for NISCs

Reconciliation and Dispute Resolution

Counterparties need to compare margin calculations with their trading counterparties and identify sources of disputes.

Industry Dependency on Middleware Providers for Reconciliation:

- Dealers exchanging initial margin use an industry middleware provider to help them review and identify sources of disputes regarding initial margin calculations. No other providers currently exist.
- Dealers electronically send their portfolio characteristics via “CRIF” files to a middleware reconciliation service provider, which provides tracking and reconciliation services on each bilateral portfolio.

Middleware Provider Readiness:

- The existing middleware reconciliation service provider will face demand from significantly more NISCs in 2019 and 2020. NISCs will each have their own operational and technical support requirements, and may face an onboarding bottleneck from service providers.
- Any middleware service providers need to scale onboarding resources to demand and communicate a detailed and credible plan to do so.

Onboarding and Testing:

- Onboarding NISCs to middleware service providers will require connections to middleware providers, testing resources, onboarding resources and credible plans.

Impact of Multiple Service Providers:

- While more reconciliation service providers may help deal with future demand, introducing too many new providers may degrade the network benefits and consistency of a single reconciliation provider, increasing disputes among market participants.

Challenges for NISCs

Funding and Collateral

- **Collateral required to be posted by NISCs may be substantial.**
 - NISCs' collection requirements could be even greater if NISCs insist on collecting initial margin using (or are forced to use) the grid methodology.
 - These higher initial margin amounts represent a real funding cost to NISCs' counterparties, and may lead to trading or pricing impact.

- **Collateral type presents another potential problem.**
 - Custodians are reluctant to accept cash for initial margin due to balance sheet impact, but many clients may see cash posting as an attractive option if they do not have eligible securities available.
 - Cash is relatively easy to settle quickly; given collateral must settle the same day as the call (T+1 requirement under US rules), many market participants will not be able to settle non-cash collateral in time.

- **Some NISCs may prefer to post equities, bonds and other securities they have on hand.**
 - Corporate bonds must be monitored according to in-house ratings which are typically proprietary. Equities need to be screened to conform to regulations requiring that they are components of specific country equity indices.
 - Custodians, banks, and NISCs may have trouble conforming to the myriad of regulations governing non-sovereign securities collateral.

The overall preparation burden for the industry, and for NISCs, custodians, and middleware providers, is staggering. The short-term, non-repeatable nature of the necessary work is also problematic.

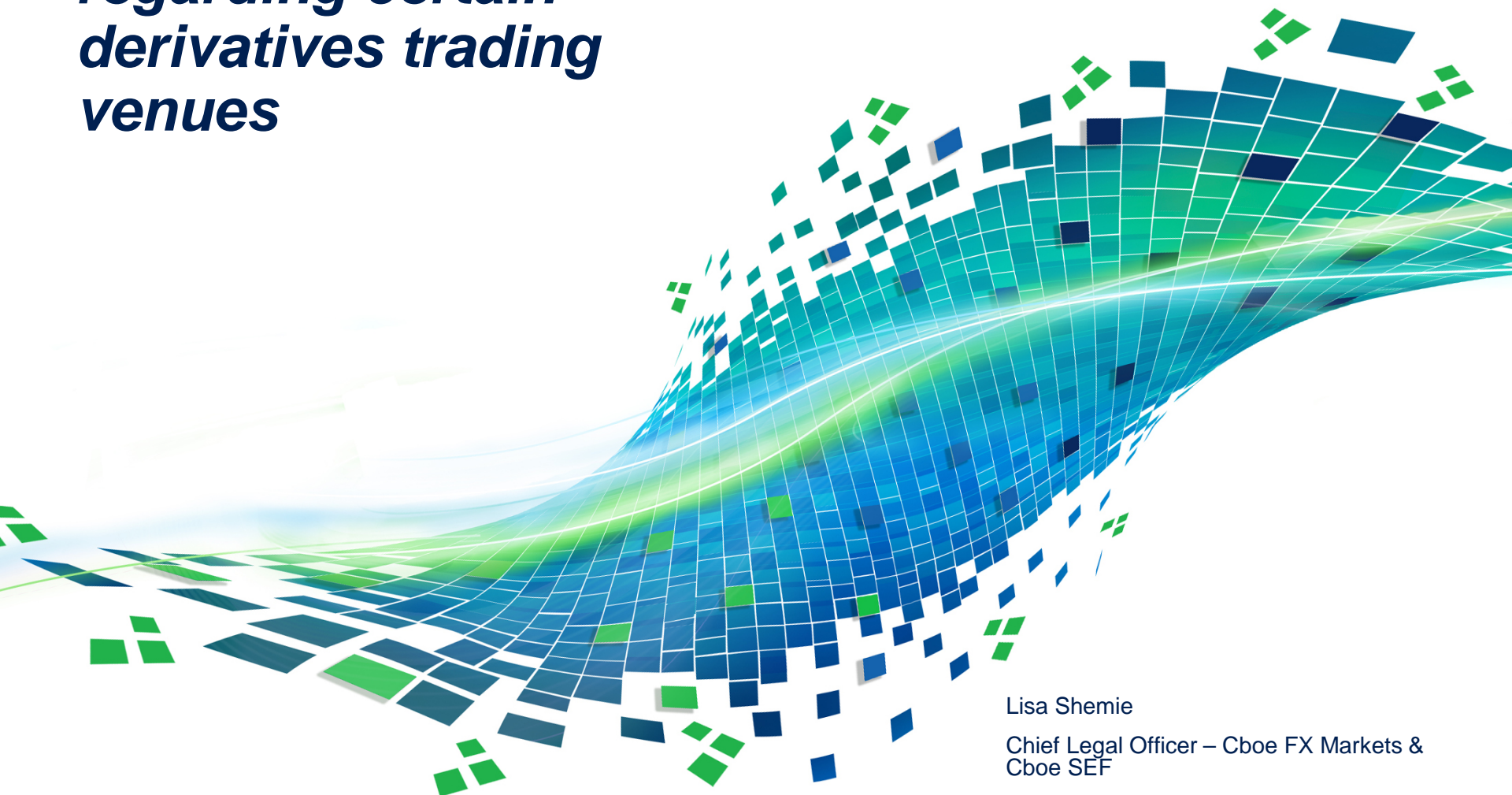
- NISCs will have significant internal demands:
 - Legal teams and/or documentation units must negotiate documents.
 - Risk teams must review processes and eligible collateral.
 - Collateral and operations teams must work out new processes.
 - Technology teams must build crucial data and calculation capabilities.

- Custodians and middleware providers will have to onboard firms, test, and handhold clients, in an extremely compressed timeframe.

- Many firms will rely on external consultants, contractors, etc. to provide short term resourcing and expertise. With thousands of participants coming onto line at once, reliable professional help will be in high demand, stretched, or simply unavailable.

- **Regulators:**
 - Set expectations for custodians, middleware providers and NICs
 - Additional harmonization and rule/guidance changes to simplify operational and documentation demands
 - Consider distributing impact across additional effective dates
- **Custodians and Middleware providers:**
 - Plan transparency
 - Must scale up offerings
 - New entrants
- **NICS**
 - Act early given long lead time for implementation (2-3 years)
 - Consider alternative products if trading will be disrupted
- **Global Dealers**
 - ISDA/SIFMA data-sharing exercise to inform implementation effort
 - Knowledge sharing with impacted clients

***US-EC equivalency
determinations
regarding certain
derivatives trading
venues***



Lisa Shemie

Chief Legal Officer – Cboe FX Markets &
Cboe SEF

June 7, 2018

CFTC and EC: “Common approach” to derivatives trading venues



- ❖ In **October 2017** the Commodity Futures Trading Commission (CFTC) and the European Commission (EC) announced a “**common approach**” to certain derivatives trading venues.
- ❖ The aim of this common approach was to ensure that:
 - EU counterparties are able to comply with the **trading obligation** under **Article 28 of the Markets in Financial Instruments Regulation (MiFIR)** by executing mandated derivatives on CFTC-authorized swap execution facilities (SEFs) or designated contract markets (DCMs), as well as on EU authorized trading venues such as multilateral trading facilities (MTFs) and organized trading facilities (OTFs), and
 - US counterparties are able to comply with the **trade execution requirement** under **Section 2(h)(8) of the Commodity Exchange Act (CEA)** by executing swaps on MTFs or OTFs, as well as on SEFs and DCMs.
- ❖ In **December 2017** the EC issued its equivalence determination, listing certain SEFs and DCMs the venues that it considered “equivalent” for trading mandate purposes. The CFTC issued a similar determination in the form of a registration exemption order.

- ❖ **Article 28 of MiFIR** aims to allow financial and certain non-financial counterparties established in the European Union to enter into derivatives transactions subject to a trading obligation on third-country venues recognized as equivalent.
- ❖ In December 2017 the EC issued its equivalence determination, concluding that the legal and supervisory arrangements governing SEFs and DCMs fulfilled the **four conditions** required under Article 28 of MiFIR:
 - That the third-country trading venue be subject to authorization and to effective supervision and enforcement on an ongoing basis;
 - That the third-country trading venue have clear and transparent rules regarding admission of financial instruments to trading so that such financial instruments are capable of being traded in a fair, orderly and efficient manner and are freely negotiable;
 - That issuers of financial instruments be subject to periodic and ongoing information requirements ensuring a high level of investor protection; and
 - That the third-country framework ensure market transparency and integrity via rules addressing market abuse in the form of insider dealing and market manipulation.

- ❖ **Section 5h(g) of the CEA** authorizes the CFTC to exempt a SEF from registration under CEA Section 5h if the CFTC finds that the facility is “subject to comparable, comprehensive supervision and regulation on a consolidated basis by...the appropriate governmental authorities in the home country of the facility.”
- ❖ In contrast to Article 28 of MiFIR, Section 5h(g) of the CEA does not prescribe specific conditions to be fulfilled in order to allow the CFTC to make this determination.
- ❖ In December 2017, the CFTC issued an exemption order, concluding that the regulatory frameworks for certain MTFs and OTFs satisfy the statutory standard set forth in Section 5h(g) of the CEA, relying on information received from the Directorate-General for Financial Stability, Financial Services and Capital Markets Union (the EC department responsible for EU policy on banking and finance).
- ❖ The order states that transactions involving swaps that are subject to CEA section 2(h)(8) (the trade execution requirement) may be executed on an MTF or OTF listed on the order, and also states that swaps that are not subject to the trade execution requirement may be executed there as well.

What does the equivalency determination mean? What does it NOT mean?

Trading obligation - **yes**

- ❖ To the extent an EU entity is required to trade certain instruments on an MTF or OTF, it may do so on a SEF or DCM. To the extent a US entity is required to trade certain instruments on a SEF or DCM, it may do so on an MTF or an OTF.

Reporting - **no**

- ❖ An EU entity may **not** satisfy its **post-trade transparency reporting requirements** by relying on the reporting of its transactions by the US trading venue, nor can a US entity rely on an MTF or OTF to satisfy its post-trade reporting requirements.
- ❖ The European Securities and Markets Authority (ESMA) is currently studying whether a second equivalency determination – relating to post-trade transparency – is warranted.

What does equivalency determination mean? What does it NOT mean?

EU local registration obligations - no

- ❖ Each EU member state has its own rules regarding the ability to provide investment services in that jurisdiction. It appears that those local requirements are not trumped by the equivalency determination. That means that in order for a SEF to allow European persons to join it, the SEF may *also* have to comply with those local requirements, notwithstanding the equivalency determination.

US local registration obligations – n/a

- ❖ Beyond registration as a SEF by the CFTC, there are no additional local registration requirements that a European person would have to comply with in order to have US persons access its MTF or OTF.

How could this uncertainty have been avoided?

- ❖ **Article 47 of MiFIR** sets out a broader equivalency decision mechanism, which allows ESMA to enter into cooperation agreements with the regulators of third countries.
- ❖ Whereas **Article 28** is limited to issues relating to trading obligations, **Article 47** appears to allow for a broader equivalency between jurisdictions. ESMA must determine whether “the legal framework of that third country provides for an effective equivalent system for the recognition of investment firms authorised under third-country legal regimes.”
- ❖ If certain conditions prescribed by Article 47 are deemed by ESMA to have been met, then it appears that a broader equivalency may be possible.

EUROPEAN REGULATORY DEVELOPMENTS: MIFID 2/MIFIR & PRIIPS

Ignacio Ollero

**Quadrilateral meeting of the
FMLC / FMLG / FLB / EFMLG**

Frankfurt, 7 & 8 June 2018

2018 started with...

...important changes in the European regulatory field. Such as:

PRIIPs

- Standardize documentation (KID) about certain products (PRIIPs)
- More simple and homogeneous information to retail clients
- Comparison among PRIIPs

- Open list: amount repayable subject to fluctuations due to exposure to reference values or assets not directly purchased by the retail investor

- Worldwide products
- EEA clients



MiFIR / MiFID 2

- Increase transparency in financial markets
- Strengthen investor protection
- Reduction of OTC trades: from OTC to trading venues

- Closed list: financial instruments

- Worldwide products
- Different obligations, different scope

PRIIPs – Extraterritorial effects

- EC “Considerations” on PRIIPs limits the territorial scope to retail clients in the EEA
- However, third country firms may be indirectly affected
- No PRIIP may be sold (by any means and irrespectively of who takes the initiative) to a retail investor in the EEA if there is no KID available
- *Manufacturers* from third countries should prepare and keep updated and available (webpage) KIDs for such PRIIPs they want to sell in EEA either directly or through a distributor, including legacy

➤ Trading obligation for shares (art. 23 MiFIR):

- Trading in shares admitted to trading on a EU trading venue (TV) must be traded on an EU TV, systematic internalizer or equivalent third country TV
- Exemptions for **(i)** ad hoc, non systemic, irregular, infrequent trades; **(ii)** trades not contributing to price discovery process
- **Problem:** equivalency only for Australia, HK, US and Switzerland
- **Solution:** ESMA Q&A dated 13th November 2017

➤ Post-transparency obligations (art. 14 & 21 MiFIR):

- Firms dealing OTC in instruments traded on a TV shall make public volume and prices of those trades
- **Problem:** no third country venue deemed to be equivalent for the time being. Does it mean is OTC and post-transparency rules apply?
- **Solution:** ESMA Opinion dated 31st May 2017

➤ Trading obligation for derivatives (art. 28 MiFIR):

- Derivatives subject to the trading obligation between FC and/or NFC+ (EMIR) shall be concluded on a EU trading venue (TV) or equivalent third country TV
- Exemptions for intragroup transactions
- **Problem:** (i) only USA equivalence decision (no other third country venue deemed to be equivalent); (ii) problems with intragroup transactions after December 2018
- **Solution:** no regulatory solution for the time being

➤ Services by third country firms (art. 46 & 47 MiFIR):

- Third country firms may provide investment services to professionals and eligible counterparties without a branch if they are included in ESMA register and its legislation is deemed to be equivalent
- **Problem:** no third country legislation deemed to be equivalent
- **Solution:** no regulatory solution for the time being

Thank you

Ignacio Ollero

**Quadrilateral meeting of the
FMLC / FMLG / FLB / EFMLG**

Frankfurt, 7 & 8 June 2018

Banking reform
REVIEW OF THE BRRD/CRR
SELECTED ISSUES
Presentation to Quadrilateral meeting
FMLC/FMLG/FLB/EFMLG
7 & 8 JUNE 2018

Asmaa CHEIKH
Director
LEGAL DEPARTMENT – FINANCIAL AND BANKING REGULATIONS



I. INTRODUCTION – EU BANKING REFORM PACKAGE

II. BRRD 2 – (EU Council Presidency Compromise text dated 22 May 2018 – 2016/0362(COD))

- A. Review of article 55 BRRD
- B. Proposed 33a BRRD on the power to suspend certain obligations (moratoria tools)
- C. Proposed article 44(2)(f) BRRD on liabilities excluded from the scope of the bail-in tool
- D. Safeguards for netting in the case of repo and stock lending whilst applying bail-in
- E. Proposed article 71a Contractual Recognition of Resolution Stay Powers

III. CRR2 (EU Council Presidency Compromise text dated 22 May 2018 – 2016/0362(COD)) – Article 494b –Transitional measures

I. INTRODUCTION

❑ EU BANKING REFORM PACKAGE (23rd November 2016)

- The EU Commission published proposals to amend and supplement certain provisions of, among other things, the Capital Requirements Directive (“CDR”), the Capital Requirements Regulation (“CRR”) and the Bank Recovery and Resolution Directive (“BRRD”)
- The proposals are wide-ranging and will be significant for many EU institutions
- They include, inter alia:
 - a binding leverage ratio
 - a binding net stable funding ratio
 - more risk-sensitive capital requirements relating to the trading book
 - new international standards to implement total-loss-absorbing capacity (“TLAC”) for global systematically-important institutions
 - a new asset class of “non-preferred” senior debt and,
 - several important amendments to the BRRD which may profoundly impact financial market law (“BRRD2”)

❑ THE LEGISLATIVE PROCESS

- The publication of these proposals kicks-off an EU legislative process ———→ “the ordinary legislative procedure”
- This procedure typically takes around 18 months but in the past more complex pieces of legislations (the original versions of CRD IV, CRR and BRRD included) have taken up to 24 months
- These proposals will need to be transposed into domestic law of member states → with the exception of article 108 BRRD, the entry into force of the new proposals are expected in 2019 at the earliest

❑ DISCUSSION

- The focus of today’s presentation is to provide an update on some of the main provisions of BRRD2

II. BRRD 2

A. Review of article 55 BRRD

Version presented by the EU Commission/23 Nov. 2016

- The Commission's proposal seeks to revise the contractual recognition of bail-in rule contained in Article 55 BRRD under which banks have to include in agreements that are governed by the law of a third country a clause by which the creditor recognizes the bail-in power (write-down and conversion powers) of the EU resolution authorities so that it can be applied by member state resolution authorities in a proportionate manner
- As this obligation applies to all contracts not excluded from the scope of bail-in, it has turned out to be particularly difficult to comply with in respect of business conducted by branches of EU banks in third countries, as such agreements are usually governed by the law of those third countries
- The EU Commission acknowledged these difficulties and provided for a waiver mechanism based on a determination that (i) the write-down and conversion powers of the resolution authorities are recognized under the laws of the third country that governs the agreement (ii) it is legally, contractually or economically impracticable for banks to include the bail-in recognition clause and (iii) that such waiver would not impede the resolvability of the bank

Presidency compromise text on the review of the BRRD/22 May 2018

- Correction of drafting errors
- Notification of impracticability mechanism with determination and justification by the institutions - no longer waiver mechanisms
- "Legally or otherwise impracticable" instead of "legally, contractually or economically impracticable"
- Approach more pragmatic and proportionate - consequences on the treatment as loss absorbing and recapitalization capacity

II. BRRD 2

B. Proposed 33a BRRD on the power to suspend certain obligations (moratoria tools)

Version presented by the EU Commission/23 Nov. 2016

- The proposal seeks to introduce new suspension powers which would authorize the competent and resolution authority to stay all payments and delivery obligations of an institution that is subject to early intervention measures and resolution. The length of potential combining stays (pursuant to new articles 27(1) and 32 (1) and article 69) could take up to 12 working days
- Several amendments and discussions on the length, scope, combination of the new stay provisions with the resolution stay and on the effect on counterparties' credit risk management

Presidency compromise text on the review of the BRRD/22 May 2018

- Pre-resolution stay powers may be exercised before the institution is placed in resolution (including powers provided under articles 70 and 71 BRRD)
- Scope:
 - * exclusions for payment and delivery obligations owed to systems or operators of systems, central counterparties and third country central counterparties recognized by ESMA and central banks
 - * appropriateness to be considered for extending the stay to eligible deposits
- Length: 2 business days
- If resolution actions are taken after resolution authorities have exercised any of the pre-resolution stay powers, the resolution authorities will no longer have jurisdiction to exercise these powers in resolution

II. BRRD 2

C. Proposed article 44(2)(f) BRRD on liabilities excluded from the scope of the bail-in tool

Version presented by the EU Commission/23 Nov. 2016

- In article 44(2) point (f) is proposed to be replaced as follows: (f) *liabilities with a remaining maturity of less than seven days, owed to systems or operators of systems designated in accordance with Directive 98/26/EC or to their participants and arising from the participation in such system, or third country central CCPs recognised by ESMA*
- Extension to third country central CCPs recognised by ESMA (article 25 EMIR)
- Comments: the recognition procedures under article 25 EMIR or by ESMA may not be sufficient

Presidency compromise text on the review of the BRRD/22 May 2018

No amendments

II. BRRD 2

D. Safeguards for netting in the case of repo and stock lending whilst applying bail-in

Version presented by the EU Commission/23 Nov. 2016

- Article 49 of the BRRD sets out the conditions that resolution authorities should comply with when bailing in derivative liabilities. In particular, resolution authorities should exercise the bail-in power only on or after closing-out the derivatives and the BRRD gives resolution authorities the power to close-out and terminate derivatives for this purpose
- To note that neither Article 49 BRRD nor the Delegated Regulation (EU/2016/1401) apply the same protection for netting in the case of other product types which rely on close-out netting under master agreement, e.g. repo and stock-lending
- Whilst liabilities under repo and stock-lending agreements are generally collateralized and would therefore not be subject to bail-in to the extent of the security, they could be eligible for bail-in to the extent there is or would be a net amount payable by the institution in resolution, taking account of collateral
- The absence of express protection for the close-out netting provisions in repo or stock-lending master agreements in article 49 may constitute an issue since relying on the NCWO principle may not be satisfactory to ensure that obligations are treated on a net basis for bail-in purposes

Presidency compromise text on the review of the BRRD/22 May 2018

No amendments

II. BRRD 2

E. Article “Article 71a Contractual Recognition of Resolution Stay Powers”

- New provision requiring contractual recognition of BRRD powers for financial contracts governed by the law of a third country:**
 - ✓ Pre-resolution moratorium powers (art. 33a BRRD)
 - ✓ Exclusion of certain contractual terms in early intervention and resolution (art.68 BRRD)
 - ✓ resolution moratorium powers (art.69 BRRD)
 - ✓ Power to restrict the enforcement of security interests (art.70 BRRD)
 - ✓ Power to temporarily suspend termination rights (art.71BRRD)
- Exclusion for inter-bank borrowing agreements where the term of the borrowing is three months or less and for financial contracts entered into with certain types of counterparties: FMIs, CCPs, central banks, central government etc.**
- Financial contracts under which new obligations are created or existing obligations are materially amended after the date of implementation in Member States**

III. CRR2 – EU Council Presidency Compromise text dated 22 May 2018

Article « 494b » Grandfathering of own funds and eligible liabilities

Grandfathering from date of implementation (TBC) for own funds instruments and eligible liabilities for instruments counting towards both the subordinated portion of TLAC/MREL and, where applicable, the non-subordinated portion of TLAC/MREL

Grandfathering for additional Tier 1 and Tier 2 debt instruments

6 years grandfathering period with respect to set-off and bail-in recognition requirements starting from date of entry into force of CRR2

Open-ended grandfathering for eligible liabilities that do not meet certain requirements with respect to no set-off, no incentive to redeem, not redeemable by holders, only being callable at issuer's discretion, only being callable subject to conditions for reducing own funds and eligible liabilities, no right for holder to accelerate future payment of interest or principal etc.

EU SUPERVISION OF THIRD COUNTRY CCPs



Niall J. Lenihan

Quadrilateral Conference, European Central Bank, Frankfurt, 7-8 June 2018

EU LEGISLATIVE PROCESS FOR EMIR2

- **Commission:**
June 2017
- **ECB: Oct. 17**
- **European
Parliament:**
May 2018
- **Council: ?**



EXISTING SET-UP FOR RECOGNITION OF 3RD COUNTRY CCPs IN EU

- **ESMA RECOGNITION**
- **LEGAL EQUIVALENCE**
- **EFFECTIVE SUPERVISION**
- **RECIPROCITY**
- **ESMA COOPERATION WITH 3RD COUNTRY AUTHORITIES**
- **28 NON-EU CCPs RECOGNISED**



REASONS FOR OVERHAULING EXISTING SYSTEM



- **SHORTCOMINGS IN EXISTING SYSTEM**
- **LEVEL-PLAYING FIELD/ REGULATORY ARBITRAGE**
- **SUBSTANTIAL EURO CLEARING IN UK – UK CCPs CLEAR 90% OF EURO AREA BANKS' EURO-DENOMINATED INTEREST RATE SWAPS – DISTURBANCE AFFECTING MAJOR CCP COULD TRIGGER SEVERE DECREASE IN EURO AREA LIQUIDITY**

LEGISLATIVE PROPOSAL

- **THREE-TIER SYSTEM**
- **TIER 1 CCPs: NOT SYSTEMICALLY IMPORTANT**
- **TIER 2 CCPs: SYSTEMICALLY IMPORTANT – MAIN CHANGE**
- **TIER 3 CCPs: OF SUCH SUBSTANTIAL SYSTEMIC IMPORTANCE THAT TIER 2 STATUS DOES NOT SUFFICIENTLY ENSURE FINANCIAL STABILITY IN EU/ ONE OR MORE EU MEMBER STATES – LAST RESORT**



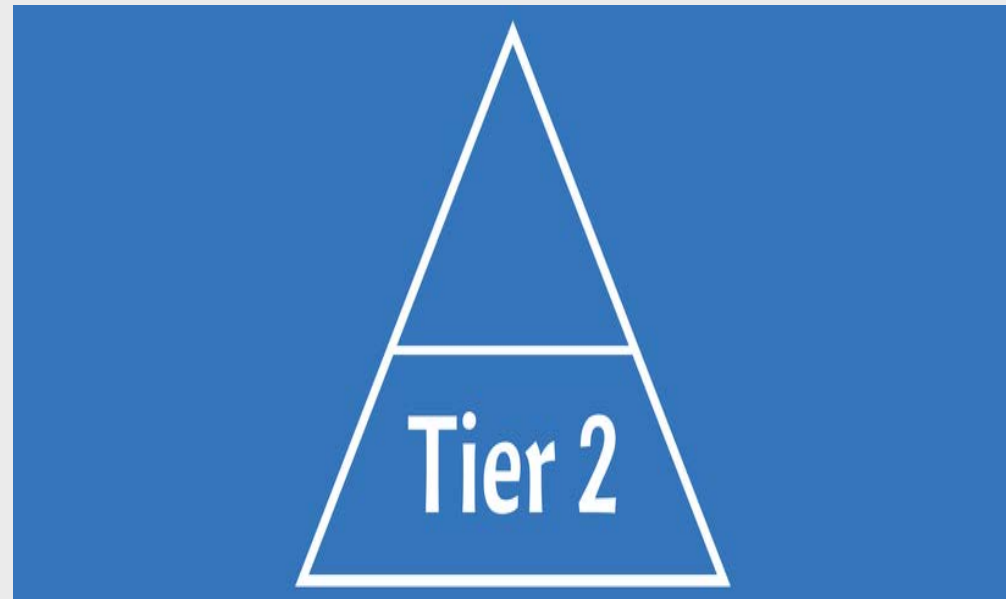
5 CRITERIA FOR TIER 2 CCPs



- **NATURE, SIZE AND COMPLEXITY OF CCP'S BUSINESS**
- **EFFECT OF CCP FAILURE/ DISRUPTION ON EU FINANCIAL STABILITY**
- **PROPORTION OF CCP'S CLEARING MEMBERS/ CLIENTS IN EU**
- **CCP'S INTER-DEPENDENCIES WITH FINANCIAL SYSTEM**
- **EFFECT OF CCP FAILURE/ DISRUPTION ON LIQUIDITY**
- **DELEGATED LEGISLATION FURTHER SPECIFYING**

OBLIGATIONS OF TIER 2 CCPs

- **COMPLIANCE WITH FULL RANGE OF EMIR2 ORGANISATIONAL, PRUDENTIAL & INTER-OPERABILITY REQUIREMENTS**
- **COMPLIANCE WITH CENTRAL BANK REQUIREMENTS - REPORTING, RESILIENCE ASSESSMENTS, CB DEPOSIT ACCOUNTS (WHERE REQUIRED), SIX-MONTH RENEWABLE SYSTEMIC LIQUIDITY RISK REQUIREMENTS**
- **ESMA SUPERVISORY POWERS – INFORMATION REPORTING, INVESTIGATIONS, ON-SITE INSPECTIONS, FINES & PENALTIES, ALL SUBJECT TO ECJ JURISDICTION**



TIER 2 CCPs' COMPLIANCE WITH COMPARABLE REQUIREMENTS IN 3RD COUNTRIES



- **CCP REQUEST FOR ESMA ASSESSMENT WHETHER 'COMPARABLE COMPLIANCE' WITH 3RD COUNTRY REQUIREMENTS SATISFIES EU REQUIREMENTS**
- **COMMISSION DELEGATED LEGISLATION RE LEGAL & SUPERVISORY EQUIVALENCE**
- **ESMA COOPERATION ARRANGEMENTS WITH 3RD COUNTRY AUTHORITIES**
- **ESMA SUPERVISORY COLLEGE FOR 3RD COUNTRY CCPs**
- **WITHDRAWAL OF RECOGNITION IF ESMA UNABLE TO EXERCISE RESPONSIBILITIES DUE TO FAILURE OF 3RD COUNTRY AUTHORITIES TO PROVIDE INFORMATION**

TIER 3 CCPs

- **SUBSTANTIAL SYSTEMIC IMPORTANCE**
- **ESMA RECOMMENDATION TO PROHIBIT CCP RECOGNITION OF TIER 2 CCP**
- **ELEMENTS TO BE CONSIDERED:**
(1) CCP'S NEED IN SEVERE STRESS FOR CENTRAL BANK LIQUIDITY ASSISTANCE; (2) PRESENCE OF VIABLE SUBSTITUTE SERVICE-PROVIDERS; (3) COSTS & BENEFITS FOR CLEARING MEMBERS & CLIENTS IN EU
- **COMMISSION DISCRETION TO PROHIBIT RECOGNITION**
- **ADAPTATION PERIOD**
- **LAST RESORT**



THANK-YOU FOR YOUR ATTENTION!



Efficient handling of NPLs and development of Secondary Markets for NPLs in the EU: The European Commission's Proposal for a Directive of March 2018 on credit servicers, credit purchasers and the recovery of collateral

Dr. Dimitris Tsibanoulis

Tsibanoulis & Partners 
LAW FIRM

**Quadrilateral meeting of the
FMLC / FMLG / FLB / EFMLG
Frankfurt am Main, 7-8 June 2018**

The need to address Non-Performing Loans in the EU (1)

- The financial crisis and ensuing recessions have left some European banks with high levels of NPLs, with significant adverse impacts on banks' profitability and their ability to lend, including to SMEs.
- NPLs constitute a drag on economic activity, especially for countries that rely mainly on bank financing, as is the case in the euro area.
- Secondary markets for distressed debt remain small and less developed in Europe than in some third countries. This greatly hinders the tackling of the large NPL volumes.
- The current size, liquidity and structure of secondary markets for NPLs in the EU are an obstacle to the management and resolution of NPLs in the EU.

The need to address Non-Performing Loans in the EU (2)

- Low demand, weak competition and low bid prices on secondary markets disincentives banks to sell NPLs
- Characteristics of EU distressed assets markets:
 - small trade volumes
 - limited number of active investors and
 - large bid-ask spreads
- Discrepancies in the required rates of return for banks and investors.
- The risk and uncertainty factors, often due to the fragmented legal regimes in the EU-member states, are the ones mostly affecting the pricing of legacy assets.
- The depth and maturity of the third party servicing industry is considered an important factor for secondary markets.

Developing an efficient secondary market for NPLs in the EU (1)

- One of the EC key policies is to develop and enhance the functioning of secondary markets for NPLs.
- National markets for NPLs and loan servicers remain fragmented and underdeveloped.
- Member States have very different rules for third parties acquiring NPLs from banks, as well as rules for offering loan servicing services. This situation restricts both the free flow of NPLs and investment opportunities for third-country investors.
- Cross-border activities require unique competences and firms should not be hindered from fully realizing their strategic objectives.

Developing an efficient secondary market for NPLs in the EU (2)

- Existing barriers from the national legal frameworks hinder the cross-border operation of NPLs servicers and discourage NPL investors to enter the market.
- Removing impediments to transfers of NPLs from banks to other entities and simplifying and harmonising requirements for loan servicers could efficiently address this problem.
- Measures at EU level are necessary in order to create a single market framework in order to
 - stimulate demand for NPLs by generating a larger investor basis through lowering entry barriers and
 - enhance greater competition among investors.
- EU measures would foster cross-border expansion of both investors and loan servicers, so as to come close to a shared investor base among all EU Member States.

Targets and application field

- To address the NPLs' issues, the European Commission launched in March of this year a Proposal for a Directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral.
- The proposed Directive aims at developing a common EU approach in order to remove existing legal constraints and barriers to market entry.
- The Directive applies to purchasers and servicers of credit originally issued by a credit institution or its subsidiaries, irrespective of the type of borrower.

Dimitris Tsibanoulis

Main objectives

- A more integrated financial system will enhance the resilience of the EMU to adverse shocks by
 - facilitating private risk-sharing across borders and
 - reducing the need for public risk-sharing.
- The Directive aims at creating the appropriate environment for credit institutions to deal with NPLs on their balance sheets, and at reducing the risk of future NPLs accumulation.
- The secondary market for credit covers both performing and non-performing credit.

Dimitris Tsibanoulis

The Proposal Directive's key characteristics and main tools

- The Proposal Directive establishes a framework for servicers of credit agreements issued by credit institutions.
- It introduces the NPLs' servicer as new regulated entity entitled to provide cross-border services in Europe and, thus, promotes the European secondary market for NPLs.
- The credit servicer is subject to authorisation and supervision.
- A uniform and harmonised set of conditions for granting and maintaining an authorisation as a credit servicer should promote trust and avoid a reduction in debtor or borrower protection:
 - Fit and proper tests for the management and the persons who hold a qualifying holding.
 - Appropriate governance arrangements and internal control mechanisms.

The debtors' protection issue

- A debtor might not be indifferent to the identity and business practices of the creditor and the NPLs' servicer.
- The Directive aims at safeguarding EU consumer protection rules: The assignment of the creditor's rights should not affect the level of protection granted by Union law to consumers.
- Tackling information asymmetries: creditors shall provide all necessary information to a credit purchaser prior to entering into a contract, with due respect to personal data protection rules. The credit purchaser shall have appropriate governance arrangements and internal control mechanisms as well as recording and handling of complaints tools.

Dimitris Tsibanoulis

Establishing extrajudicial enforcement procedures

- The Directive aims at helping banks to better manage NPLs by increasing the efficiency of debt recovery procedures.
- It introduces an accelerated extrajudicial collateral enforcement mechanism as a flexible, contractual, based out of court enforcement mechanism, which can be adapted to the different national legal frameworks and the specific needs of the banking system.
- The accelerated extrajudicial collateral enforcement mechanism
 - as a voluntary instrument subject to agreement between the secured creditor and the business borrower, effective to recover value from collateral;
 - as a directly enforceable title through a clause in the agreement, enabling direct execution of the collateral without the need to obtain an enforceable title from the court.

A Time of Transition



- **The new senior managers’ regime and the FCA’s focus on “transforming culture” inside authorised firms;**
- **An update on ring-fencing of retail banking from investment banking.**

Nathaniel Lalone, Katten Muchin Rosenman LLP

Registered Charity Number: 1164902.

"The FMLC" and "The Financial Markets Law Committee" are terms used to describe a committee appointed by Financial Markets Law Committee, a limited company ("FMLC" or "the Company"). Registered office: 8 Lothbury, London, EC2R 7HH. Registered in England and Wales. Company Registration Number: 8733443.

Transforming Culture

UK authorities have increased their focus on the culture of the firms they regulate.

“Culture in financial services is widely accepted as a key root cause of the major conduct failings that have occurred within the industry in recent history, causing harm to both consumers and markets... Given its impact and the role it needs to play in re-building trust in financial services, firms’ culture is a priority for the FCA. We expect firms to foster cultures which support the spirit of regulation in preventing harm to consumers and markets”.

Goal is to move from a “compliance culture” to an “ethical” culture.

What is culture?

“Culture is everywhere and nowhere”.

Three Key Sources

- Speech by Jonathan Davidson, FCA Executive Director of Supervision – 20 September 2017
- FCA Discussion Paper 18/2 published – 12 March 2018
- Speech by Andrew Bailey, FCA Chief Executive – 19 March 2018

Culture may not be measurable, but it can be managed. The FCA will look at four main drivers:

- The firm's purpose.
- The firm's leadership.
- The firm's approach to rewarding/managing people.
- The firm's governance arrangements.

Focus is not on having the “right” culture but cultivating a “healthy” culture.

The Accountability Regime

- The FCA's new Accountability Regime will build on, and effectively replace, the current Approved Persons regime.
- Individuals within firms will be held personally accountable for their work.
- The Senior Managers and Certification Regime will be extended to cover all FCA supervised firms.
- Senior managers must be “fit and proper”, and establish clear lines of accountability within the firm.
- Persons who are in significant positions of conduct must be subject to certification and review.
- Five core conduct goals:
 - To act with integrity.
 - To act with due care, skill and diligence.
 - To be open and cooperative with the supervisory authorities.
 - To pay due regard to the interests of customers and to treat them fairly.
 - To observe proper standards of market conduct.

Market Abuse Regulation and the Capital Markets



Michael Sholem, Davis Polk & Wardwell London LLP

Registered Charity Number: 1164902.

"The FMLC" and "The Financial Markets Law Committee" are terms used to describe a committee appointed by Financial Markets Law Committee, a limited company ("FMLC" or "the Company"). Registered office: 8 Lothbury, London, EC2R 7HH. Registered in England and Wales. Company Registration Number: 8733443.

Market Abuse Regulation

The Market Abuse Regulation (596/2014/EU) (“**MAR**”) came into force in July 3, 2016:

- The market soundings regime
 - Uncertainty over application of MAR to non-EU capital markets activity
 - Meaning of terms “announcement” and “transaction” in the context of market soundings
 - A self-standing regime or a safe harbour?

- FMLC – Issues of Legal Uncertainty Arising in the Context of the Market Abuse Regulation (May 2017)
 - Discussed an approach on price linkage between instruments admitted to trading on an EU venue and those admitted to trading outside the EU.

- Updated MAR Q&A produced by ESMA on September 1st, 2017
- Response from FCA on September 5th, 2017.

- Other areas of uncertainty in MAR:
 - Application of PDMR disclosure and trading obligations
 - Stabilisation activities

ANDERSON
MŌRI &
TOMOTSUNE

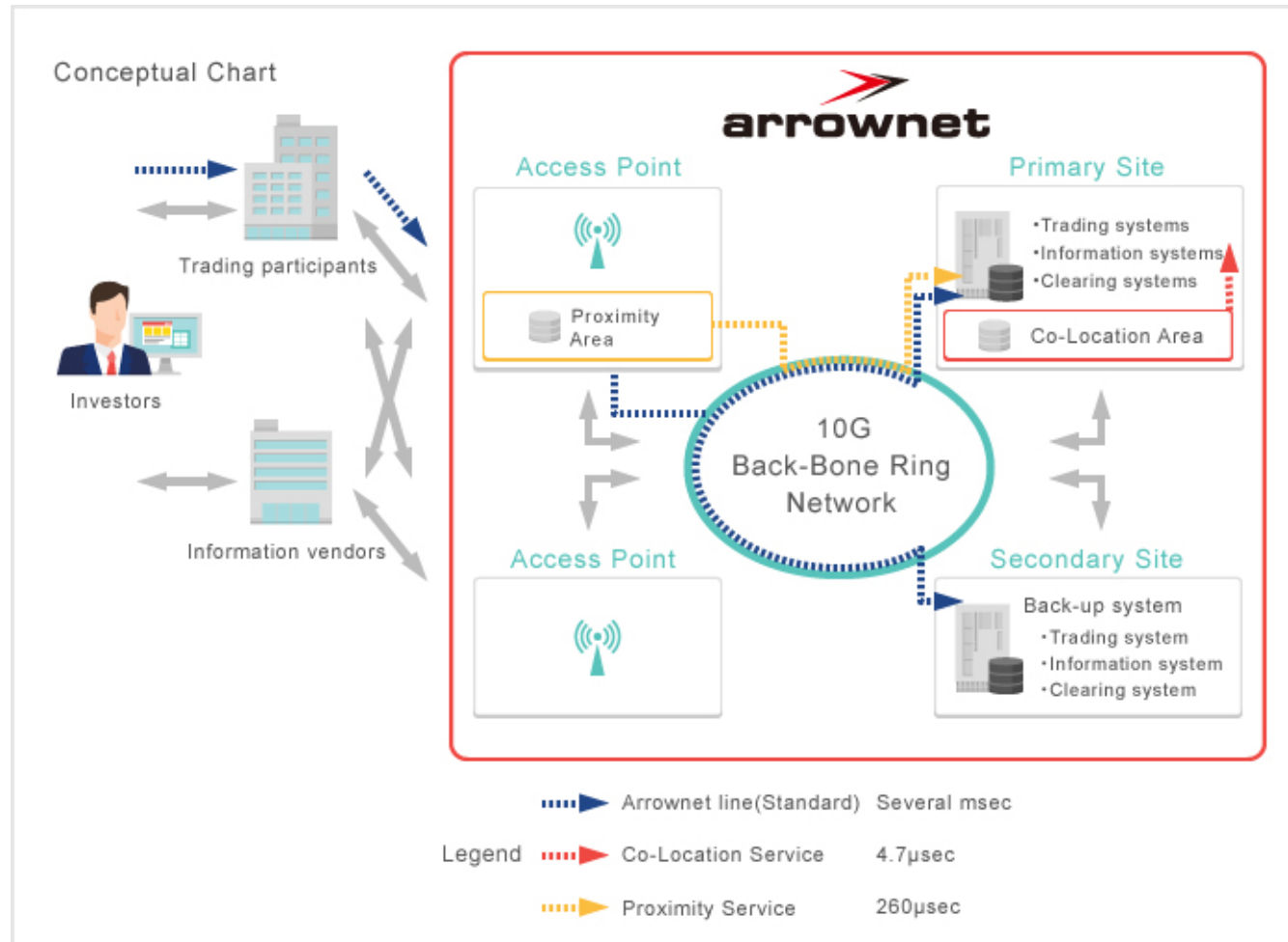
*Regulation on High Speed
Trading in Japan*

Anderson Mori & Tomotsune

Daisuke Tanimoto

7 June 2018

Rise of High Speed Algorithmic Trading



(Source) Website of the Tokyo Stock Exchange

Background

- Working Group on Financial Markets under the Financial System Council:
 - Since May 2016, the WG was held twelve times and it discussed issues including high speed algorithmic trading ("HST"); and
 - The Final Report was published on 22 December 2016
- Final Report of the WG:
 - Improvement of processing speed of trades by using co-location service (enabling traders to install servers close to the exchange's trading system);
 - Increase in the share of orders which are processed through co-location services with the TSE (70% on an order base and 40-50% on an executed trade base in 2016);
 - Acknowledgement of HST's contribution to liquidity and tighter spreads, but concerns about the impact of HST on market stability, efficiency, fairness, price discovery functions and system vulnerabilities; and
 - Regulators face difficulties grasping the full picture of HST

New HST Regulation under the FIEA

- The Amendment to the Financial Instruments and Exchange Act ("FIEA")
 - The amendment to the FIEA was enacted on 17 May 2017;
 - The final rule of subordinated regulations was published on 27 December 2017; and
 - The regulation came into force on 1 April 2018
- New registration requirement mandatory to an HST trader:
 - Both domestic and overseas HST traders are subject to registration requirements as an HST trader going forward; and
 - Six months grace period has been extended for existing HST traders
- Prohibition of order acceptance by securities firms:
 - Locally-registered securities firms are prohibited from accepting orders from an unregistered HST trader

Definition of HST - Type of Trades/Trading Venue

- Type of trading included in the HST definition:
 - Sale/purchase of securities or exchange-traded derivatives ("In-Scope Trades");
 - Entrustment of In-Scope Trades;
 - Making investment in In-Scope Trades for investment management of funds or other assets (including giving an investment instruction); and
 - Causing a person to conduct In-Scope Trades by entering into over-the-counter derivative transactions with such person or by any other method
- Scope of trading venues:
 - Trading executed at locally-licensed financial instruments exchanges and/or PTS designated by the FSA Commissioner falls under the definition of HST;
 - Tokyo Stock Exchange, Osaka Exchange, Nagoya Stock Exchange, Fukuoka Stock Exchange and Sapporo Stock Exchange are designated as such financial instruments exchanges; and
 - SBI Japannext Co. and Chi-X Japan are designated as such PTS

Definition of HST - Information Processing System

- Automation of decision-making:
 - Decision-making concerning relevant trading activities is determined automatically through an electronic information processing system
- Method to shorten the time for communication meeting the following criteria:
 - A facility that houses an electronic information processing system to perform automated determination of investments is located in or around a place where a matching engine of the relevant trading venue is installed; and
 - A mechanism that prevents such communication from conflicting with other communications is established

Application Procedure for HST Registration

- Application procedure for registering as an HST:
 - Prior consultation with the FSA/KLFB and then filing a formal application;
 - Application documents can be prepared in English (New!); and
 - An overseas applicant not having a presence in Japan is required to appoint a local representative/agent (e.g., local lawyer) who can handle communications with the regulator on their behalf
- "Form and Example/Notes of the Application Document and its Attachments" are available in English on the FSA's website, which include:
 - Application Form;
 - Document regarding Business Content and Method; and
 - Document regarding Personnel and Business Execution Structure

Regulatory Obligations of Registered HST Trader

- Personnel and Business Execution Structure:
 - Trading strategy/algorithm;
 - Programming/IT technology/IT infrastructure;
 - Operations;
 - Compliance; and
 - Risk
- Measures to prevent unfair trading:
 - Insider trading using "corporate-related information"; and
 - market manipulation etc.
- Record keeping and regulatory filing:
 - Submission of an annual business report to the regulator; and
 - Preparation and retention of books and records

Resume



Daisuke Tanimoto

Partner

- Professional Admissions
Japan (2006)
- He advises on a wide range of regulatory and compliance issues, and has expertise in derivatives, securitization, structured finance and other financial transactions

E-mail: daisuke.tanimoto@amt-law.com

Tel: +81-3-6775-1154

Fax: +81-3-6775-2154

Education

- The University of Tokyo (LL.B., 2005)
- London School of Economics and Political Science (LL.M., 2014)

Work Experience

- Deputy Director, the Financial Markets Division, the Financial Services Agency of Japan (Mar 2012 to June 2013)
- Issues Assistant, the Financial Markets Law Committee, London (Sep 2014 - Jan 2015)

Publications

- Clause-by-Clause Commentary: the 2013 Amendments to the Financial Instruments and Exchange Act, Shoji Homu (Apr 2014)

Lectures

- Margin Requirements for Non-cleared OTC derivatives in Japan and Other Jurisdictions, Seminar Info (May 2016)

ANDERSON
MŌRI &
TOMOTSUNE

■ Contact

Daisuke Tanimoto

Tel: +81-3-6775-1154

Fax: +81-3-6775-2154

E-mail: daisuke.tanimoto@amt-law.com

Anderson Mori & Tomotsune

Otemachi Park Building, 1-1-1 Otemachi

Chiyoda-ku, Tokyo 100-8136, Japan

<https://www.amt-law.com>



F M L G | F I N A N C I A L M A R K E T S L A W Y E R S G R O U P

2018 Quadrilateral Conference
Friday, June 8, 2018
European Central Bank, Frankfurt

Supplemental Ethics Materials for Cluster II: FX Global Code

Restatement (Third) of the Law Governing Lawyers § 94(3).....2

Model Rules of Professional Conduct of the American Bar Association § 2.1 11

Dan Awrey, William Blair, and David Kershaw, “Between Law and Markets:
Is There a Role for Culture and Ethics in Financial Regulation?”
38 *Del. J. Corp. L.* 191 (2013) 13

• • • • •

The Financial Markets Lawyers Group comprises lawyers who support foreign exchange and other financial markets trading in leading worldwide financial institutions. It is sponsored by, but is not part of, the Federal Reserve Bank of New York. Any views expressed by the Financial Markets Lawyers Group do not necessarily represent the views of the Federal Reserve Bank of New York or the Federal Reserve System.



1 of 1 DOCUMENT

Restatement of the Law, Third, The Law Governing Lawyers
Copyright (c) 2000, The American Law Institute

Case Citations

Chapter 6 - Representing Clients--in General

Topic 1 - Lawyer Functions in Representing Clients--in General

Restat 3d of the Law Governing Lawyers, § 94

§ 94 Advising and Assisting a Client--In General

(1) A lawyer who counsels or assists a client to engage in conduct that violates the rights of a third person is subject to liability:

(a) to the third person to the extent stated in §§ 51 and 56-57; and

(b) to the client to the extent stated in §§ 50, 55, and 56.

(2) For purposes of professional discipline, a lawyer may not counsel or assist a client in conduct that the lawyer knows to be criminal or fraudulent or in violation of a court order with the intent of facilitating or encouraging the conduct, but the lawyer may counsel or assist a client in conduct when the lawyer reasonably believes:

(a) that the client's conduct constitutes a good-faith effort to determine the validity, scope, meaning, or application of a law or court order; or

(b) that the client can assert a nonfrivolous argument that the client's conduct will not constitute a crime or fraud or violate a court order.

(3) In counseling a client, a lawyer may address nonlegal aspects of a proposed course of conduct, including moral, reputational, economic, social, political, and business aspects.

COMMENTS & ILLUSTRATIONS: Comment:

a. Scope and cross-references. Subsection (1) cross-references to other Sections describing a lawyer's civil liability for counseling or otherwise assisting a client to violate the rights of a third person. Comments to this Section describe some of the implications of such liability rules for the counseling role of a lawyer. Subsections (2) and (3) state specific rules derived from the lawyer codes. Lawyer liability under Subsection (1) and under other law, such as the law of crimes (see § 8), may define scienter and other elements of liability differently from the Subsection.

Subsection (2) is stated as a rule of professional discipline, and the discussion in the Comments is similarly limited

to that context. Other, possibly different liability rules govern other remedies, such as those of the criminal law or the law regulating liability to third persons. Whether and the extent to which the considerations in those Subsections and related Comments may apply in other remedial contexts are questions beyond the scope of this Restatement.

"Counseling" by a lawyer within the meaning of the Section means providing advice to the client about the legality of contemplated activities with the intent of facilitating or encouraging the client's action. "Assisting" a client refers to providing, with a similar intent, other professional services, such as preparing documents, drafting correspondence, negotiating with a nonclient, or contacting a governmental agency.

On withdrawal from a representation to avoid assisting an illegal, imprudent, or repugnant client objective, see § 32. On the disciplinary prohibitions against dishonesty and similar conduct, see § 5, Comment *c*. On a lawyer's right to refuse to assist acts that the lawyer believes to be unlawful, see § 23(1). On the duty not to counsel or assist a client to falsify or destroy relevant evidence, see § 118. On disclosure of a client's confidential information concerning certain client acts likely to cause substantial physical injury or financial loss, see §§ 66-67. On the crime-fraud exception to the attorney-client privilege, see § 82; on the corresponding exception to the work-product immunity, see § 93.

On counseling an organizational or governmental client, see §§ 96-97. With respect to fraudulent statements and similar deceit by a lawyer, see § 98.

b. Rationale. Lawyers play an important public role by advising clients about law and the operation of the legal system and providing other assistance to clients. In counseling clients a lawyer may appropriately advise them about the legality of contemplated or past activities. Certain limits confine that function, as stated in this Section. A lawyer is not privileged by virtue of professional role to violate criminal laws that otherwise apply to the lawyer. Thus, criminal prohibitions against acting as principal or accomplice apply when acting for a client during the course of representation (see § 8). Similarly, certain rules of civil liability, cross-referred to in Subsection (1), may also apply to a lawyer, in effect superseding to that extent the general rule that a lawyer may act guided only by the objective of furthering the interests of the lawyer's client.

c. Counseling about activity of doubtful legality. Lawyers are occupationally engaged in advising clients about activities on which law has an often uncertain bearing. A lawyer who proceeds reasonably to advise a client with the intent of providing the client with legal advice on how to comply with the law does not act wrongfully, even if the client employs that advice for wrongful purposes or even if a tribunal later determines that the lawyer's advice was incorrect. As stated in Subsection (2)(b), a lawyer acts appropriately for purposes of professional discipline so long as the lawyer reasonably believes that the client can assert a nonfrivolous argument that the client's intended action will not constitute a crime or fraud or violate a court order (see also Comment *e*). The requirement of a nonfrivolous argument is measured by an objective test. In such circumstances, if the lawyer's advice or other assistance proves to be inaccurate as a result of the lawyer's negligence, the lawyer may be liable to the client for harm caused (see Subsection (1)(b) & § 50), but the lawyer is not susceptible to professional discipline (other than for incompetence) for counseling wrongful conduct. On the extent to which the lawyer may be civilly liable to nonclients who may be injured, see § 51.

Under Subsection (2), a lawyer who counsels or assists a client to engage in activity that the lawyer knows to be criminal or fraudulent or in violation of a court order, other than as described in the Subsection, is subject to professional discipline. Such a rule (applicable to crime and fraud) is stated in the widely adopted ABA Model Rules of Professional Conduct, Rule 1.2(d) (1983); on violation of a court order, see Comment *d*. "Fraud" is defined in the Terminology section of the ABA Model Rules as denoting "conduct having a purpose to deceive and not merely negligent misrepresentation or failure to apprise another of relevant information." Failure to apprise another of relevant information may constitute such fraud, as when a lawyer purposefully fails to disclose information necessary to render a statement of the lawyer not materially deceptive (see § 98 & Comment *e*). A lawyer's intent to facilitate or encourage wrongful action may be inferred if in the circumstances it should have been apparent to the lawyer that the client would employ the assistance to further the client's wrongful conduct and the lawyer nonetheless provided the assistance.

In certain instances, a disciplinary violation occurs as stated in Subsection (2) even though neither civil nor criminal remedies would apply. For example, substantive law commonly requires that a defrauded person show reasonable reliance and resulting harm before certain remedies for civil fraud are available (see § 56). However, a disciplinary violation occurs even in the absence of third-person reliance or harm, although the absence of reliance or harm may be relevant to the level of sanction imposed.

That a client intends to commit a crime or fraud or violate a court order does not by itself preclude a lawyer from providing legal advice to the client concerning that conduct. Because Subsection (2) prohibits counseling or assisting a client only with the intent to facilitate or encourage the action (see Comment *a*), a lawyer may, for example, indicate to the client the illegal nature of the conduct in an effort to dissuade the client from committing it. (On civil disobedience, see Comment *e*.)

A lawyer's counseling or assisting a client in conduct that does not constitute a crime or fraud or violation of a court order is not subject to professional discipline under Subsection (2), even if the client or lawyer would be subject to other remedies, such as damages in a civil action by an injured third person. For example, it is not a disciplinary violation nor does it create liability to a third person (see § 57, Comment *g*) to prepare a document for a client that, when executed by the client, breaches contractual obligations of the client.

d. Violation of a court order. Violation of a court order directly challenges the rule of law. Rule 1.2(d) of the ABA Model Rules of Professional Conduct (1983), prohibiting assistance to a client's crime or fraud, omits explicit reference to the client's violation of a court order. However, decisional law treats it as equally wrongful for a lawyer knowingly to counsel or assist a client to violate a court order. The decisions often employ the prohibition stated in ABA Model Rule 8.4(d) against conduct prejudicial to the administration of justice. Moreover, in many circumstances a client's violation of a court order constitutes the crime of contempt, and a lawyer's assistance may thus directly violate ABA Model Rule 1.2(d). A lawyer also may be guilty of contempt of court as a principal with respect to the lawyer's own acts in assisting a client to violate a valid court order.

Accordingly, a lawyer counseling or assisting a client who contemplates violating a court order is legally constrained in much the same manner as when the client's conduct is a crime or fraud (see Comment *c*). The lawyer may contest a request for such an order before it is entered or seek later clarification, modification, vacatur, or appellate review. However, as stated in Subsection (2), a lawyer may not knowingly counsel or assist the client to violate a court order. On a good-faith challenge to a court order of doubtful validity, see Comment *e*.

e. A reasonable test of a legal obligation. The scope of legal obligations is in many instances unclear, calling for the exercise by the lawyer of legal skill and judgment in assessing the limits of legality (see Comment *c*). Moreover, even if an obligation is clearly stated, an invalid statute or regulation ordinarily need not be obeyed; in other instances, as with some court orders, law may require that the statute or regulation be obeyed until it is set aside by a reviewing tribunal. The terms of such law are in general beyond the scope of the Restatement.

A client may wish to test the legal validity or applicability of a statute, regulation (including a standing court rule), or (subject to the above) a court order by violating it and testing its validity or scope in an enforcement proceeding. A lawyer's assistance to a client in such circumstances is not improper when the lawyer reasonably believes that the client's conduct constitutes a good-faith effort to determine the validity, scope, meaning, or application of the law or court order (see Subsection (2)(a) & Comment *c* hereto). With respect to matters in which the lawyer represents the client in litigation, see § 110 on required nonfrivolous grounds for legal contentions.

A reasonable test of a legal obligation may in some instances require that available and appropriate steps be taken to bring the act to the attention of appropriate enforcement authorities. For example, a lawyer may incur personal liability for contempt (or assist a client to incur such liability) with the objective of obtaining appellate review of a trial-court ruling when doing so is appropriate and necessary to obtain such review. (A lawyer is not under a duty to the client to do so (see § 63, Comment *b*.) A lawyer may not, however, ignore or counsel or assist a client to ignore a

mandatory court order surreptitiously and seek to excuse noncompliance on the asserted justification of providing a basis for appellate review if detected (see Comment *d*).

Subsection (2)(a) does not require advising the client that the contemplated test of a legal obligation be an open one in all instances. Attempted enforcement may provide ample opportunity to assert that the requirement is invalid or unenforceable. A lawyer might, for example, counsel a client not to file a document required by a government regulation if the lawyer reasonably determines that the client is making a good-faith effort to determine the validity or application of the regulation.

With respect to particular lawyer services, for example assistance to a client in preparing a tax return, specific statutes or regulations may prescribe responsibility for advising on doubtful positions. Such requirements are beyond the scope of the Restatement.

When a lawyer's prediction that a statute or regulation is inapplicable or unenforceable proves to be inaccurate, the consequences of an effort to test the issue in compliance with Subsection (2)(a) may vary for purposes of remedies other than professional discipline. The lawyer's state of mind may be relevant under criminal law (see § 8) and as a defense with respect to civil liability to third persons (see Chapter 4). With respect to challenges to court orders, although the lawyer may theoretically remain liable to remedies such as contempt, the practice of courts is not to impose sanctions for contempt when the lawyer's resistance was based on a nonfrivolous factual and legal position and reasonably necessary in order to obtain an authoritative judicial resolution of the client's challenge.

Different considerations may apply when the contemplated client activity that a lawyer counsels or assists is criminal but the client, having been counseled that the activity is criminal, nonetheless proposes to commit the act for reasons of conscience. The disciplinary consequences of lawyer involvement in such instances of civil disobedience have not been adjudicated and the Restatement takes no position on them.

f. Advice about enforcement policy. A lawyer's advice to a client about the degree of risk that a law violation will be detected or prosecuted violates the rule of Subsection (2) when the circumstances indicate that the lawyer thereby intended to counsel or assist the client's crime, fraud, or violation of a court order. No bright-line rule immunizes the lawyer from adverse legal consequences. In many borderline situations, the lawyer's intent will be a disputable question of fact (see Comments *a* & *c*), as will be questions of the lawyer's knowledge (see Comment *g*). Such questions will be determined from all the circumstances. In general, a lawyer may advise a client about enforcement policy in areas of doubtful legality so long as the lawyer does not knowingly counsel or assist the client to engage in criminal or fraudulent activity or activity that violates a court order. Clearly, such advice is permissible when the lawyer knows that nonenforcement amounts to effective abandonment of the prohibition and not simply temporary dereliction on the part of enforcing authorities or ignorance on their part of sufficient facts to bring an enforcement proceeding.

Illustrations:

1. Client plays cards with friends in Client's home and asks Lawyer whether it would be illegal for the players to place small bets on the games. Lawyer knows that a criminal statute prohibiting gambling literally applies to such betting. Lawyer also knows that as a matter of long-standing policy and practice, persons who gamble on social games played in private homes for small stakes are not prosecuted. Lawyer may advise Client about the nonenforcement policy and practice.

2. Lawyer reasonably believes that Client has a nonfrivolous basis for asserting on state income-tax returns that Client's use of a personal automobile is for a business purpose and thus that related expenses are a proper deduction. Among other things, Lawyer has advised Client concerning the likelihood of an audit by tax authorities if Client takes the intended deduction. Lawyer bases the assessment of audit likelihood on published figures showing the incidence of audits for automobile use for taxpayers at Client's income level. In the course of that discussion, Client also asks Lawyer what the average taxpayer

at Client's income level deducts for charitable contributions in a year without incurring an audit. From prior dealings with Client, Lawyer knows that Client seldom makes charitable contributions and in past years has not made contributions of more than a few dollars. In the circumstances, Lawyer's advice about enforcement policy concerning the automobile use was appropriate within Subsection (2). While the facts stated above suggest that advice concerning enforcement policy for charitable deductions would not be permissible, whether under all the facts Lawyer may so advise Client depends on whether Lawyer reasonably believes that Client will likely use Lawyer's advice to claim false deductions.

g. A lawyer's knowledge of the wrongful nature of a client's conduct. A lawyer's disciplinary liability under Subsection (2) turns on client activity that the lawyer knows to be criminal or fraudulent or in violation of a court order. On other, nondisciplinary-law definitions of the kind of knowledge that will incur liability, see Comment *a*. In general, actual knowledge of the client's wrongful purpose is required (see § 56, Comment *f*). Knowledge under Subsection (2) may be inferred from circumstances and determining the issue is generally for the finder of fact.

When a lawyer's state of knowledge is relevant, in the absence of circumstances indicating otherwise, a lawyer may assume that a client will use the lawyer's counsel for proper purposes. Mere suspicion on the part of the lawyer that the client might intend to commit a crime or fraud is not knowledge. Under the actual knowledge standard of Subsection (2), a lawyer is not required to make a particular kind of investigation in order to ascertain more certainly what the facts are, although it will often be prudent for the lawyer to do so. Only information known to the lawyer at the time the lawyer provides the assistance is relevant, not information learned afterwards. On the other hand, the prohibitions of Subsection (2) apply at whatever point the lawyer does know that the client's intended conduct is criminal, fraudulent, or in violation of a court order. On withdrawal in such circumstances, see § 32(3); see also §§ 66-67 (disclosure to prevent certain injuries) and § 51, Comment *h* (duty based on lawyer's knowledge of client's breach of fiduciary duty).

For purposes of Subsection (2), only the knowledge of the lawyer performing the counseling or other assistance in question is determinative. If the facts warrant, a finder of fact may infer that the lawyer gained information possessed by other associated lawyers, such as other lawyers in the same law firm, where such an inference would be warranted due to the particular circumstances of the persons working together. Thus, for example, in particular circumstances it may be reasonable to infer that a lawyer who regularly consulted about a matter with another lawyer in the same law firm became aware of the other lawyer's information about a fact. The principles applicable in this context differ from rules applied in other situations, in which the knowledge of one lawyer within a firm is sometimes invariably imputed to other firm lawyers regardless of particular circumstances (see § 123, Comment *b* (imputation for purposes of many conflict-of-interest rules); cf. § 28, Comment *b* (knowledge imputation within a firm for purposes of certain notice requirements) & § 58 (vicarious liability)).

h. Advice concerning nonlegal considerations. As stated in Subsection (3), a lawyer's advice to a client may properly include the lawyer's views concerning aspects of a proposed course of conduct that are not narrowly legal in nature. Such advice, when given as part of legal services provided to the client, is within the scope of § 72 for purposes of the attorney-client privilege, and it is within § 59 for purposes of the general duty of confidentiality (see § 60). A lawyer's advice on significant nonlegal aspects of a matter may be particularly appropriate when the client reasonably appears to be unaware of such considerations or their importance or when it should be apparent that the client expects more than narrow legal counsel. A lawyer is required to provide such assistance when necessary in the exercise of care to the extent stated in § 52. Whether a lawyer may appropriately charge an hourly fee for advice defined in this Comment depends on whether the parties contemplated that the lawyer's compensated services would include such advice (see § 38).

REPORTERS NOTES: REPORTER'S NOTE

Comment b. Rationale. On the general responsibility of lawyers concerning counseling crimes or frauds, see G. Hazard & W. Hodes, *The Law of Lawyering* § 1.2:500 (2d ed.1990); C. Wolfram, *Modern Legal Ethics* § 13.3 (1986); Hazard, *How Far May a Lawyer Go in Assisting a Client in Legally Wrongful Conduct?*, 35 U. Miami L. Rev. 669

(1981); Pepper, *Counseling at the Limits of the Law: An Exercise in the Jurisprudence and Ethics of Lawyering*, 104 *Yale L. J.* 1545 (1995); but see, e.g., Newman, *Legal Advice Toward Illegal Ends*, 28 *U. Richmond L. Rev.* 287, 288 (1994) (analysis based on assertion that "under the substantive law, lawyers are not liable unless they do something more active than merely furnishing advice"). On the value of legal advice to individuals who receive advice and to society generally, compare Kaplow & Shavell, *Private Versus Socially Optimal Provision of Ex Ante Legal Advice*, 8 *J. L. & Econ. Org.* 306 (1992) (if sanctions appropriately set, legal advice to parties planning activity--in contrast to advice to parties in litigation--will communicate those sanctions and improve law compliance), with Bundy & Elhauge, *Knowledge About Legal Sanctions*, 92 *Mich. L. Rev.* 261 (1993) (fairness and law-compliance considerations both indicate desirability of latitude to lawyers in giving advice in both preconduct and litigation contexts).

Comment c. Counseling about activity of doubtful legality. Subsection (2) is based on Rule 1.2(d) of the ABA Model Rules of Professional Conduct (1983) ("a lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent") (emphasis supplied). (On assisting a client with respect to violation of a court order, see authority cited in Reporter's Note to Comment *d* hereto.) Cf. ABA Model Code of Professional Responsibility DR 7-102(A)(7) (1969) ("in his representation of a client, a lawyer shall not counsel or assist his client in conduct that the lawyer knows to be *illegal or fraudulent*") (emphasis supplied). The arguably more inclusive reference to "illegal" client conduct in the ABA Model Code was susceptible of a reading beyond the reference to "criminal" client conduct in ABA Model Rule 1.2(d), but the phrase has not been interpreted broadly in judicial decisions. On the legislative history of the ABA Model Rules proscription, see, e.g., C. Wolfram, *Modern Legal Ethics* 705 (1986); ABA Center for Professional Responsibility, *The Legislative History of the Model Rules of Professional Conduct* 31-35 (1987); Conn. B. Ass'n Informal Op. 91-92 at 2-3 (1991).

See also ABA Model Rule 1.2(d), Comment P [6]:

A lawyer is required to give an honest opinion about the actual consequences that appear likely to result from a client's conduct. The fact that a client uses advice in a course of action that is criminal or fraudulent does not, of itself, make a lawyer a party to the course of action. However, a lawyer may not knowingly assist a client in criminal or fraudulent conduct. There is a critical distinction between presenting an analysis of legal aspects of questionable conduct and recommending the means by which a crime or fraud might be committed with impunity.

The distinction to which the ABA Model Rule Comment refers in the last-quoted sentence is one of fact, and the issue is determined by reference to the particular circumstances involved in the lawyer's actions.

Among the discipline cases for assisting a client in criminal activities, see, e.g., *In re Young*, 776 P.2d 1021 (Cal.1989) (discipline following conviction as accessory to felon, where lawyer assisted fugitive client by arranging bail under false name that client habitually used); *State ex rel. Nebraska St. Bar Ass'n v. Cohen*, 436 N.W.2d 202 (Neb.1989) (lawyer assisted client in criminal offense of attempting to hold for ransom savings bonds found by client); *Office of Disciplinary Counsel v. Stern*, 526 A.2d 1180 (Pa.1987) (disbarment of large-firm specialists in labor law for facilitating client's illegal bribes by paying money to union agent in violation of federal criminal statute); *Comm'n on Legal Ethics v. Hart*, 410 S.E.2d 714 (W.Va.1991) (disbarment of lawyer convicted of aiding and assisting in preparing and presenting false and fraudulent income-tax return of client). See also, e.g., ABA Informal Opinion 1141 (1970) (lawyer may continue to represent fugitive client but may not advise on how to avoid capture). See generally C. Wolfram, *supra* § 13.3.2; Kaplan, *Tax Adviser Exposure to Criminal Penalties*, 46 *N.Y.U. Ann. Inst. Fed. Tax* 16-1 (1988). On a lawyer's susceptibility to criminal conviction as principal or accomplice in general, see § 8, Reporter's Note.

On discipline for involvement in client fraud, see, e.g., *Townsend v. State Bar of California*, 197 P.2d 326 (Cal.1948) (discipline where lawyer advised client to convey property to defraud judgment creditor); Conn. B. Ass'n Informal Op. 91-92 (1991) (participation in client's fraudulent conveyance). A fortiori, a lawyer may not actively and directly engage in a client's fraudulent activity, for example by knowingly misrepresenting a material fact to a third

party. E.g., *Louisiana St. Bar Ass'n v. Warner*, 576 So.2d 14 (La.1991) (aiding client's scheme to coerce property owner to sell property by misrepresenting identity of prospective purchaser). See also § 56, Comment *f*, and Reporter's Note thereto (fraudulent-misrepresentation recovery by nonclient from lawyer); § 98.

Whether a lawyer's continued representation of a client in the midst of client activities that the lawyer knows to constitute a fraud amounts to impermissible assistance depends on the circumstances. More must be shown than mere presence of the lawyer during the transaction and the lawyer's knowledge of the client's intended wrongdoing. It has been suggested that it would be sufficient to show that the lawyer's presence significantly aided the fraud, as by providing a misleading aura of legal rectitude to the client's activities in the transaction. E.g., *Attorney Grievance Comm'n v. Rohrback*, 591 A.2d 488 (Md.1991) (lawyer who merely arranged appointment with bondsman committed no disciplinary violation thereby, despite lawyer's knowledge that client was using assumed name because lawyer told bondsman of that fact; lawyer's remaining in courtroom when bondsman and client posted bond under false name "came perilously close to assisting the fraud" but no violation made out in absence of showing of effect of lawyer's presence). A potentially expansive view of "assist" was indicated in ABA Formal Opinion 92-366 (1992) (lawyer may be held to "assist" client's fraud, within meaning of ABA Model Rule 1.2(d), if lawyer knows that client intends to perpetrate fraud through reuse of lawyer's year-old opinion letter and lawyer fails to notify intended victim that lawyer withdraws opinion letter or if lawyer continues to represent client on unrelated matters thus lending aura of respectability to client's activities). On the facts of the formal opinion, disciplinary liability should attach only when the lawyer knows that such an effect will result from the lawyer's inaction or action.

In certain instances, a lawyer violates legal limitations solely by giving advice and without otherwise assisting the client's misconduct. The cases involve instances in which the lawyer advised a client to act illegally and in circumstances indicating the lawyer's intent to facilitate the client's illegal objective. E.g., *United States v. Perlstein*, 126 F.2d 789 (3d Cir.1942) (criminal offense of obstruction of justice for advising client to destroy documents); *In re Nulle*, 620 P.2d 214 (Ariz.1980) (discipline for advising client to conceal identity of true owners in application for liquor license); *In re Agnew*, 311 N.W.2d 869 (Minn. 1981) (discipline for advising client to flee state to avoid prosecution).

The foregoing concepts are encompassed within the definition of "counsel" and "assist" provided in Comment *a*. It is believed that the notion of facilitation or encouragement reflects both disciplinary cases and decisions in other areas, such as the law of criminal complicity.

On a lawyer's nonliability for assisting in client torts or breaches of contract, see, e.g., *Hackfeld v. Hurren*, 167 B.R. 429 (W.D.Tex.1991); *Boyd Real Estate, Inc. v. Shissler Seed Co.*, 571 N.E.2d 1171 (Ill.App. Ct.), cert. denied, 580 N.E.2d 109 (Ill. 1991) (unqualified privilege in absence of showing of actual malice and intent to harm complaining nonclient); *Solovay v. Greater New York Savings Bank*, 603 N.Y.S.2d 124 (N.Y.App.Div.1993) (lawyer not subject to liability for aiding and abetting tort of client); cf., e.g., *Los Angeles Airways, Inc. v. Davis*, 687 F.2d 321 (9th Cir.1982) (qualified privilege); *Joel v. Weber*, 602 N.Y.S.2d 383 (N.Y.App.Div.1993) (no privilege upon proof of fraud, collusion, malice, or bad faith); see generally § 57, Comment *g*, and Reporter's Note thereto.

Comment d. Violation of a court order. E.g., *Comm'n on Prof. Ethics v. Crary*, 245 N.W.2d 298 (Iowa 1976) (lawyer disbarred for, among other violations, aiding client to violate custody decree); *Wright v. Roberts*, 573 S.W.2d 468 (Tenn.1978) (lawyer suspended for advising client to violate restraining order in divorce case); *In re Robinson*, 639 A.2d 1384 (Vt.1994) (same; visitation rights); see also, e.g., *Davis v. Goodson*, 635 S.W.2d 226 (Ark.1982) (lawyer in contempt for advising client, in open court, to disregard judge's order that client take breathalyzer test); cf., e.g., *In re Callan*, 331 A.2d 612, 616 (N.J.1975) (in view of lawyers' strong advice to clients to follow court order and lack of showing of lawyers' knowledge of subsequent violation, no contempt by lawyers for failing to inform court of violation).

Procedural rules typically state that injunctions and restraining orders also apply directly to a lawyer representing a party specifically named in the order. E.g., Fed. R. Civ. Proc. 65(d) (every such order "is binding . . . upon the parties to the action, their officers, agents, servants, employees, and *attorneys*") (emphasis supplied); *Savarese v. Agriss*, 883 F.2d

1194, 1209 n.27 (3d Cir.1989) (even if person was not party to lawsuit, status as attorney for party made it proper to include him in injunctive order).

Comment e. A reasonable test of a legal obligation. Rule 1.2(d) of the ABA Model Rules of Professional Conduct (1983) recognizes the lawyer's privilege as a disciplinary matter to "counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law." Subsection (2) employs the ABA Model Rule 1.2(d) formulation as illustrative of a general rule with necessary limitations. However, the Subsection replaces the "good faith" formulation with a "reasonably believes" standard. The good-faith formulation is not defined or explained anywhere in the ABA Model Rules. On the other hand, reasonable belief is a term explicitly defined there (ABA Model Rules, Terminology P [8]). The "good faith" concept in Rule 1.2(d) corresponds to its usage in ABA Model Rule 3.1 with respect to the definition of nonfrivolous legal positions (see § 110(1)). There is no indication in the ABA Model Rules that "good faith" is to be determined other than as an objective standard, which is more clearly indicated by "reasonably believes."

On counseling a client to challenge a void order, see, e.g., *In re Tamblyn*, 695 P.2d 902 (Or.1985) (telling client in open court to ignore or disobey void order not violation of lawyercode prohibition against advising client to disregard court order). On counseling a client to refuse to act as required by a court order in order to test its validity on appeal, see, e.g., *Maness v. Meyers*, 419 U.S. 449, 95 S.Ct. 584, 42 L.Ed.2d 574 (1975) (lawyer advised client to refuse to testify in order to provide contempt order as basis for immediate appellate review of ruling on claim of privilege against self-incrimination, in circumstances where procedural rules provided no other means of protecting client's interest and compliance with court order would cause client irreparable injury); *Ariz. Bar Ethics Op. 87-5* (1987) (lawyer may advise client to refuse a blood-alcohol test where the state law is unsettled regarding one's right to refuse or may advise the client about the law's unsettled nature and let the client decide what to do); see generally § 105, *Comment e*, and Reporter's Note thereto.

On lawyer counseling of civil disobedience, see, e.g., 1 G. Hazard & W. Hodes, *The Law of Lawyering* § 1.2:514 (1991 supp.); C. Wolfram, *Modern Legal Ethics* § 13.3.8 (1986); Symposium, 52 U. Pitts. L. Rev. 723 (1991); Weiers, *The Disciplinary Dilemma Confronting Attorneys Seeking to Counsel Civil Disobedience*, 23 Duq. L. Rev. 715 (1985); DiSalvo, *The Fracture of Good Order: An Argument for Allowing Lawyers to Counsel the Civilly Disobedient*, 17 Ga. L. Rev. 109 (1982).

Comment f. Advice about enforcement policy. See 1 G. Hazard & W. Hodes, *The Law of Lawyering* § 1.2:510-512 (2d ed.1990); W. Simon, *The Practice of Justice* 78-79, 105-08 (1998); C. Wolfram, *Modern Legal Ethics* § 13.3.8 (1986); Pepper, *Counseling at the Limits of the Law: An Exercise in the Jurisprudence and Ethics of Lawyering*, 104 Yale L.J. 1545 (1995). Very few decisions discuss the subject of the Comment. Compare, e.g., *Committee on Legal Ethics v. Printz*, 416 S.E.2d 720 (W.Va.1992) (1923 statute prohibiting seeking restitution in lieu of criminal prosecution unenforceable on ground of nonenforcement; lawyer who participated with client in activity that violated literal terms of statute committed no disciplinary violation), with, e.g., *Schlachet v. Schlachet*, 378 N.Y.S.2d 308 (N.Y.Sup.Ct.1976) (separation agreement may not grant predivorce sexual freedom when unrepealed statute continues to define adultery as misdemeanor). Neither Illustration has direct support in a reported decision, but both are supportable on general legal grounds.

Comment g. A lawyer's knowledge of the wrongful nature of a client's conduct. E.g., *Newburger, Loeb & Co. v. Gross*, 563 F.2d 1057, 1080 (2d Cir.1977), cert. denied, 434 U.S. 1035, 98 S.Ct. 769, 54 L.Ed.2d 782 (1978) (under standard that, for civil liability to nonclient, lawyer must have acted "maliciously, fraudulently, or knowingly to tread upon the legal rights of others," lawyer here liable for inducing and participating in client's breach of fiduciary duty); *Attorney Grievance Comm'n v. Sait*, 482 A.2d 898, 902-03 (Md.1984) (lawyer's lack of knowledge of means that client would employ in abducting his 2 children from spouse's custody supported finding of innocence of charge of counseling client in known illegal conduct); *In re Callan*, 331 A.2d 612, 615-16 (N.J.1975) (where record inadequate to demonstrate lawyers' knowledge of clients' violation of court order and lawyers had earlier strongly advised clients against violation, lawyers could not be held in criminal contempt); cf. *Barker v. Henderson, Franklin, Starnes & Holt*,

797 F.2d 490, 496-97 (7th Cir.1986) (lawyer not liable to injured third person in absence of evidence that lawyer knew of facts indicating wrongful nature of client's activities); *State ex rel. Miller v. Rahmani*, 472 N.W.2d 254 (Iowa 1991) (lawyer could not be held liable under state consumer-protection law where lawyer was unaware of client's fraud or of use to which client would put brochures impounded by postal authorities after release obtained through lawyer's efforts); *Cronin v. Scott*, 432 N.Y.S.2d 656 (N.Y.App.Div.1980), appeal dismissed, 419 N.E.2d 1079 (N.Y.1981) (lawyer for co-defendant not liable for fraudulent misrepresentation of client's financial condition in course of settlement discussions in absence of allegation that lawyer was aware of falsity of representation). On the other hand, when a lawyer owes a duty of care to a nonclient (see § 51), negligence suffices as a basis for civil liability. Because of differences in definitions of the requisite level of lawyer knowledge, the level may be lower for the purposes of some forms of criminal responsibility than for arguably comparable forms of civil liability, see Freeman, *The Duties and Liabilities of Attorneys in Rendering Legal Opinions*, 1989 Colum. Bus. L. Rev. 235, 257.

The matter of a lawyer's deliberate attempt not to learn additional information despite awareness of facts sufficiently indicating the illegal nature of a client's conduct has been discussed in various decisions. E.g., *United States v. Cavin*, 39 F.3d 1299, 1310 (5th Cir.1994) (proper to give jury instruction in prosecution of lawyer when prosecution showed: (1) subjective awareness of high probability of existence of illegal conduct; and (2) purposeful contrivance by the lawyer to avoid learning of illegal conduct); *United States v. Sarantos*, 455 F.2d 877, 880-81 (2d Cir.1972) (similar); *Wyle v. R.J. Reynolds Indus., Inc.*, 709 F.2d 585, 590 (9th Cir.1983) (given law firm's awareness of high probability of rebates, trial court properly found that firm was intentionally ignorant of client's illegal payment of rebates); *United States v. Benjamin*, 328 F.2d 854 (2d Cir.1964) (lawyer could not consciously disregard readily available information demonstrating illegal nature of client's transaction). In the Reporter's view, the preferable rule is that proof of a lawyer's conscious disregard of facts is relevant evidence which, together with other evidence bearing on the question, may warrant a finding of actual knowledge. There is no requirement that the claimant also show that the lawyer was specifically aware that a law made the client's activity criminal or otherwise illegal. See *Johnson v. Youden*, [1950] 1 K.B. 544, 546 (K.B.1950).

Comment h. Advice concerning nonlegal considerations. E.g., ABA Model Rules of Professional Conduct, Rule 2.1 (1983):

In representing a client, a lawyer shall exercise independent professional judgment and render candid advice. In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation.

See also *id.* Comment (P2):

Advice couched in narrowly legal terms may be of little value to a client, especially where practical considerations, such as cost or effects on other people, are predominant. Purely technical legal advice, therefore, can sometimes be inadequate Although a lawyer is not a moral advisor as such, moral and ethical considerations impinge upon most legal questions and may decisively influence how the law will be applied.

The question of advising a client about matters beyond the strict requirements and permissions of the law is much discussed in the literature. For one view, see W. Simon, *The Practice of Justice: A Theory of Lawyers' Ethics* (1998) (argument for broadening categorical norms of the profession to place greater stress on considerations of justice). See generally papers presented in two symposiums: Symposium: *The Lawyer's Duty to Promote the Common Good*, 40 *So. Tex. L. Rev.* 1-309 (1999); Review Essay Symposium: *The Practice of Justice*, 51 *Stan. L. Rev.* 867-1006 (1999).



5 of 5 DOCUMENTS

Copyright 2013 American Bar Association
ABA MODEL RULES OF PROFESSIONAL CONDUCT

COUNSELOR

2013

RULE 2.1: ADVISOR

In representing a client, a lawyer shall exercise independent professional judgment and render candid advice. In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation.

Comment

Scope of Advice

[1] A client is entitled to straightforward advice expressing the lawyer's honest assessment. Legal advice often involves unpleasant facts and alternatives that a client may be disinclined to confront. In presenting advice, a lawyer endeavors to sustain the client's morale and may put advice in as acceptable a form as honesty permits. However, a lawyer should not be deterred from giving candid advice by the prospect that the advice will be unpalatable to the client.

[2] Advice couched in narrow legal terms may be of little value to a client, especially where practical considerations, such as cost or effects on other people, are predominant. Purely technical legal advice, therefore, can sometimes be inadequate. It is proper for a lawyer to refer to relevant moral and ethical considerations in giving advice. Although a lawyer is not a moral advisor as such, moral and ethical considerations impinge upon most legal questions and may decisively influence how the law will be applied.

[3] A client may expressly or impliedly ask the lawyer for purely technical advice. When such a request is made by a client experienced in legal matters, the lawyer may accept it at face value. When such a request is made by a client inexperienced in legal matters, however, the lawyer's responsibility as advisor may include indicating that more may be involved than strictly legal considerations.

[4] Matters that go beyond strictly legal questions may also be in the domain of another profession. Family matters can involve problems within the professional competence of psychiatry, clinical psychology or social work; business matters can involve problems within the competence of the accounting profession or of financial specialists. Where consultation with a professional in another field is itself something a competent lawyer would recommend, the lawyer should make such a recommendation. At the same time, a lawyer's advice at its best often consists of recommending a course of action in the face of conflicting recommendations of experts.

Offering Advice

[5] In general, a lawyer is not expected to give advice until asked by the client. However, when a lawyer knows that a client proposes a course of action that is likely to result in substantial adverse legal consequences to the client, the lawyer's duty to the client under Rule 1.4 may require that the lawyer offer advice if the client's course of action is related to the representation. Similarly, when a matter is likely to involve litigation, it may be necessary under Rule 1.4 to inform the client of forms of dispute resolution that might constitute reasonable alternatives to litigation. A lawyer ordinarily has no duty to initiate investigation of a client's affairs or to give advice that the client has indicated is unwanted, but a lawyer may initiate advice to a client when doing so appears to be in the client's interest.

BETWEEN LAW AND MARKETS: IS THERE A ROLE FOR
CULTURE AND ETHICS IN FINANCIAL REGULATION?

BY DAN AWREY, WILLIAM BLAIR AND DAVID KERSHAW*

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.

*Dan Awrey is a University Lecturer in Law & Finance at Oxford University and a Fellow of Linacre College, Oxford; Sir William Blair is a Judge of the High Court of England and Wales; and David Kershaw is a Professor of Law at the London School of Economics. The authors would like to thank John Armour, Thomas C. Baxter, Jr., Raj Bhala, Sir Ross Cranston, Justice Randy Holland, and the participants at seminars hosted by University College London and Oxford University for their very helpful comments on earlier versions of this article and Tucker McCarthy for superb research assistance.

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 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.

TABLE OF CONTENTS

I. INTRODUCTION.....	193
II. THE LIMITS OF LAW AND MARKETS	196
A. <i>The Limits of Markets</i>	196
B. <i>The Limits of Financial Law and Regulation</i>	198
III. THE ROLE AND LIMITS OF CULTURE AND ETHICS IN FINANCE	205
A. <i>Making Sense of Culture and Ethics</i>	205
B. <i>The Role and Limits of Ethics</i>	207
C. <i>The Role and Limits of Culture in Finance</i>	211
D. <i>Toward a More Ethical Culture in Finance</i>	217
IV. WHO IS MY CLIENT? CARVING OUT A ROLE FOR A MORE ETHICAL CULTURE IN BILATERAL COUNTERPARTY RELATIONSHIPS	217
A. <i>The TCF Initiative</i>	218
B. <i>The Extended TCF Initiative</i>	225
V. WHO IS MY NEIGHBOR? CARVING OUT A ROLE FOR A MORE ETHICAL CULTURE IN SYSTEMIC RISK REGULATION.....	227
VI. TREATING BANKS DIFFERENTLY: PRECONDITIONS TO THE EMERGENCE OF BINDING CULTURAL AND ETHICAL CONSTRAINTS	231
A. <i>Composition Reforms: A Board Level Ethics Committee</i>	232
B. <i>Remuneration</i>	234
C. <i>Corporate Law: The Objective of Bank Activity</i>	238
D. <i>Corporate Law: Shareholder Rights</i>	240
E. <i>Corporate Law: The Duty of Care</i>	242
VII. CONCLUSION.....	245

I. INTRODUCTION

The limits of markets as mechanisms for constraining socially suboptimal behavior and outcomes are numerous and well documented.¹ 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*.² In theory, both can play an important role as extra-contractual or extra-legal gap fillers by helping to constrain socially undesirable activities in the vacuum between law and markets.³ 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.⁴ 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.⁵ 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 Trust⁶ and Enron,⁷ to ABACUS,⁸ Libor,⁹ and the

¹See, e.g., Marion Fourcade & Kieran Healy, *Moral Views of Market Society*, 33 ANN. REV. SOC. 285, 291-305 (2007) (summarizing recent theoretical literature).

²See *infra* Part III.A (mapping the distinction between "cultural," "commercial," and other norms, on one hand, and personal "ethics" on the other).

³See *infra* notes 113-16 and accompanying text (synthesizing from empirical research the traits of effective cultural norms).

⁴See *infra* notes 121-134 and accompanying text (providing evidence of limited behavioral impact of cultural norms in the financial services industry).

⁵See *infra* note 81 and accompanying text (noting the difficulty of modeling or measuring personal ethics).

⁶See *In re* Missner, Exchange Act Release No. 33-7124, 34-35136, SEC Docket 1145 (Dec. 22, 1994); *In re* BT Sec. Corp., CTFC Docket No. 95-3, 1994 WL 711224 (Dec. 22, 1994); *BT Securities Censured and Fined \$10 Million for Antifraud and Reporting Violations Relating to the Sales of Derivatives*, 94-243 SEC NEWS DIGEST, Dec. 22, 1994, available at <http://www.sec.gov/news/digest/digarchives/digarch1994.shtml>; Kelley Holland, Linda Himmelstein & Zachary Schiller, *The Bankers Trust Tapes*, BUSINESSWEEK, Oct. 16, 1995, <http://www.businessweek.com/1995/42/b34461.htm>.

⁷See, e.g., BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* 18-21 (2004) (discussing how Enron used profit shifting in hopes of showing "Wall Street that it could produce steadily increasing earnings"); FRANK PARTNOY, *INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED FINANCIAL MARKETS* 30 (2003) (recalling how Enron was one of the companies "accused of inflating revenues and

breaches of U.S. money laundering regulations by HSBC and Standard Chartered,¹⁰ recent financial history is replete with examples of what regulators, politicians, business, and religious leaders have all recognized as,¹¹ 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"¹² (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*¹³—can be fostered and come to play a meaningful role in constraining undesirable conduct and practices within the financial services

reducing expenses to meet quarterly earnings targets").

⁸See SEC v. Goldman Sachs & Co., Litig. Release No. 21489 (April 16, 2010), <http://www.sec.gov/litigation/litreleases/2010/lr21489.htm>; Press Release, U.S. Sec. & Exchange Comm'n, Goldman Sachs to Pay Record \$550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (July 15, 2010), <http://www.sec.gov/news/press/2010/2010-123.htm>; Press Release, Fin. Servs. Auth., FSA Fines Goldman Sachs Int'l £17.5 Million for Weaknesses in Controls to Provide FSA with Appropriate Info. (Sept. 9, 2010), <http://www.fsa.gov.uk/library/communication/pr/2010/141.shtml>.

⁹See Press Release, Fin. Servs. Auth., Barclays Fined £59.5 Million for Significant Failings in relation to LIBOR and EURIBOR (June 27, 2012), <http://www.fsa.gov.uk/library/communication/pr/2012/070.shtml>; Press Release, U.S. Commodity Futures Trading Comm'n, CFTC Orders Barclays to Pay \$200 Million Penalty for Attempted Manipulation of and False Reporting Concerning LIBOR and Euribor Benchmark Interest Rates (June 27, 2012), <http://www.cftc.gov/PressRoom/PressReleases/pr6289-12>; Press Release, U.S. Dep't of Justice, Barclays Bank PLC Admits Misconduct Related to Submissions for the London Interbank Offered Rate and the Euro Interbank Offered Rate and Agrees to Pay \$160 Million Penalty (June 27, 2012), <http://www.justice.gov/opa/pr/2012/June/12-crm-815.html>.

¹⁰See *HSBC's Grilling: What Comes Out in the Wash*, THE ECONOMIST, July 21, 2012, <http://www.economist.com/node/21559349>; Jessica Silver-Greenberg, *British Bank in \$340 Million Settlement for Laundering*, N.Y. TIMES, (Aug. 14, 2012), http://www.nytimes.com/2012/08/15/business/standard-chartered-settles-with-new-york-for-340-million.html?pagewanted=all&_moc.semityn.www.

¹¹See *infra* note 149; see also Emiliya Mychasuk, *Money and Morals*, FIN. TIMES (London), Oct. 24, 2009, at 13 (reporting on a seminar for financial sector leaders conducted by the Archbishop of Westminster); Jonathan Sacks, *Has Europe Lost its Soul to the Markets?*, TIMES (London), Dec. 12, 2011, at 22 (arguing to revitalize Judeo-Christian foundations of markets to develop an ethical culture). See generally WILLIAM BLAIR, STANDARDS AND THE RULE OF LAW AFTER THE GLOBAL FINANCIAL CRISIS in INTERNATIONAL MONETARY AND FINANCIAL LAW: THE GLOBAL CRISIS 97 (Mario Giovanoli & Diego Devos eds., 2010) (suggesting that the "governance of the international financial system will lack the necessary ethical underpinning to enable real progress to higher standards").

¹²Howard 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>.

¹³As described in greater detail in Part IV, our use of the term "ethical culture" is motivated by the inherent "chicken and egg" problem *vis-à-vis* culture and ethics.

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"¹⁴ 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, 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.¹⁵ Put simply, for ethical frameworks to have traction within organizational culture and decision-making they must be given room to breathe. Yet the existing governance arrangements within financial institutions 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.¹⁶ These incentive structures are likely to crowd out efforts to foster the formation of a more ethical culture.¹⁷ 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.¹⁸

This Article proceeds as follows: Part III maps out the limits of both law and markets as mechanisms for governing conduct within the financial services industry. Part IV then draws out the important distinction between cultural, commercial, and other norms on the one hand, and personal ethics

¹⁴See discussion *infra* Part III.A (explaining process-oriented regulation and applying it to a case study).

¹⁵See *infra* note 140 and accompanying text.

¹⁶See *infra* notes 228-231 and accompanying text explaining why in financial institutions in particular shareholder primacy generates these problematic effects. Generally, on variation in governance arrangements, see e.g., Sofie Cools, *The Real Difference in Corporate Law Between the United States and Continental Europe: Distribution of Powers*, 30 DEL. J. CORP. L. 697, 762 (2005).

¹⁷See *infra* notes 141-45 and accompanying text.

¹⁸There 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.

on the other, to examine 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 V 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 Initiative" ("TCF"), a process-oriented regulatory strategy designed to influence organizational culture surrounding the provision of retail financial services. Part V also examines the merits and potential drawbacks of expanding the TCF Initiative to encompass transactions involving more sophisticated market counterparties. Part VI then examines whether it may be possible to employ similar process-oriented strategies 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, moving to the second dimension, Part VII examines why it might be necessary to reconfigure the core internal governance arrangements within financial institutions as a precondition to the emergence of meaningful cultural and/or ethical constraints, and 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 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.

II. THE LIMITS OF LAW AND MARKETS

A. *The Limits of Markets*

Markets are good at 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.¹⁹ 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

¹⁹See *infra* notes 21-22.

Pareto-efficient equilibrium.²⁰ This is the essence of Friedrich Hayek's "spontaneous ordering."²¹ It is also the theoretical foundation of arguments which view free and unfettered markets as the optimal means of allocating society's resources.²²

In reality, of course, complete and perfectly competitive markets exist only in 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; and 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 (the "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.²³ For example, as Gary Gorton has observed, 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.²⁴ 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 underlying assets, and (2) the systematic interconnections between these assets.²⁵ Perhaps more importantly, however, socially excessive private risk-taking—driven by, *inter alia*, information

²⁰See Kenneth Arrow & Gerard Debreu, *Existence of an Equilibrium for a Competitive Economy*, 22 *ECONOMETRICA* 265, 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. *Id.*

²¹See FRIEDRICH A. HAYEK, *INDIVIDUALISM AND ECONOMIC ORDER: THE USE OF KNOWLEDGE IN SOCIETY* 86 (1948) ("The whole acts as one market, not because any of its members survey the whole field, but because their limited individual fields of vision sufficiently overlap so that through many intermediaries the relevant information is communicated to all.").

²²See *id.* at 77-81.

²³See, e.g., Robert P. Bartlett, III, *Inefficiencies in the Information Thicket: A Case Study of Derivative Disclosures During the Financial Crisis*, 36 *J. CORP. L.* 1, 57 (2010) (demonstrating how high information costs and low salience of information lead market participants to overlook valuable trading opportunities).

²⁴See Gary Gorton, *The Panic of 2007*, 20-34 (Aug. 4, 2008), available at <http://www.kc.frb.org/publicat/sympos/2008/gorton.08.04.08.pdf>.

²⁵See Joshua Coval, Jakub Jurek & Erik Stafford, *The Economics of Structured Finance*, 23 *J. OF ECON. PERSP.* 3, 23 (2009).

problems,²⁶ the status of liquidity and financial stability as public goods,²⁷ and the moral hazard and competitive distortions created by the so-called "too big to fail" ("TBTF") subsidy²⁸—generated huge negative externalities, the effects of which are still reverberating throughout the global economy. It should come as no surprise then that much of the post-GFC policy debate can be distilled to a single question: what should we do when markets fail to function effectively?

B. *The Limits of Financial Law and Regulation*

When markets fail we instinctively reach for the regulatory toolbox to directly address the identified failings. If counterparties are uninformed, we seek to ensure that they receive more information; if certain activities are associated with excessive risk-taking, we seek to separate those activities from core banking functions; if private governance arrangements, such as Libor, are broken, we seek to fix them through public regulatory intervention. Although such reforms are important, we need to be cognizant of the limits of conventional legal and regulatory approaches as tools for 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.²⁹ Indeed, to many, these predictions have considerable explanatory power in the context of the pre-and post-crisis regulation of the financial services industry.³⁰ At the same time, we must not assume the omniscience of public

²⁶See *supra* notes 23-25.

²⁷See Dirk Schoenmaker, *The Financial Trilemma 1* (Duisenberg Sch. of Fin. - Tinbergen Inst. Discussion Papers 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.

²⁸Translating 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 (2009), available at http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

²⁹See JAMES M. BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT* 82, 127, 242 (1962); George J. Stigler, *The Theory of Economic Regulation*, 2 *BELL J. ECON. & MGMT. SCI.* 3, 11-12 (1971); Kenneth J. Arrow, *SOCIAL CHOICE AND INDIVIDUAL VALUES* 119 (2d. ed. 1963); Duncan Black, *On the Rationale of Group Decision-Making*, 56 *J. POL. ECON.* 23, 29 (1948).

³⁰Similarly, ostensibly desirable regulation is susceptible to being diluted over time by industry lobbying. See, e.g., Sebastian Mallaby, *Sombre Spanish Lessons on Fighting Credit Bubbles*, *FIN. TIMES* (London), June 14, 2012, available at <http://www.ft.com> (search title) (describing how Spanish dynamic provisioning was watered down in response to industry lobbying); 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, 1763-65 (2011) (describing the gradual

actors. As the GFC has made clear, public regulators often face acute asymmetries of information and expertise *vis-à-vis* regulated constituencies.³¹ These asymmetries limit the ability of regulators to effectively identify and monitor the location, nature, and extent of potential risks, or design and implement effective regulatory responses.³² As a result, we must maintain a healthy degree of skepticism respecting the policy choices of public actors.³³

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 envision the entire universe of potential future states of the world.³⁴ 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.³⁵ Simultaneously, legal rules—once established may be are often inflexible. They are also often over- or under-inclusive.³⁶ This inflexibility generates opportunities for creative compliance and regulatory arbitrage by actors whose incentives are not aligned with regulatory objectives.³⁷ There is also the related prospect that prescriptive legal rules will be rendered anachronistic (or perhaps even harmful) by subsequent developments.³⁸ 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.³⁹

dismantling of section 23A of the U.S. Federal Reserve Act); *see also* SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN (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 and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1026-27 (2012) (observing similar "downsizing" in connection with the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter *Dodd-Frank Act*]).

³¹Dan Awrey, *Regulating Financial Innovation: A More Principles-Based Proposal?*, 5 BROOK. J. CORP. FIN. & COM. L. 273, 292 n.92 (2011).

³²*See* Dan Awrey, *Complexity, Innovation and the Regulation of Modern Financial Markets*, 2 HARV. BUS. L. REV. 235, 276 (2012)

³³*See id.* at 276-77.

³⁴*See* Awrey, *supra* note 31, at 277.

³⁵*See id.*

³⁶*See id.* at 292 n.93.

³⁷*See* Doreen McBarnet, *After Enron Will "Whiter than White Collar Crime" Still Wash?*, 46 BRIT. J. CRIMINOLOGY 1091, 1092 (2006).

³⁸*See, e.g.*, 17 C.F.R. § 270.2a-7 (2012) (requiring U.S. domiciled money market funds to only hold debt instruments rated by an NRSRO).

³⁹*See* Mark W. Nelson, *Behavioral Evidence on the Effects of Principles- and Rules-Based Standards*, 17 ACCT. HORIZONS 91, 93 (2003).

Two examples will help illustrate the limits of conventional legal and regulatory 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.⁴⁰ The second strategy is to impose a duty on financial intermediaries to act, to a greater or lesser extent, in the interests of other (less informed) parties.⁴¹ Strategies falling into this category include both suitability requirements and fiduciary duties. The third strategy includes various forms of product regulation designed, in effect, to insulate less informed parties from risks which they may not fully understand.⁴²

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.⁴³ As Robert Bartlett has observed,

⁴⁰Consider, 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. Dodd-Frank Act, Pub. L. No. 111-203, § 731, 124 Stat. 1708, 1785 (2010). 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." *Id.* § 932, 124 Stat. 1879, 1879 (2010). 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 the Securities Act of 1933, as am. Pub. Law 112-106). See Asset-Backed Securities, Exchange Act Release Nos. 33-9117, 34-61858, 98 SEC Docket 460 (Apr. 7, 2010).

⁴¹See FINANCIAL CONDUCT AUTHORITY, CONDUCT OF BUSINESS SOURCEBOOK §§ 3, 9 (2013) [hereinafter COBS], available at <http://fshandbook.info/FS/html/FCA/COBS> (discussing client categorization and duty of suitability in the U.K.). 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*, 80 TEX. L. REV. 1255 (2002) and Frederick Mark Gedicks, *Suitability Claims and Purchases of Unrecommended Securities: An Agency Theory of Broker-Dealer Liability*, 37 ARIZ. ST. L.J. 535 (2005).

⁴²This 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* 53-54 (Harvard Bus. Sch. & NBER, Working Paper, Aug. 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. 63, 68 (2012).

⁴³See Awrey, *supra* note 32, at 237, 242.

accurately valuing even a single CDO, for example, demands a multi-faceted analysis of an enormous volume of legal and financial data.⁴⁴ 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 a magnitude higher.⁴⁵ 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.⁴⁶ Ultimately, it is the asymmetrical distribution of these endowments which render disclosure, in and of itself, a relatively ineffective strategy for addressing opportunism within the context of bilateral counterparty relationships.⁴⁷

The limits of duty-based strategies stem from the fact that they conflict with the basic tenets of freedom of contract: the notion that individuals are entitled to 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 the incentives of investors to engage in information and price discovery. Ultimately, while the resulting costs may be justified where significant asymmetries of information and expertise exist (*i.e.*, in the retail

⁴⁴Bartlett, *supra* note 23, at 3.

⁴⁵Broadly 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, Fall 2010, available at http://www.brookings.edu/~media/projects/bpea/fall%202010/2010b_bpea_gorton; Zoltan Pozsar 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.

⁴⁶See generally Awrey, *supra* note 32, 242-258 (discussing the complexity of modern financial markets); see also Complaint ¶ 17, SEC v. Goldman Sachs & Co., No. 10-CV-3229 (S.D.N.Y. 2010), available at <http://www.sec.gov/litigation/complaints/2010/comp21489.pdf> (referring to 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 based [on] the 'news' available everywhere are actually realized.") (emphasis added).

⁴⁷See Awrey, *supra* note 32, at 236-37.

context⁴⁸), such strategies are more difficult to justify in contexts involving ostensibly more sophisticated market participants.⁴⁹

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 financial 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, arguably impeding the development and spread of new markets for useful products and services.⁵⁰ Second, the very asymmetries of information and expertise product regulation is designed to ameliorate may render the public actors who design and implement these requirements poorly equipped to identify which products and services pose the greatest risks.⁵¹ Finally, the market distortions generated by these types of requirements have a long history of generating unintended, sometimes even adverse, consequences.⁵²

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.⁵³ Capital adequacy regulation, for example, has been at the forefront of the post-crisis regulatory response. Yet the crisis

⁴⁸See COBS, *supra* note 41, §§ 9.2.1-2 (referring to the U.K.); *see also id.* § 10.2 (providing an "appropriateness regime" in relation to non-recommended/advised services which is again structured around client knowledge and sophistication); 17 C.F.R. §§ 240.10b-3, 240.15c2-5(a)(2) (2012) (focusing on the counterparty's financial situation and needs in the US); *Padgett v. Dapelo*, 826 F. Supp. 99, 100 (S.D.N.Y. 1993) (observing the counterparty's level of sophistication and the likelihood that the broker controlled her account); *Rolf v. Blyth Eastman Dillon & Co.*, 424 F. Supp. 1021, 1026-27 (S.D.N.Y. 1977) (discussing how there was enough evidence to prove that the plaintiff kept careful watch over his securities and that he was not an unsophisticated investor). For a detailed discussion of these provisions, *see Engel & McCoy, supra* note 41, at 1258. *See also* Jonathan Macey et al., *Helping Law Catch Up to Markets: Applying Broker-Dealer Law to Subprime Mortgages*, 34 J. CORP. L. 789, 815 (2009) (observing that "[t]oday, like in the 1930s, most actions against broker-dealers for suitability and suitability-like violations involve sad stories of elderly and/or infirm individuals swindled by unscrupulous broker-dealers").

⁴⁹*See* Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CALIF. L. REV. 627, 690 (1996).

⁵⁰Simultaneously, of course, they may be *under*-inclusive: failing to capture the entire universe of parties in need of protection. *See* Awrey, *supra* note 31, at 277.

⁵¹*See* Yesha Yadav, *The Specter of Sisyphus: Re-making International Financial Regulation After the Global Financial Crisis*, 24 EMORY INT'L L. REV. 83, 110 (2010).

⁵²*See* Arnold Kling, *Not What They Had in Mind: A History of Policies That Produced the Financial Crisis of 2008* 37 (Mercatus Fin. Mkts. Working Grp., Working Paper No. 1474430, 2009), available at <http://mercatus.org/uploadedFiles/Mercatus/Publications/NotWhatTheyHadInMind.pdf>.

⁵³*See* Robert F. Weber, *New Governance, Financial Regulation, and Challenges to Legitimacy: The Example of the Internal Models Approach to Capital Adequacy Regulation*, 62 ADMIN. L. REV. 783, 790 (2010).

itself has revealed the profound limitations of such regulation—limitations that some leading regulators are beginning to publicly acknowledge.⁵⁴ 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.⁵⁵ While Basel III has removed some of this rigidity,⁵⁶ banks are still able to rely on their own models in assessing asset quality. As a result, arbitrage opportunities still exist.⁵⁷ Yet the obvious alternative is to substitute banks' internal risk assessments for those of bank supervisors: a strategy which was employed by Basel I and subsequently rejected as both inflexible and inaccurate.⁵⁸ Capital adequacy regulation can thus be viewed as involving a choice between two second-best strategies. Second, and partially as a result of these limitations, reported regulatory capital levels are not always an accurate reflection of underlying bank solvency.⁵⁹ For example, just fifteen days prior to filing for bankruptcy, Lehman Brothers reported a Tier 1 capital ratio of 11%–7% higher than the minimum requirement under Basel II.⁶⁰ Similarly, Northern Rock was, on paper at least, the best capitalized major U.K. bank just prior to its demise.⁶¹

⁵⁴See Brooke Masters, *Haldane Calls for a Rethink of Basel III*, FIN. TIMES (London), 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. *Id.*

⁵⁵See David Jones, *Emerging Problems with the Basel Capital Accord: Regulatory Capital Arbitrage and Related Issues*, 24 J. BANKING & FIN. 35, 42-47 (2000) (describing how financial institutions utilized structural subordination (*i.e.*, tranching), remote origination (*i.e.*, structured investment vehicles), and indirect credit enhancement (*i.e.*, structured liquidity facilities) to lower their regulatory capital requirements without reducing the underlying economic risk).

⁵⁶See generally Basel Committee on Banking Supervision, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems*, BANK FOR INT'L SETTLEMENTS, 29-54 (June 2011), available at <http://www.bis.org/publ/bcbs189.pdf> (outlining "the reforms to the counterparty credit risk framework").

⁵⁷See Brooke Masters et. al., *Fears Rise Over Banks' Capital Tinkering*, FIN. TIMES (London), Nov. 13, 2011, available at <http://www.ft.com> (search title) (reporting that "[c]oncern 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"); Brooke Masters, *Investors Lose Faith in Banks' RWA Models*, FIN. TIMES (London), May 23, 2012, available at <http://www.ft.com> (search title).

⁵⁸See Ines Drumond, *Bank Capital Requirements, Business Cycle Fluctuations and the Basel Accords: A Synthesis*, 23 J. ECON. SURVS. 798, 807 (2009) (discussing proposed and actual changes to Basel II).

⁵⁹The other distortion being that Basel II (unlike Basel III) did not measure liquidity. *See id.* at 812.

⁶⁰See Candemir Baltali & Joseph Tanega, *Basel III: Dehybridization of Capital*, 8 N.Y.U. J. L. & BUS. 1, 15-16 (2011).

⁶¹*Id.* at 15.

Looking forward, it seems almost inevitable that post-crisis reforms such as the U.S. "Volcker Rule,"⁶² the U.K.'s retail ring-fence,⁶³ and the EU's proposed Liikanen ring-fence, if implemented,⁶⁴ will also be vulnerable to regulatory arbitrage. The objective of these reforms is to insulate deposit-taking institutions from the risks associated with more speculative investment banking and proprietary trading activities.⁶⁵ At the same time, however, these reforms contemplate that deposit-taking institutions will still be permitted to utilize these instruments for risk management (*i.e.*, hedging) purposes. Yet articulating a comprehensive legal definition of proprietary trading—and distinguishing such trading from permissible hedging activities—is far from straightforward. For a salient example, one need look no further than J.P. Morgan's recent trading loss—estimated to be in the range of two to five billion dollars⁶⁶—on what was, ostensibly at least, a hedging transaction.⁶⁷ This vulnerability underscores the limits of conventional regulatory approaches to excessive risk-taking.

Much of the financial regulatory toolbox deployed in response to the GFC is therefore limited in its likely effectiveness. Perhaps as important, it is also limited in its *outlook*. Specifically, these conventional regulatory responses share a common approach to regulation which attempts to dictate or directly influence how market participants act.⁶⁸ They do not, however, attempt to mold how people think when they act.⁶⁹ Put differently, the

⁶²See Dodd-Frank Act, Pub. L. 111-203, § 619, 124 Stat. 1376, 1617 (2010) (amending the Bank Holding Company Act of 1956, 12 U.S.C. § 1841 et. seq., to add prohibitions on proprietary trading and certain relationships with hedge funds and private equity funds).

⁶³See HM TREASURY, BANKING REFORM: DELIVERING STABILITY AND SUPPORTING A SUSTAINABLE ECONOMY 15 (2012), available at http://www.hm-treasury.gov.uk/d/whitepaper_banking_reform_140512.pdf.

⁶⁴See EU High-Level Group on Reforming the Structure of the EU Banking Sector, *Final Report* EUROPEAN COMM'N, 99 §5.5 (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.

⁶⁵For example, risks involving positions in OTC derivatives. See *infra* note 111 and accompanying text.

⁶⁶See 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/>.

⁶⁷See Shahien Nasiripour & Tom Braithwaite, *JP Morgan Faces Fresh Probe*, FIN. TIMES (London), Sept. 6, 2012, available at <http://www.ft.com/intl/cms/s/0/5f418ff4-f84a-11e1-bec8-00144feabdc0.html> (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), *aff'd*, [2012] EWCA (Comm) 1049 (Eng.) (noting an arbitral tribunal reached a different conclusion on similar facts in a claim by Citibank).

⁶⁸See *infra* notes 238-39 and accompanying text.

⁶⁹See *infra* Part III.A.

conventional regulatory toolbox 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.⁷⁰

III. THE ROLE AND LIMITS OF CULTURE AND ETHICS IN FINANCE

A. *Making Sense of Culture and Ethics*

We are sympathetic to the view reflected in Andrew Hill's statement—"when I hear the words corporate culture, I reach for my pistol"⁷¹—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.⁷² Nevertheless, we also know that culture and ethics are important determinants of human and organizational behavior. As a starting point, some degree of definitional precision is thus required. 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.⁷³ Ellickson draws a distinction between first, second, and third-party behavioral constraints.⁷⁴ First-party constraints are imposed

⁷⁰Paul A. Volcker, former chairman of the Federal Reserve and the Economic Recovery Advisory Board, recognized the importance of organizational culture in filling this gap in proposing his "Volcker Rule." See Letter from Paul A. Volcker to U.S. Dep't of Treasury, Fed. Reserve Bd., Fed. Deposit Ins. Corp., Secs. & Exch. Comm'n, Commodity Futures Trading Comm'n (Feb. 13, 2012), available at http://www.federalreserve.gov/SECRES/2012/February/20120216/R-1432/R-1432_021312_105358_329618485095_1.pdf.

⁷¹Andrew Hill, *Culture Questions for Goldman's Blankfein*, FIN.TIMES BLOG (Mar. 14, 2012, 1:05 PM), <http://www.ft.com> (search title).

⁷²See Sebastian Mallaby, *Woodrow Wilson Knew How to Beard Behemoths*, FIN. TIMES (London), July 6, 2012, <http://www.ft.com> (search title) (observing that "[w]hen policy debates are dominated by the c-word, you know we are out of practical ideas").

⁷³See ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES 123 (1991).

⁷⁴*Id.* at 126-27 (employing "controllers" terminology to describe these constraints).

by an actor on him or herself. This is the domain of "*personal ethics*."⁷⁵ 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*."⁷⁶ 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.⁷⁷ 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.⁷⁸

Culture, ethics, and the law can thus all be viewed as mechanisms—empty vessels—through which various substantive norms are generated, monitored, and enforced. The substantive content of cultural norms and ethics (or, indeed, the law⁷⁹) may be identical. The prohibition against the taking of human life, for example, exists across all three dimensions. But equally, cultural, ethical, and legal norms may come into conflict with one another. The key distinction for our purposes 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, by contrast, it is *internal*, or endogenous.⁸⁰

⁷⁵*Id.* at 126.

⁷⁶*Id.*

⁷⁷See ELICKSON, *supra* note 73, at 127. Although even this distinction is incomplete insofar as membership in many organizations is often contractual in nature.

⁷⁸We 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". See *id.* 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 *infra* Part IV.C. 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 110-12 (Steven Lukes ed., W.D. Halls trans. 1982) (distinguishing between individual and collective representations); NIKLAS LUHMANN, ESSAYS ON SELF REFERENCE 24 (1990) (distinguishing between psychic and communicative systems); Gunther Teubner, *How the Law Thinks: Toward a Constructivist Epistemology of the Law*, 23 L. & SOC'Y REV. 727, 732 (1989) (distinguishing between "psychic intentions" and "social communication").

⁷⁹Although, as we have seen, the law can be an inflexible tool for articulating this content. See *supra* Part II.B.

⁸⁰Ultimately, of course, it is difficult to unpack which factors are either exogenous or

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 that follows, we largely bracket these questions and use 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 model in theory and measure in the real world.⁸¹ 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,"⁸² not play the slightest role. Moreover, even within these (somewhat artificial⁸³) categories there exist substantial problems of inter-personal 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.⁸⁴

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.

⁸¹Although this is precisely what the field of neuro-ethics attempts to do. See generally EDWARD O. WILSON, *THE SOCIAL CONQUEST OF EARTH* (2012) (espousing theories of evolutionary ethics).

⁸²Mr. Oliver Wendell Holmes, Jr., Justice, 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 Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 459-61 (1897) (stating that "a [bad] man who cares nothing for an ethical rule which is believed and practised by his neighbors is likely nevertheless to care a good deal to avoid being made to pay money, and will want to keep out of jail if he can").

⁸³Both 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.

⁸⁴See MICHAEL J. SANDEL, *WHAT MONEY CAN'T BUY: THE MORAL LIMITS OF MARKETS* 6 (2012) (providing a contemporary discussion about markets).

The internal nature of ethics also raises a problem for regulation: namely, how can it influence internal ethical perspectives and decision-making? Here, ongoing work in the fields of cognitive and social psychology offer some potentially valuable insights. First, the moral intensity (or salience) of an ethical problem can be an important determinant of ethical decision-making.⁸⁵ As Thomas Jones explains, the moral intensity of a problem is a function of, *inter alia*: (1) the magnitude of the potential consequences; (2) the probability that consequences will occur; (3) their concentration; (4) temporal immediacy; (5) social consensus and; importantly (6) proximity.⁸⁶ Proximity is a measure of the physical, psychological, social, or cultural distance between a decision-maker and those whom their decisions affect.⁸⁷ 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.⁸⁸ The potential upshot, however, is that by reconfiguring financial institutions and markets with a view to reducing physical or psychological distance, it may be possible to enhance ethical decision-making.⁸⁹

Importantly, the factors identified by Jones as contributing to moral intensity are characteristics of the ethical problem itself, not of decision-makers.⁹⁰ 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. In the classic 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.⁹¹ Participants are then told that, by pulling a switch, they can redirect

⁸⁵See Thomas M. Jones, *Ethical Decision Making by Individuals in Organizations: An Issue-Contingent Model*, 16 ACAD. MGMT. REV. 366, 372-74 (1991). Consistent with the relevant cognitive science literature, the terms "moral" and "ethical" (and their various derivations) are used interchangeably in this section.

⁸⁶*Id.* at 374-78

⁸⁷*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 A. Kallgren et al., *A Focus Theory of Normative Conduct: When Norms Do and Do Not Affect Behavior*, 26 PERSONALITY & SOC. PSYCHOL. BULL. 1002, 1006 (2000).

⁸⁸See Jones, *supra* note 85, at 376 ("Intuitively, people care more about other people who are close to them (socially, culturally, psychologically, or physically) than they do for people who are distant.").

⁸⁹See *id.* at 376, 387-88; Stanley Milgram, OBEDIENCE TO AUTHORITY: AN EXPERIMENTAL VIEW 33-34 (1974).

⁹⁰Jones, *supra* note 85, at 371.

⁹¹See JUDITH JARVIS THOMSON, RIGHTS, RESTITUTION, AND RISK: ESSAYS IN MORAL THEORY 94-116 (William Parent ed., 1986); Philippa Foot, *The Problem of Abortion and the*

the train onto a second track to which a single person is tied.⁹² In both cases, the person(s) tied to the tracks in the path of the train are certain to perish.⁹³ 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.⁹⁴ Notably, while the welfare implications are identical in each case, experimental evidence suggests 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.⁹⁵ The implication, in the view of many, is that by 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.⁹⁶ 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 deliberate (System 2).⁹⁷ Several

Doctrine of the Double Effect, 5 OXFORD REV. 1, 2 (1967), reprinted in PHILIPPA FOOT, VIRTUES AND VICES AND OTHER ESSAYS IN MORAL PHILOSOPHY 23 (1978).

⁹²See THOMSON, *supra* note 91, at 94.

⁹³See *id.*

⁹⁴See *id.* at 82.

⁹⁵See Piercarlo Valdesolo & David DeSteno, *Manipulations of Emotional Context Shape Moral Judgment*, 17 PSYCHOL. SCI. 476, 476 (2006); Joshua D. Greene et al., *An fMRI Investigation of Emotional Engagement in Moral Judgment*, 293 SCI. 2105, 2106 (2001); Natalie Gold et al., *Framing Effects in Ethical Dilemmas: Research Project in Experimental Philosophy (Experimental Ethics)* (Arts & Humanities Research Council Workshop May 3-4, 2012), <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* 19, 54-55 (2008) (discussing framing effects more generally).

⁹⁶See Lawrence Kohlberg, *Stage and Sequence: The Cognitive-Developmental Approach to Socialization*, in HANDBOOK OF SOCIALIZATION THEORY AND RESEARCH 347 (David A. Goslin ed., 1969); J. Keith Murnighan et al., *Bounded Personal Ethics and the Tap Dance of the Real Estate Agency*, in ADVANCES IN QUALITATIVE ORGANIZATIONAL RESEARCH 23 (2001); Brian Gunia et al., *Contemplation and Conversation: Subtle Influences on Moral Decision Making*, 55 ACAD. MGMT. J. 13, 13 (2012). Others, meanwhile, suggest that reflection and reasoning simply serve to generate *ex post* rationalizations of *ex ante* moral intuitions. See Jonathan Haidt, *The Emotional Dog and Its Rational Tail: A Social Intuitionist Approach to Moral Judgment*, 108 PSYCHOL. REV. 814, 814 (2001). Haidt's social intuitionist model, however, is grounded in right-wrong decisions designed to evoke disgust (*i.e.*, incest) on the part of test subjects. See *id.* at 817. We submit that the vast majority of ethical decisions within the business context do not evoke similar emotions.

⁹⁷See Daniel Kahneman & Shane Frederick, *Representativeness Revisited: Attribute Substitution in Intuitive Judgment*, in HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT 51 (Thomas Gilovich et al. eds., 2002); Seymour Epstein, *Integration of the Cognitive and Psychodynamic Unconscious*, 49 AM. PSYCHOLOGIST 709, 710 (1994); Shane Frederick, *Cognitive Reflection and Decision Making*, 19 J. ECON. PERSP. 25, 26 (2005); Keith E. Stanovich & Richard F. West, *Individual Differences in Reasoning: Implications for the Rationality Debate?*, 23

scholars have proposed that utilitarian or consequentialist moral judgments take place within System 2.⁹⁸ This view finds empirical support in a recent study by Gunia, Wang, Huang, Wang, and Murnighan, in which test subjects were given three 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.⁹⁹ The authors of the study found that subjects in this contemplation condition were five times more likely to tell the truth than subjects asked to make an immediate decision.¹⁰⁰ In the view of some scholars, this apparent link between intuitive processes and self-interested decisions reflects deeply engrained evolutionary motives.¹⁰¹ Moreover, these motives may dominate in environments such as finance where a premium is placed on quick thinking and decisiveness.¹⁰² Contemplation, in contrast, allows individuals to consciously weigh ethical considerations against self-interest.¹⁰³ As a result, slowing decision-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.¹⁰⁴ Gunia et al., for example, found that test subjects having even a brief, anonymous, and electronic morally-oriented conversation were four times more likely to tell the truth than subjects having a self-interested conversation.¹⁰⁵ 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.¹⁰⁶ Simultaneously,

BEHAV. & BRAIN SCI. 645, 658 (2000); Daniel Kahneman, Nobel Prize Lecture, *Maps of Bounded Rationality: A Perspective on Intuitive Judgment and Choice* (Dec. 8, 2002), available at http://www.nobelprize.org/nobel_prizes/economics/laureates/2002/kahnemann-lecture.pdf.

⁹⁸See Joshua D. Greene, *Why are VMPFC Patients More Utilitarian?: A Dual-Process Theory of Moral Judgment Explains*, 11 TRENDS IN COGNITIVE SCI. 322, 322 (2007); Joshua D. Greene et al., *The Neural Bases of Cognitive Conflict and Control in Moral Judgment*, 44 NEURON 389, 391 (2004); Greene et al., *supra* note 95, at 2107.

⁹⁹Gunia et al., *supra* note 96, at 19-20.

¹⁰⁰*See id.* at 22; *see also* Joseph M. Paxton et al., *Reflection and Reasoning in Moral Judgment*, 36 COGNITIVE SCI. 163, 171 (2012) (documenting an increased utilitarian moral judgment after inducing people to be more reflective).

¹⁰¹*See* Murnighan et al., *supra* note 96, at 20-22.

¹⁰²*See* Gunia et al., *supra* note 96, at 27.

¹⁰³*See id.* at 15-16.

¹⁰⁴*See id.* at 17-18.

¹⁰⁵*See id.* at 24.

¹⁰⁶*See* AMITAI ETZIONI, THE MORAL DIMENSION: TOWARD A NEW ECONOMICS 42 (1988). This, of course, works in both directions: conversations which emphasize self-interest may have the opposite effect. *See* Rebecca K. Ratner & Dale T. Miller, *The Norm of Self-Interest and Its Effects on Social Action*, 81 J. PERSONALITY & SOC. PSYCHOL. 5, 5 (2001).

however, these conversations must be about more than simply allowing individuals and groups to construct *ex post* explanations which reinforce their *ex ante* intuitions.¹⁰⁷

Ultimately, of course, the insights of cognitive and social psychology must be approached with caution as potential drivers of public policy.¹⁰⁸ 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 confound these predictions. Organizational and other environmental factors may similarly interfere with strategies designed to enhance ethical decision-making.¹⁰⁹ 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.¹¹⁰

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.¹¹¹ Perhaps not surprisingly, therefore, a significant body of scholarship has emerged, dedicated to exploring the precise circumstances in which privately generated norms arise and when they can be expected to yield Pareto improvements over both law and markets.¹¹² The majority of this scholarship

¹⁰⁷See Gunia et al., *supra* note 96, at 18-19; Haidt, *supra* note 96, at 822.

¹⁰⁸See Ben Seymour & Ivo Vlaev, *Can, and Should, Behavioural Neuroscience Influence Public Policy?*, 16 TRENDS IN COGNITIVE SCI. 449, 551 (2012).

¹⁰⁹See Kallgren et al., *supra* note 87, at 1011 ("A variety of situational factors may draw attention to a relevant norm or distract attention from it.")

¹¹⁰Neal M. Ashkanasy et. al., *Bad Apples in Bad Barrels Revisited: Cognitive Moral Development, Just World Beliefs, Rewards, and Ethical Decision-Making*, 16 BUS. ETHICS Q. 449, 451 (2006) ("The 'bad apples' perspective suggests that individual differences affect ethical decision-making and behavior.")

¹¹¹See, *e.g.*, Dan Awrey, *The Dynamics of OTC Derivatives Regulation: Bridging the Public-Private Divide*, 11 EUR. BUS. ORG. L. REV. 155, 163-64 (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).

¹¹²See Stephen E. Ellis & Grant M. Hayden, *The Cult of Efficiency in Corporate Law*, 5 VA.

has centered around homogeneous and geographically proximate groups of market actors—for example, ranchers,¹¹³ diamond merchants,¹¹⁴ and cotton merchants¹¹⁵—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.¹¹⁶ 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 norms. Prominent examples include the Chartered Financial Analyst (the "CFA") Institute's *Code of Ethics and Standards of Professional Conduct*,¹¹⁷ the Chartered Institute for Securities and Investment's *Code of Conduct*,¹¹⁸ and the Alternative Investment Management Association *Guides to Sound Practices*.¹¹⁹ The salient

L. & BUS. REV. 239, 241-245 (2010) (explaining the Pareto principal and its relation to corporate governance).

¹¹³See ELLICKSON, *supra* note 73, at 1.

¹¹⁴See Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 115 (1992).

¹¹⁵See Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724, 1725-28 (2001).

¹¹⁶See Bernstein, *supra* note 114, at 124-30 (discussing the New York Diamond Club's private arbitration system and how it resolves disputes on the basis of trade customs and usages); Bernstein, *supra* note 115, at 1726-28, 1737-38 (discussing how merchants comply with arbitration decisions of cotton trade associations because failing to do so results in a widely publicized expulsion which affects the profitability of a merchant's business and his reputation); Avner Greif, *Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition*, 83 AM. ECON. REV. 525, 525-26, 528-29, 535, 544 (1993) (discussing how the Maghribi's information-transmission mechanism enabled merchants to monitor agents and make cheating known to all, which prevented the agents from acting opportunistically and embezzling trader's goods); ELLICKSON, *supra* note 73, at 1 (discussing how neighbors in a rural county in California "resolve a variety of disputes that arise from wayward cattle"). In viewing diffusion mechanisms as key to the enforcement of norms, we adopt an individualist rather than an institutionalist approach 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).

¹¹⁷*Code of Ethics and Standards of Professional Conduct*, CHARTERED FIN. ANALYSIS INST. [Code of Ethics], <http://www.cfainstitute.org/ethics/codes/ethics/Pages/index.aspx> (last visited Sept. 27, 2012).

¹¹⁸*Code of Conduct*, CHARTERED INST. FOR SECS. & INVS., http://www.siservices.co.uk/brochures/img_pdf/Code%20of%20Conduct%202011a5%20without.pdf (last visited Sept. 27, 2012).

¹¹⁹*Guides to Sound Practices*, ALT. INV. MGMT ASS'N, <http://www.aima.org/en/knowledge>

question, however, is whether these norms generate meaningful behavioral constraints across the financial services industry.¹²⁰ 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.¹²¹ These asymmetries undermine the ability of market participants with lower tolerances for this complexity to detect violations of any relevant norms, either by their own counterparties, or in the marketplace more generally.¹²² 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")—the predecessor to the new Financial Conduct Authority ("FCA")—completed a review which found evidence of widespread mis-selling of complex interest rate hedging products to relatively unsophisticated small and medium sized enterprises.¹²³ Previous FSA reviews have also uncovered extensive mis-selling of, *inter alia*, payment protection insurance¹²⁴ and sub-prime mortgage products.¹²⁵ The U.S. has similarly experienced a spate of mis-selling claims in the wake of the GFC.¹²⁶ Importantly, this behavior emerged and persisted despite the existence of

[_centre/sound-practices/guides-to-sound-practices.cfm](#) (last visited Sept. 27, 2012).

¹²⁰See *supra* notes 46-47 and accompanying text.

¹²¹See *supra* notes 47-49 and accompanying text.

¹²²See Awrey, *supra* note 111, 175-77.

¹²³See 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 U.K. has recently been reformed. As of April 1, 2013, the existing functions of the FSA in relation to market conduct have been transferred to a new Financial Conduct Authority. See *Regulatory Reform – Background*, FSA, http://www.fsa.gov.uk/about/what/reg_reform/background. Its current prudential regulation function, meanwhile, has been transferred to a new Prudential Regulatory Authority ("PRA"), a subsidiary of the Bank of England. See *id.*

¹²⁴See 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; *Payment Protection Insurance Market Investigation Order 2011*, COMPETITION COMM'N (Mar. 24, 2011), available at <http://www.competition-commission.org.uk/> (search title). As of April 2013, £9.3 billion has been paid out in refunds and compensation for mis-sold payment protection insurance. See *Monthly PPI Refunds and Compensation*, FCA, <http://www.fca.org.uk/consumers/financial-services-products/insurance/payment-protection-insurance/refunds> (last visited April 25, 2013).

¹²⁵See 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>.

¹²⁶See Tom Braithwaite et al., *Banks Sued Over Mortgage Deals*, FIN. TIMES (London), Sept. 3, 2011, available at <http://www.ft.com> (search title).

numerous industry codes and institutional pronouncements stating, in effect, that the customer *always* comes first.¹²⁷ 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's *Code of Ethics* provides an illustrative example.¹²⁸ 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.¹²⁹ In the context of advisory relationships, it also imposes duties of loyalty, fair dealing, suitability, and disclosure of conflicts of interest.¹³⁰ These important ethical objectives have much in common with those articulated in other professional contexts such as law and accountancy.¹³¹ The CFA Institute has established a disciplinary procedure to address violations of the *Code of Ethics*, with its most powerful sanctions being to suspend or revoke a violator's membership.¹³²

As an organization whose reputation and financial resources are derived from its ability to attract and retain its members, however, the CFA Institute's incentives to vigorously pursue enforcement action are relatively weak.¹³³ This weakness 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 98,000.¹³⁴ This

¹²⁷See, e.g., *Business Principles and Standards: Golden Sachs Business Principles*, GOLDMAN SACHS, <http://www.goldmansachs.com/who-we-are/business-standards/business-principles/index.html> (last visited Feb. 21, 2013) (stating "[o]ur clients' interests always come first.").

¹²⁸See generally *Disciplinary Statistics*, CFA INST. (2000-12), available at www.cfainstitute.org/ethics/Documents/Professional%20Conduct%20Program%20Documents/mem_discipline_stats.pdf (illustrating examples and giving guidance on the Standards of day-to-day professional activities).

¹²⁹*Code of Ethics and Standards of Professional Conduct*, CFA, www.cfapubs.org/doi/pdf/10.2469/ccb.v2010.n14.1 (last visited Feb. 24, 2013).

¹³⁰See *id.*

¹³¹See, e.g., *Solicitors Regulatory Authority Handbook*, SOLICITORS REG. AUTH. (Oct. 6, 2011), <http://www.sra.org.uk/handbook/> (legal standards); *Ethical Standards for Auditors*, FIN. REPORTING COUNCIL, <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> (last visited Feb. 24, 2013) (accounting standards).

¹³²See *Current Industry-Related Sanctions*, CFA INST., available at www.cfainstitute.org/ethics/conduct/pages/current_industry_related_sanctions.aspx (last visited Feb. 24, 2013). It can also issue, *inter alia*, cautionary letters, private reprimands and public censures. *Id.*

¹³³See generally *Disciplinary Statistics*, CFA INST., available at www.cfainstitute.org/ethics/Documents/Professional%20Conduct%20Program%20Documents/mem_discipline_stats.pdf (last visited Feb. 24, 2013) (presenting the lack of enforcement in the statistics of professional conduct cases involving industry matters from 2000-2012).

¹³⁴See *id.* The figures over the same period for cautionary letters, private reprimands and censures are, respectively, 16.25, 5.83 and 1.17 per year. See *id.*

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.¹³⁵ 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.¹³⁶ 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.¹³⁷ Concomitantly, it is not uncommon for market participants to make significant relationship-specific investments in the financial services firms with which they do business.¹³⁸ 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* renegotiation or alternative dispute resolution (as opposed to *public* litigation) as a means of compensating the aggrieved party for any loss.¹³⁹ 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 the most fertile ground for the formation and cultivation of cultural norms, the structure of the firm arguably holds considerably more promise. The frequency of interactions within a firm will often render violations of firm-specific norms (relatively)

¹³⁵See Cindy R. Alexander, *On the Nature of the Reputational Penalty for Corporate Crime*, 42 J. L. & ECON. 489, 490-91 (1999); John Armour et al., *Regulatory Sanctions and Reputational Damage in Financial Markets 1* (Oxford Legal Studies Research Paper No. 62/2010, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1678028; John R. Graham et al., *Corporate Misreporting and Bank loan Contracting*, 89 J. FIN. ECON. 44, 46 (2008); Gregg Jarrell & Sam Peltzman, *The Impact of Product Recalls on the Wealth of Sellers*, 93 J. POL. ECON. 512, 513 (1985); Jonathan M. Karpoff et al., *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANTITATIVE ANALYSIS 581, 583 (2008); Benjamin Klein & Keith Laffler, *The Role of Market Forces in Ensuring Contractual Performance*, 89 J. POL. ECON. 615, 616 (1981).

¹³⁶John Armour et al., *supra* note 135, at 11.

¹³⁷*See id.* 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?

¹³⁸Klein & Keith, *supra* note 135, at 616.

¹³⁹Alexander, *supra* note 135, at 516-17.

observable.¹⁴⁰ 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.

The key question for financial services firms is thus not how to generate, monitor, and enforce compliance with cultural norms per se 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,"¹⁴¹ a norm reinforced by existing incentive structures.¹⁴² Notably, "self-interest" in this context may encompass the interests of individual employees, teams, divisions,¹⁴³ or even the entire institution.¹⁴⁴ 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.¹⁴⁵

¹⁴⁰Although, 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.

¹⁴¹Ratner & Miller, *supra* note 106, at 5.

¹⁴²See *Salz Review: An Independent Review of Barclay's Business Practices* (2013) at 6 (observing that "[w]e believe that the business practices for which Barclays has rightly been criticised were shaped predominantly by its cultures"), available at <http://group.barclays.com/about-barclays/citizenship/salz-review-report>. See also Grant Woods, *Barclays Culture Discouraged Staff from Raising Concerns*, FIN. TIMES (London), July 10, 2012, available at <http://www.ft.com> (search title) for anecdotal evidence supporting the view that a culture of individualism is readily enforced within financial services firms. See also *id.* ("The 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.").

¹⁴³See Gillian Tett, *Insight: Anthropological Insights into Banking Behaviour*, FIN. TIMES (London), Jan. 17, 2008, at 1 (referring to "warring . . . tribal cultures" in Citibank and Merrill Lynch).

¹⁴⁴See *id.*

¹⁴⁵See *Shaming the Banks into Better Ways: Barclays Affair Shines Unsparing Light on Financial Sector*, FIN. TIMES (London), June 28, 2012, at 8 (referring to the "rotten culture at Barclays").

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.¹⁴⁶ The common theme underlying both of these objectives is the desire to promote what can best be characterized as a norm of "other regarding" behavior within financial services firms, one which, to the fullest extent possible, attempts to induce firms to take into account the private and social costs of their decisions.¹⁴⁷ 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 behavioral impact of these norms.

IV. 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 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."¹⁴⁸ Many senior figures within the financial services industry have, similarly, signaled that they are receptive to the idea that culture can

¹⁴⁶See *supra* Part II.B.

¹⁴⁷It 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 96, at 14.

¹⁴⁸*Principles for Enhancing Corporate Governance*, BCBS, 8, 22 (Oct. 4, 2010), available at <http://www.bis.org/publ/bcbs176.pdf> ("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.").

play a meaningful role in firm governance.¹⁴⁹ 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.¹⁵⁰ As a result, while 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.

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 (the "TCF") Initiative.¹⁵¹ As its name implies, the objective of the TCF Initiative is to compel financial services firms to treat retail clients fairly.¹⁵² The first incarnation of the TCF Initiative was introduced in 2001 in response to a raft of mis-selling claims involving various financial products.¹⁵³ Notably, however, the legal obligation on U.K. financial services firms to treat customers fairly predates the TCF Initiative.¹⁵⁴ 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 . . ."¹⁵⁵ These requirements are reflected in the

¹⁴⁹*See, e.g.*, STEPHEN GREEN, GOOD VALUE: REFLECTIONS ON MONEY, MORALITY AND AN UNCERTAIN WORLD 198 (2009) (observing that "[e]veryone knows about the importance of trust and honesty for a sustainable business").

¹⁵⁰*See, e.g.*, Davies, *supra* note 12 (emphasizing that "it is not for regulators to devise a full-scale ethical code for financial firms"); *City's Ethics Awareness Lessons Must Percolate Down*, FIN. TIMES (London), October 4, 2010, available at <http://www.ft.com> (search title) (observing that Hector Sants, former CEO of the U.K.'s FSA, "was told on arrival at the FSA that the regulator 'does not do ethics'").

¹⁵¹*See Treating Customers Fairly*, FSA, <http://www.fsa.gov.uk/doing/regulated/tcf> (last visited January 16, 2013).

¹⁵²*See id.*

¹⁵³*See* Sharon Gilad, *Overcoming Resistance to Regulation via Reframing and Delegation*, in REGULATION & GOVERNANCE (forthcoming 2012) (manuscript at 9), available at <http://law.huji.ac.il/upload/Sharon.Gilad.pdf>.

¹⁵⁴*See* Julia Black et al., *Making a Success of Principles-based Regulation*, 1 LAW & FIN. MKT. 191, 191 (2007).

¹⁵⁵Council Directive 2004/39, art. 19(1), 2004 O.J. (L 145/1) (EC). 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." Explanatory Memorandum on Proposed Directive on Markets in Financial Instruments repealing Directive 2004/39/EC of the European Parliament and of the Council, s. 3.4.8 (October 20, 2011), available at <http://eur->

FCA's, as well as its predecessor 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.¹⁵⁶ What distinguishes the TCF Initiative from these broader regulatory pronouncements, however, is that firm processes and culture are the *targets* of regulation.

The TCF Initiative falls under the umbrella of a diverse collection of regulatory strategies, which is often described as "process-oriented" regulation.¹⁵⁷ 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 relationship between regulators and regulated actors.¹⁵⁸ The hallmark of process-oriented regulation, then, 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 regulator.¹⁵⁹ Simultaneously, however, process-oriented regulation is about more than leveraging firm-specific information to produce tailored systems and controls. Process-oriented regulation is also about incorporating the regulatory objectives (or outcomes) into firm culture.¹⁶⁰ As Christine Parker observes, process-oriented regulation, which

lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0656:FIN:en:PDF; Norton Rose, *MiFID Review: Overview*, <http://www.nortonrose.com/knowledge/publications/57748/mifid-review-overview> (last visited Jan. 16, 2013).

¹⁵⁶Financial Services Authority *Handbook, Principles for Business*, FSA, § 2.1.1 (2001), available at <http://fshandbook.info/FS/html/FCA/PRIN>.

¹⁵⁷See Gilad, *supra* note 153, at 27. Members of this family include "systems-based regulation, enforced self-regulation, management-based regulation, principles-based regulation, and meta-regulation." Sharon Gilad, *It Runs in the Family: Meta-regulation and Its Siblings*, 4 REG. & GOVERNANCE 485, 485 (2010).

¹⁵⁸See JULIA BLACK, RULES AND REGULATORS 136 (1997); Cass R. Sunstein, *Problems with Rules*, 83 CALIF. L. REV. 953, 993-94; Gilad, *supra* note 157, at 488.

¹⁵⁹See Christine Parker, *Meta-Regulation: Legal Accountability for Corporate Social Responsibility*, in THE NEW CORPORATE ACCOUNTABILITY: CORPORATE SOCIAL RESPONSIBILITY AND THE LAW 220, 224 (Doreen McBarnet et al., eds., 2008).

¹⁶⁰See *Treating Customers Fairly – Towards Fair Outcomes for Consumers*, FSA, 11 (July 2006), available at http://www.fsa.gov.uk/pubs/other/tcf_towards.pdf; see also Julia Black, *Forms and Paradoxes of Principles-Based Regulation*, 3 CAPITAL MKTS. 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); Parker, *supra* note 159, at 215-16 (stating that the aim for each company would be to have "an organisational culture that supports and sustains responsibility, and that management would be carried out in practice in a way that demonstrates responsibility").

she labels "meta-regulation," focuses "on the inside of corporations to constitute corporate consciences that go beyond compliance"¹⁶¹

It is important to understand how the TCF Initiative seeks to affect cultural change. Two ideas appear to underpin this process. The first is connected to the preconditions to the formation of cultural norms identified in Part IV: observability, dissemination, and enforcement.¹⁶² Of central importance in this regard is "tone from the top."¹⁶³ More specifically, a key foundation for cultural change is that senior managers make it clear to the rest of the firm that (1) the regulatory objectives reflected in the TCF Initiative matter, and (2) violations will result in internal sanctions.¹⁶⁴ 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.¹⁶⁵

In its *ideal form*, process-oriented regulation promotes dialogue, processes, systems, and controls that generate behavioral norms that are articulated, disseminated, monitored, and enforced by internal mechanisms backed by senior management's imprimatur.¹⁶⁶ As Parker and Sharon Gilad point out, however, it is improbable that firm culture can be instrumentally created in this way.¹⁶⁷ Any attempt to foster specified normative positions takes place through agents (including senior management) that may have countervailing normative commitments and incentives and who may, therefore, deploy strategies to resist cultural change.¹⁶⁸ A more realistic way to look at process-oriented regulation is thus as one of several complimentary strategies¹⁶⁹ designed to increase the probability that certain normative

¹⁶¹*Id.* at 211-12. *See also id.* at 214. ("A corporate conscience is created when values that transcend narrow self-interest are built into the practice and structure of the enterprise.") (quoting PHILIP SELZNICK, *THE COMMUNITARIAN PERSUASION* 101 (2002)).

¹⁶²*See Treating Customers Fairly*, *supra* note 160, at 19-20.

¹⁶³*See id.* at 11.

¹⁶⁴*See Black*, *supra* note 158, at 203.

¹⁶⁵This view finds support in both organizational and sociological theory. *See, e.g.*, Silbey et al., "The Sociological Citizen" *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 Interpretive Theory of Culture*, in *THE INTERPRETATION OF CULTURES: SELECTED ESSAYS* 17 (1973) (observing that "it is through the flow of behaviour—or, more precisely, social action—that cultural forms find articulation").

¹⁶⁶*See Gilad*, *supra* note 157, at 486, 500.

¹⁶⁷Christine Parker & Sharon Gilad, *Internal Corporate Compliance Management Systems: Structure, Culture and Agency*, in *EXPLAINING COMPLIANCE: BUSINESS RESPONSES TO REGULATION* 170, 176-77 (Christine Parker & Vibeke Lehmann Nielson eds., 2011).

¹⁶⁸*See id.* at 180.

¹⁶⁹*See infra* Part V (exploring supportive incentive structures).

positions can be voiced and gain traction within the firm. Put differently, it seeks to bias the internal battleground of firm culture in favor of specified regulatory objectives.

The TCF Initiative proceeds from the identification of six outcomes which the FSA expects financial services firms to achieve on behalf of their retail clients.¹⁷⁰ 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 their provider, submit a claim, or make a complaint.¹⁷¹ The FSA has also produced "extensive guidance" about how firms should approach their obligations under the TCF Initiative.¹⁷² 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.¹⁷³

Consistent with its process-oriented approach, the TCF Initiative compels firms to design and evaluate their own organizational processes against desired regulatory outcomes.¹⁷⁴ 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 regulator to regulated firms themselves.¹⁷⁵ The TCF Initiative places the onus on firms, and specifically on senior management, to promote an organizational culture that encourages meaningful internal dialogue about firm practices, their impact on retail clients, and whether or not they meet the required regulatory outcomes.¹⁷⁶ Indeed, the FSA describes the TCF Initiative as "a cultural issue,"¹⁷⁷ observing: "[i]t is only through establishing the right culture that

¹⁷⁰See *Treating Customers Fairly – Guide To Management Information*, FIN. SERVS. AUTH., 11 (July 2007), available at http://www.fsa.gov.uk/pubs/other/tcf_mi.pdf.

¹⁷¹*Id.* at 11-13.

¹⁷²See Gilad, *supra* note 157, at 14-15; *Guide to Management*, *supra* note 170, at 3.

¹⁷³See *Treating Customers Fairly*, *supra* note 160, at 5.

¹⁷⁴See *id.* at 9; Gilad, *supra* note 157, at 11.

¹⁷⁵See *Guide to Management*, *supra* note 170, at 1.

¹⁷⁶See *Treating Customers Fairly*, *supra* note 160, at 11.

¹⁷⁷*Treating Customers Fairly – Culture*, FIN. SERVS. AUTH., 2 (July 2007), available at http://www.fsa.gov.uk/pubs/other/tcf_culture.pdf; see also *Treating Customers Fairly*, *supra* note 160, at 11-12 (referring as well to the goal of effecting a "cultural shift").

senior management can convert their good intentions into actual fair outcomes for consumers."¹⁷⁸

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 pre-conditions to its effective implementation.¹⁷⁹ There are two central findings of this important work. First, external enforcement matters.¹⁸⁰ Gilad's findings suggest that many financial services firms were initially reluctant to engage with the TCF Initiative because, in their view, these firms already treated their customers fairly.¹⁸¹ 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 employees.¹⁸² As Gilad notes, however, this view changed, and more meaningful engagement ensued following a marked increase in the number of enforcement actions stemming from the failure of individual firms to treat customers fairly.¹⁸³ Importantly, the regulator also signaled a firm's failure to meaningfully *engage* with desired regulatory outcomes—as well as the failure to *achieve* them—would trigger enforcement action.¹⁸⁴

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*.¹⁸⁵ 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.¹⁸⁶ All of this requires clear signals from senior management that they support (indeed, *demand*) engagement with TCF Initiative by all

¹⁷⁸*Culture*, *supra* note 177, at 2.

¹⁷⁹*See* Gilad, *supra* note 157, at 9.

¹⁸⁰*See id.* at 29.

¹⁸¹Even when these firms were implicated in various mis-selling claims. *See id.* at 11-14.

¹⁸²*See id.* at 12.

¹⁸³*See* Gilad, *supra* note 157, at 14-16.

¹⁸⁴*See Treating Customers Fairly*, *supra* note 160, at 9 ("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 46 (stating that the FSA is "more likely to take enforcement action in cases where a firm has not responded to indications that there are problems, has failed to identify shortcomings and to develop a strategy to deal with them").

¹⁸⁵*See supra* notes 174-78 and accompanying text.

¹⁸⁶*See* Gilad, *supra* note 157, at 486.

employees.¹⁸⁷ 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 perspective: when firms viewed the TCF Initiative as the responsibility of compliance professionals, implementation was measurably slower and less effective.¹⁸⁸ Notably, then, Gilad's two findings interact: the threat of external enforcement spurs management buy-in, and management buy-in internal enforcement and, ultimately, cultural change.

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, 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.¹⁸⁹ If enforcement action, market discipline, and managerial leadership are together able to send a clear, unified signal that engagement will be rewarded—and non-engagement sanctioned—then the TCF Initiative will have made a meaningful contribution to the promotion of a more ethical culture within financial services firms.

¹⁸⁷Indeed, the FSA has itself stressed that commitment on the part of senior management is crucial to the successful implementation of the TCF Initiative. See *Treating Customers Fairly*, *supra* note 160, at 11. 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 *generally id* at 2-13 (describing the various roles of senior management). 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 (3d. 2004) (observing that "[i]t can be argued that the only thing of real importance that leaders do is to create and manage culture; that the unique talent of leaders is their ability to understand and work with culture; and that it is an ultimate act of leadership to destroy culture when it is viewed as dysfunctional").

¹⁸⁸See Gilad, *supra* note 157, at 20.

¹⁸⁹Although, 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.

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 FCA would do well to draw on the insights of cognitive and social psychology canvassed in Part IV of this article.¹⁹⁰ 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 FCA could provide guidance to the effect that meaningful engagement with the TCF Initiative includes reviewing the results of previous 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 confirm that they would recommend purchase of the product or service in question to their grandmother, parent or child (thus enhancing *proximity*).¹⁹¹

The FCA could also mandate that all new financial products and services be vetted and approved by an internal (sub-board level) "ethics" committee—analogue to existing credit committees—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 four 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 important business issue.¹⁹² Second, it would provide an opportunity for *reflection*—for sober second thought about the impact of business decisions on client welfare.¹⁹³ 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.¹⁹⁴ Finally, it would provide a direct means of monitoring compliance with ethical norms

¹⁹⁰See *supra* Part IV.

¹⁹¹For 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.

¹⁹²See Gilad, *supra* note 157, at 20.

¹⁹³See *id.* at 22-23.

¹⁹⁴See *id.* at 24.

by employees.¹⁹⁵ As examined in greater detail in Part V, many of these same benefits could also flow from the introduction of a *board level* ethics committee.¹⁹⁶

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. Moreover, they would allow personal ethical commitments to be foregrounded, and their expression legitimized. As a result, they would enable the personal ethical commitments of employees and managers that are consistent with the TCF Initiative to play a more prominent role in the formation of cultural norms within financial firms.¹⁹⁷

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 regulatory strategy beyond its current narrow focus on retail customers to encompass transactions involving ostensibly more sophisticated counterparties.¹⁹⁸ An "Extended" Treating *Counterparties* Fairly ("Extended TCF") Initiative could apply to transactions involving, for example, swaps and other over-the-counter ("OTC") derivatives, structured finance vehicles, structured investment products, and other more exotic financial instruments.¹⁹⁹ 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

¹⁹⁵See *id.* at 26.

¹⁹⁶See *infra* Part V.

¹⁹⁷See Jones, *supra* note 85, at 366.

¹⁹⁸In 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 41, § 3.6. Per se eligible counterparties include, *inter alia*, investment firms, credit institutions, insurance companies, collective investment schemes, pension funds, governments, and central banks. *Id.* § 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.* § 3.6.4.

¹⁹⁹We 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.

serve to deter the design and marketing of financial products and services intended, either in whole or in part, to extract rents from less sophisticated "sophisticated" counterparties.²⁰⁰

As with the TCF Initiative, regulators would need to identify the regulatory objectives (or outcomes) an Extended TCF is designed to achieve. These objectives would be tailored to the business context in which they were applied and, therefore, necessarily would be somewhat different from the objectives identified in the retail context. These objectives 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 a reasonably sophisticated market participant would be unable to understand and/or price accurately.

Led by senior management, firms would then be expected to take responsibility for designing bespoke systems, processes, and controls to give effect to these objectives. As with the retail TCF Initiative, the resulting engagement and conversation, backed up by internal enforcement, would facilitate the formation of an ethical culture that treats sophisticated counterparties in accordance with the Extended TCF objectives and legitimizes the expression of consistent personal ethical commitments.

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.²⁰¹ Once again, a credible external enforcement threat, in relation to engagement as well as outcomes, is key.²⁰² So too is commitment on the part of senior management.²⁰³ 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. Meanwhile, taking another page from cognitive and social psychology, the FCA could require counterparties to transact "face-to-face" (*i.e.*, either physically or via teleconference) or otherwise attempt to reduce their

²⁰⁰See *supra* notes 46, 123 and accompanying text.

²⁰¹See, *e.g.*, *Principles-Based Regulation: Focusing on the Outcomes that Matter*, FIN. SERVS. AUTH., 2 (Apr. 2007), available at <http://www.fsa.gov.uk/pubs/other/principles.pdf> (noting that "[f]irms' behaviour and positive engagement with the regulatory outcomes will also be a factor that is taken into account in [the FCA's] regulatory action towards that firm").

²⁰²See *Treating Customers Fairly*, *supra* note 160, at 9.

²⁰³*Id.* at 11.

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 problem²⁰⁴—that it is often more difficult to take advantage of your counterparty once you have shaken their hand.

There are, however, 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.²⁰⁵ 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 for firms which are deemed to have treated their counterparties unfairly.²⁰⁶ Ultimately, however, such likely counterarguments arguably miss the point. As Milton Friedman observed, efficiency demands that contractual exchange is both voluntary and, importantly, *informed*.²⁰⁷ 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.

V. 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.²⁰⁸

²⁰⁴See Valdesolo & DeSteno, *supra* note 95, at 476; Greene et al., *supra* note 99, at 2106; Gold et al., *supra* note 95.

²⁰⁵See Clive Adamson, Dir. of Supervision, Conduct Bus. Unit, Speech on the FCA at the Bloomberg Conference: Conduct Supervision and the Move Towards the FCA (noting that the FCA "will generally continue to rely on the caveat emptor principle and not seek to introduce concepts of detriment and redress that we use in retail markets to wholesale markets").

²⁰⁶In response to the loss of reputational discipline, the regulator could deploy other enforcement strategies. See *infra* notes 211-12 (discussing the "fit and proper purpose regime").

²⁰⁷MILTON FRIEDMAN, CAPITALISM AND FREEDOM 13 (1962).

²⁰⁸See, e.g., Jaime Caruana, *Bank for Int'l Settlements, Systemic Risk: How to Deal with It?*, 1 (Feb. 12, 2010) available at <http://www.bis.org/publ/othp08.htm> (noting that "[s]ystemic risk was

While these firms, their shareholders, and their employees capture the benefits derived from their socially excessive risk-taking, they bear only a portion of the attendant costs. Indeed, of all the issues to emerge from this crisis, the diversion of public resources to private firms in order 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 "Taking Externalities Seriously" (or "TES") Initiative?²⁰⁹

A TES Initiative could identify and seek to achieve the following regulatory objectives: (1) ensure that the identification and avoidance of socially excessive risk-taking is embedded in corporate culture; (2) identify and continually monitor any risks generated by the firm's activities which manifest the potential to create or exacerbate systemic risk; (3) better understand a firm's exposure to systemic risks; and (4) 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 risk—something which represents an ongoing challenge for regulators.²¹⁰ 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 seek to 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,

underestimated across the board before this crisis").

²⁰⁹For 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 is only those institutions whose failure threatens to generate the type of negative externalities unleashed by the GFC. There are, however, 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.

²¹⁰See Dimitrios Bisias et al., *A Survey of Systemic Risk Analytics* 46 (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.

systems, and controls—backed by managerial commitment—the TES Initiative would aim to foster the generation of a cultural norm within firms that promotes 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 full systemic implications of their activities. Yet awareness that their actions *may* have systemic implications may generate some individual restraint, as well as encourage engagement with the processes, systems and controls designed to manage these risks.

In effect, the processes, systems, 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 or counterparty relationships.²¹¹ 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.²¹² These enforcement problems would be compounded by the likely impotence of market-based (*i.e.*, reputational) sanctions in response to socially excessive risk-taking.²¹³

Perhaps the most compelling response to these very legitimate concerns is that, as described above, process-oriented regulation is designed to promote engagement with desired regulatory outcomes and, through engagement, to promote cultural norms that deter socially undesirable

²¹¹As the six outcomes identified by the TCF Initiative attest. See *Treating Customers Fairly*, *supra* note 160, at 3.

²¹²Any uncertainty regarding the required regulatory standard could of course 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.

²¹³See, *e.g.*, Armour et al., *supra* note 135, at 3 (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).

behavior.²¹⁴ In the aftermath of the GFC, 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.²¹⁵ It then provides firms with the flexibility to design and implement firm-specific processes which reflect the results of this dialogic process.²¹⁶ 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 question the impact of their activities on others.²¹⁷ Viewed in this light, 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 undoubtedly be more problematic in connection with the TES (relative to the TCF) Initiative, it bears emphasizing that enforcement action need not be based solely on the failure to achieve outcomes, but also on the basis of the firm's engagement with, and the level of commitment by senior management to, achieving the regulatory outcomes.²¹⁸ Moreover, regulators could also deploy indirect sanctions. Utilizing a holistic²¹⁹ approved persons regime,²²⁰

²¹⁴See *supra* notes 159-60, 165 and accompanying text.

²¹⁵See *supra* notes 176, 186 and accompanying text.

²¹⁶See *supra* note 159 and accompanying text.

²¹⁷See *supra* note 161 and accompanying text.

²¹⁸See *supra* notes 148, 187 and accompanying text.

²¹⁹Under such a regime, when presented with an approval request for a controlled function (see note below), the FCA would consider the fitness of the applicant relative to the fitness and competences of the board and management as a whole. The FCA 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 appropriate competences as a whole. FSA, CONSULTATION PAPER 10/3, EFFECTIVE CORPORATE GOVERNANCE: SIGNIFICANT INFLUENCE CONTROLLED FUNCTIONS AND THE WALKER REVIEW § 4.28 (2010).

²²⁰Any person performing a "controlled function" of an authorized person must be approved by the FCA. Financial Services and Markets Act 2000, 2000, c. 8, § 59(1) (U.K.). Such person must be "a fit and proper person." *Id.* § 61(1). 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. FCA, FCA HANDBOOK CHAPTER 10: APPROVED PERSONS § 10.4 (2013), available at <http://info/fs/html/handbook/FCA/SUP/6>. The FCA has recently proposed broadening the range of control functions, a change that, although currently delayed, will enhance the FCA's control over the

for example, a regulator could deny approval if the candidate did not have the skills, qualities, or commitment necessary to counteract a firm's ineffective engagement with the TES Initiative. Alternatively, regulators could designate a candidate as "board-level champion" for the TES Initiative.²²¹

VI. 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, private incentives will at times come into conflict with both pre-existing personal ethical commitments as well as the pursuit of public regulatory objectives.²²² 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. This section explores some of the ways this might be achieved.

The U.K.'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 TCF, Extended TCF, and TES Initiatives (and then monitor and enforce compliance), it is highly unlikely that the desired "cultural shift" will take place.²²³ However, whereas employees will observe and easily interpret mixed managerial signals, regulators may struggle to differentiate between managerial (unequivocal) word and (equivocal) action. 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 the initiatives.

There are two key drivers of the incentive structures of senior 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, ultimately,

personnel and board structure of financial institutions. FSA, IMPLEMENTATION OF THE NEW SIGNIFICANT INFLUENCE CONTROLLED FUNCTIONS (SIFs) DEFERRED (2011).

²²¹See *Treating Customers Fairly*, *supra* note 164, at 3.3 (noting that some firms have designated a board-level champion for the TCF Initiative).

²²²See *supra* notes 23-28 and accompanying text.

²²³See *supra* note 187 and accompanying text.

shareholder value. Shareholders in financial institutions, as in other firms, possess strong incentives to encourage managers to focus on value creation.²²⁴ Within systemically important financial institutions, however, these same incentives also drive shareholders to encourage managers to take socially excessive risks.²²⁵ As has been argued elsewhere, where creditors do not discipline institutions that benefit from the TBTF subsidy and where the state does not demand full payment for its implicit guarantee,²²⁶ shareholders, including long-term shareholders, have powerful incentives to encourage managers to increase the volatility and, therefore, riskiness of the institution's asset profile.²²⁷ That is, encouraging managers to "bet the bank" is rational for shareholders who think only about the value of their own portfolio. Accordingly, to increase the probability that measures such as the TCF, Extended TCF, and TES Initiatives will succeed, managers need to be given room to resist shareholder pressure to focus only on shareholder value.

What, then, are the remuneration and other governance tools available to create the decision-making space necessary to enable a more ethical culture—institutionalized through measures such as the TCF, Extended TCF, and TES Initiatives—to flourish? Below we canvass a range of possible strategies.²²⁸ Some of these strategies—remuneration and corporate objective regulation, for example—may be viewed as pre-requisites.²²⁹ Others, meanwhile, may be more appropriately viewed as facilitative but, ultimately, optional. Moreover, 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 governance structures that provide fertile soil for our proposals must be assessed holistically. Such comparative jurisdictional assessments are beyond the scope of this article.

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 directors of financial

²²⁴See *supra* note 16 and accompanying text.

²²⁵See *supra* notes 141-45 and accompanying text.

²²⁶See JOSEPH NOSS & RHIANNON SOWERBUTT, BANK OF ENGLAND, FINANCIAL STABILITY PAPER NO. 15, THE IMPLICIT SUBSIDY OF BANK (2012), available at http://www.bankofengland.co.uk/publications/Documents/fsr/fs_paper15.pdf.

²²⁷See Christopher M. Bruner, *Corporate Governance Reform in a Time of Crisis*, 36 J. CORP. L. 309, 312 (2011).

²²⁸See *infra* Parts VI.B-E.

²²⁹See *infra* Parts VI.B-C.

institutions were a proximate cause of their failure. The focus to date has been on the competences of independent non-executive directors—*i.e.*, whether they were sufficiently knowledgeable about their firms and the financial services industry—and the role of the board in effectively managing risk.²³⁰ The primary regulatory response in this regard has been to require or recommend that financial institutions (*i.e.*, banks and other "credit institutions") form board-level risk committees under the control of independent directors.²³¹

To date, ethics and culture have not been 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 envision a specific role for boards with regard to firm ethical culture.²³² Nevertheless, many U.K. companies, including financial institutions, do have (and had prior to the crisis) board committees whose remit it is to address firm ethics.²³³ It is important to keep in mind, however, the limits to 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 bank failures in question or, indeed, have altered the board composition of many of those failed banks.²³⁴

Nevertheless, the role of a board-level ethics committee within financial institutions is worth canvassing in the post-crisis board composition

²³⁰See, e.g., DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE IN U.K. BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES: FINAL RECOMMENDATIONS 14, 19 (2009), available at http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf (recommending that non-executive directors "have the knowledge and understanding of the business to enable them to contribute effectively").

²³¹See, e.g., BCBS, PRINCIPLES FOR ENHANCING CORPORATE GOVERNANCE § 52 (2010), available at <http://www.bis.org/publ/bcbs176.pdf> (suggesting a board-level risk committee for banks which would be "responsible for advising the board on the bank's overall current and future risk tolerance/ appetite and strategy, and for overseeing senior management's implementation of that strategy"); FCA, SENIOR MANAGEMENT ARRANGEMENTS, SYSTEMS AND CONTROLS § 21.1.5 (2013) ("The FCA [suggests] that . . . firms should consider establishing a *governing body* risk committee to provide focused support and advice on risk governance.").

²³²See generally WALKER, *supra* note 230, at 14-18 (focusing on how the board will provide business awareness).

²³³See DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE IN U.K. BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES: CONSULTATION DOCUMENT 128 (2009), available at http://webarchive.nationalarchives.gov.uk/+http://www.hmtreasury.gov.uk/d/walker_review_consultation_160709.pdf (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.

²³⁴See, e.g., THE ROYAL BANK OF SCOTLAND, ANNUAL REPORT AND ACCOUNTS 2 (2006), available at http://www.investors.rbs.com/download/report/RBSplc_Accounts_2006.pdf (listing the bank's pre-crisis board of directors).

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 strategies place significant weight on the role played by senior 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 senior management, an ethics committee would take the lead in establishing and revising a firm's cultural/ethical objectives consistent with applicable regulatory objectives, including those identified by the TCF, Extended TCF, and TES Initiatives.²³⁵ 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 practice and over time.²³⁶ 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 to 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 accountable 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 was the remuneration arrangements of both executive directors and lower level bankers and traders. These arrangements incentivized decision-making that

²³⁵See *supra* note 160 and accompanying text.

²³⁶As 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.

focused on short-term financial gains (often unrealized in cash terms). Indeed, 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.²³⁷ In the wake of the crisis, domestic and transnational regulatory responses²³⁸ 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 (*i.e.*, over three to five years).²³⁹

Even where remuneration arrangements are linked to the long-term value of the firm, however, these arrangements may still generate incentives to cut ethical corners. To the extent that firms profit from the exploitation of asymmetries of information and expertise in relation to highly complex products 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. Specifically, if the primary objective of financial

²³⁷See generally Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers Pay*, 98 GEO. L. J. 247(2010) (examining and suggesting alternatives to compensation structures that focused on short-term results and encouraged excessive risk-taking); see also Coffee, *supra* note 30, at 1047 ("Because a rapid shift towards incentive-based compensation at financial institutions focused senior management on short-term results, longer-term risks were ignored or excessively discounted.").

²³⁸See, e.g., COMMISSION OF THE EUROPEAN COMMUNITIES, 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 ("Remuneration policy should be in line with the business strategy, objectives, values and long-term interest of the financial undertaking . . ."); COMMITTEE OF EUROPEAN BANKING SUPERVISORS, GUIDELINES ON REMUNERATION POLICIES AND PRACTICES (2010), available at <http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Remuneration/Guidelines.pdf>; FDIC, FIL-7-2011 (It is . . . appropriate to specify clear principles on sound remuneration to ensure that the structure of remuneration does not encourage excessive risk-taking by individuals or moral hazard and is aligned with the risk appetite, values and long-term interests of the credit institution or investment firm."); INTERAGENCY NOTICE OF PROPOSED RULEMAKING: INCENTIVE-BASED COMPENSATION ARRANGEMENTS (2011), available at <http://www.fdic.gov/news/news/financial/2011/fil11007.pdf> ("This [Notice on Proposed Rulemaking] seeks to strengthen the incentive compensation practices at covered institutions by better aligning employee rewards with longer-term institutional objectives."); SENIOR MANAGEMENT ARRANGEMENTS, *supra* note 235, § 19A ("A firm must ensure that its remuneration policy is in line with the business strategy, objectives, values and long term interest of the firm.").

²³⁹See SENIOR MANAGEMENT ARRANGEMENTS, *supra* note 231, § 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.

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.²⁴⁰

As a result, maximizing shareholder value will 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.²⁴¹ Requiring employees to maximize a firm's 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.

In theory, claw-back provisions hold out greater potential to alter the incentives of senior managers and other employees. Correctly drafted, claw-backs can ensure that the costs generated by socially excessive risks are borne not just by society, but also by the individuals who actually took them. The devil of such claw-backs, however, is in the detail. Do they apply to *paid* or merely *deferred* remuneration? If the former, how far is the look-back period in relation to which the claw-back can be applied? What is the extent of prior earnings which must be re-paid? Claw-backs of the variety set forth in the FCA's Remuneration Code,²⁴² which apply only to unvested deferred remuneration, incentivize rational managers and employees to discount only the deferred benefit of the socially excessive risk-taking by the probability that the risks will be realized within the vesting timeframe.²⁴³ In these behavioral calculations, we would expect the senior managers or employees to also take into account the benefits of any increase in fixed (and non-recoverable) salary, as well as job security, arising from risk-taking aligned with broader institutional incentives. Compounding matters, financial institutions may attempt to realign incentives by simply increasing fixed pay.

The Dodd-Frank Act, in contrast, authorizes the FDIC to impose claw-backs on senior executives who are "substantially responsible" for bank failure.²⁴⁴ On one level, the FDIC claw-backs are broader than those

²⁴⁰See Coffee, *supra* note 30, at 1053; see generally Noss & Sowerbutts, *supra* note 230 (examining public costs of the implicit government guarantee).

²⁴¹See Coffee, *supra* note 30, at 1048.

²⁴²See SENIOR MANAGEMENT ARRANGEMENTS, *supra* note 231, § 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").

²⁴³See *id.* § 19A.3.52-53.

²⁴⁴Dodd-Frank Act, Pub. L. No. 111-203, §203(s), 124 Stat. 1376, 1514 (2010). In the event of bank bailout, the FDIC would not be appointed as receiver. There remain doubts about the legality of this provision. See Dorothy Shapiro, *Federalizing Fiduciary Duty: The Altered Scope of*

provided for under FCA rules insofar as they apply to *all* compensation.²⁴⁵ On another level, however, they are narrower in that they (1) focus on personal rather than collective (*i.e.*, business unit) responsibility and (2) only apply when a bank is in FDIC receivership.²⁴⁶ Furthermore, the FDIC rules will only apply to compensation earned within one to two years of the appointment of the FDIC as receiver.²⁴⁷ A rational manager 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 "substantial responsibility"). As the crisis has demonstrated, however, holding individual managers accountable is very difficult. Moreover, for systemically important banks, the probability of even entering an insolvency proceeding is low. As such, the probability of claw-back under these rules is also low.

The personal and institutional incentives of senior managers and other employees subject to the reformed remuneration rules manifest the potential to crowd out a process-oriented approach to cultural and ethical norm formation. Within 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. At the same time, it has now become relatively commonplace for companies to include non-financial targets such as employee satisfaction, health and safety, and environmental measures alongside financial measures in executive remuneration arrangements.²⁴⁸ Indeed, the U.K. FCA's Remuneration Code states that "[n]on-financial performance metrics should form a significant part of the performance assessment process [these non-financial risk metrics include] risk management and compliance with the *regulatory system*"²⁴⁹ Indeed, some financial institutions have voluntarily gone further than this. Morgan Stanley, for example, has recently altered the provisions in its remuneration arrangements with senior managers to enable claw-backs where, *inter alia*, there are violations of articulated ethical standards.²⁵⁰ Such non-financial

Officer Fiduciary Duty Following Orderly Liquidation under Dodd-Frank, 17 STAN. J.L. BUS. & FIN. 223, 226.

²⁴⁵See Dodd-Frank Act § 203(s).

²⁴⁶See *id.*

²⁴⁷*Id.*

²⁴⁸See PRICEWATERHOUSECOOPERS, EXECUTIVE COMPENSATION: REVIEW OF THE YEAR 2009 70-71 (2010), available at <http://www.pwc.co.uk/assets/pdf/executive-compensation-review-of-the-year-2009-pwc.pdf>.

²⁴⁹SENIOR MANAGEMENT ARRANGEMENTS, *supra* note 231, § 19A.3.37.

²⁵⁰See Morgan Stanley, Proxy Statement (Schedule 14A), 28-29 (Apr. 5, 2012), available at <http://www.sec.gov/Archives/edgar/data/895421/000119312512151028/d303252ddef14a.htm>. See generally Sharlene Goff & Daniel Schäfer, *Banks Ready to Claw Back More Bonuses*, FIN. TIMES (London), Aug. 27, 2012, available at <http://ft.com> (search title) (discussing how "recent scandals

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,²⁵¹ the ethics committee could take responsibility for setting such non-financial remuneration targets. Furthermore, by connecting remuneration to the performance of a *collective* part of the financial institution—a product group, business unit, or division, for example—remuneration could drive peer group monitoring, thereby strengthening two of the three pillars of norm formation: the observation and dissemination of information about the violation of cultural norms.

C. Corporate Law: The Objective of Bank Activity

There is a longstanding debate regarding in whose interests a company should be run—*i.e.*, whose interests should directors consider when they make decisions.²⁵² 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.²⁵³ This approach is referred to by commentators as a "pluralistic" or "multiple-interest" model of the corporation.²⁵⁴

Several justifications have been given for this approach. For example, some commentators, 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.²⁵⁵ 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.²⁵⁶ Whether or not one is persuaded by such arguments more

in the sector . . . and mis-selling of financial products to anti-money laundering failures and sanctions breaches – are prompting big banks to increasingly strip staff of awards they received for past performances that no longer look favourable").

²⁵¹See, e.g., SENIOR MANAGEMENT ARRANGEMENTS, *supra* note 231, § 21.1.5(f) (suggesting that "the firm's governing body . . . should consider establishing a governing body risk committee to provide focused support and advice on risk governance").

²⁵²DAVID KERSHAW, COMPANY LAW IN CONTEXT: TEXT AND MATERIALS 357 (2d ed. 2012).

²⁵³See generally *id.* at 357-78 (discussing commentators' perspectives regarding shareholder and stakeholder interests as comprising a company's interests).

²⁵⁴See *id.* at 370.

²⁵⁵See E. Merrick Dodd, Jr., *For Whom are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1149 (1932).

²⁵⁶See Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 272 (1999).

generally—given the stark consequences of the GFC and the necessity for publicly funded bail-outs—the case for a multiple-interest model in relation to 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 weighting to the interests of customers (depositors, counterparties, etc.), shareholders, and 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 individual trader, need to know that when there is a conflict between regulatory objectives and the pursuit of value that it is lawful, legitimate, and *expected* that they will prioritize fair treatment or the avoidance of potential externalities. Managerial leadership and commitment—an essential pre-requisite 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 achieving this objective. 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.

In most jurisdictions, this pre-requisite to the formation of a more ethical culture 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.²⁵⁷ The U.K., however, is one jurisdiction where this is not the case. This is because, in the U.K., directors' duties require them to act in a way in which that they consider will promote shareholder interests.²⁵⁸ Indeed, it is worthwhile noting in this regard that the *Walker Review* rejected the suggestion that the existing duty should be amended to reflect the fact that banks are different.²⁵⁹ Encouragingly, however, recent remarks by a former CEO of the FSA on the

²⁵⁷See N.Y. BUS. CORP. LAW § 717(b) (2010); AUS. STOCK CORP. LAW § 70(1) (2013). In Germany, while the Stock Corporation Act is silent on the question of corporate objectives, it is widely accepted that the management board should act in the interests of shareholders, 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).

²⁵⁸Companies Act, 2006, c. 46, § 172. Whilst the provision requires that directors have regard to other stakeholders, the provision is clear that the decision itself must prioritize the interests of the shareholders. *See id.*

²⁵⁹See WALKER REVIEW, *supra* note 230, at 138.

subject of banking culture suggest that U.K. regulators may be open to the idea of revisiting this issue.²⁶⁰

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 will be compelled 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 influence 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.²⁶¹ As a result, the effects those rights have on senior management and firm decision-making and behavior may also differ.

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 resolution,²⁶² along with the right to call a meeting at any time when five percent of the shareholder body instructs the board to call a meeting.²⁶³ By way of contrast, in the U.S., although the rules vary from state to state, most financial institutions may select jurisdictions which permit weaker removal rights. A firm incorporated in Delaware, for example, can elect to have a classified board where the directors have three year terms and can only be removed with cause²⁶⁴ during this term.²⁶⁵

²⁶⁰Hector Sants, Chief Executive, FSA, Speech to the Chartered Inst. of Secs.& Invs. Conference: Do Regulators Have a Role to Play in Judging Culture and Ethics? (June 17, 2010) (transcript available at http://www.fsa.gov.uk/library/communication/speeches/2010/0617_hs.shtml) (stating that the corporate purpose objective must include "a stronger and more explicit obligation to wider society").

²⁶¹Compare DEL. CODE. ANN. tit. 8, § 141(k) (2010) ("Any director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors, except as [provided under subsections (1) or (2)]."), with Companies Act, 2006, c. 46, § 168(1) ("A company may by ordinary resolution at a meeting remove a director before the expiration of his period of office, notwithstanding anything in any agreement between it and him.").

²⁶²See Companies Act, 2006, c. 46, § 168.

²⁶³See *id.* §§ 303-05.

²⁶⁴See *Campbell v. Loews, Inc.*, 134 A.2d 852, 857 (Del. Ch. 1957) (The "cause" threshold is a high one in effect requiring some form of breach of duty or illegality).

²⁶⁵See tit. 8, § 141(k). Note that the "with cause" removal right is itself a default rule that can be amended by amending the certificate of incorporation. See *id.*

Furthermore, shareholders of a Delaware company will only have the right to call an interim shareholder meeting where the charter or bylaws authorize them to do so.²⁶⁶ 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.²⁶⁷

Recent empirical work suggests that this predicted relationship between shareholder rights and the behavior of financial institutions is very real indeed.²⁶⁸ 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.²⁶⁹ They then regress MII index scores against, *inter alia*, data on which banks were bailed-out through the U.S. Troubled Asset Relief Program (TARP).²⁷⁰ TARP is viewed by the authors as a proxy for a bank's pre-crisis susceptibility to failure and an arguable proxy for excessive risk-taking.²⁷¹ They find that banks which were less insulated were more likely to be bailed out.²⁷² For Ferreira et al. the most compelling explanation for the relationship between managerial insulation and bank failure is that the banks which are subject to stronger shareholder rights would be more susceptible to shareholder pressure to take excessive risks and, therefore, more likely to fail.²⁷³ This generates what would be for many commentators and policymakers a counterintuitive result: *for banks* stronger, and not weaker, shareholder rights are a problem.²⁷⁴

For our purposes, this suggests that where directors of financial institutions are subject to powerful shareholder rights, then the ethical cultural objectives are likely to be subordinated. This effect will be more powerful when strong shareholder rights and pressure are combined with a corporate objective that prioritizes shareholder interests.²⁷⁵ However, even when a bank is subject to a multiple-interest rule, as Ferreira et al.'s U.S.

²⁶⁶*Id.* § 211(d).

²⁶⁷Aktiengesetz [AktG] [Stock Corporation Act], Sep. 6, 1965, BGBI. I § 103 (Ger.).

²⁶⁸See Daniel Ferreira et al., *Shareholder Empowerment and Bank Bail Outs* 24 (2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2170392.

²⁶⁹*See id.* at 5.

²⁷⁰*See id.* at 13.

²⁷¹*See id.* at 24.

²⁷²*See* Ferreira et al., *supra* note 268, at 2.

²⁷³*See id.* at 25.

²⁷⁴*See* Reint Gropp & Matthias Köhler, *Bank Owners or Bank Managers: Who is Keen on Risk? Evidence from the Financial Crisis* 4 (European Bus. Sch., Research Paper No. 10-02, Feb. 23, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1555663 (taking a different approach but reaching some similar conclusions).

²⁷⁵*See* Gropp & Köhler, *supra* note 274, at 22.

study shows, such rights may drive behavior that disregards non-shareholder concerns.²⁷⁶ It follows that where there are more powerful shareholder rights, managers' commitment to the implementation of the TCF, Extended TCF, and TES Initiatives is likely to be more muted, thus undermining their 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.²⁷⁷ 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*

We have considered the ways in which an ethical culture could be connected to remuneration and other governance arrangements which incentivize senior managers to commit to measures such as the TCF, Extended TCF, and TES Initiatives and to insulate them, to a degree, from pressures to pursue shareholder value. But as managerial leadership is central to the success of these strategies, we also need to consider the role that the threat of potential liability might 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.²⁷⁸ 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.²⁷⁹ 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.²⁸⁰ As a result, directors may either refuse to serve or take an excessively risk-averse approach toward the generation, monitoring, and enforcement of the relevant processes, systems, and controls.

²⁷⁶See Ferreira et al., *supra* note 268, at 25.

²⁷⁷See Gropp & Köhler, *supra* note 274, at 22.

²⁷⁸See Sants, *supra* note 260 ("Behaviour is influenced by leadership, strategy, decisions, incentives, controls and the threat of sanctions: deterrence.").

²⁷⁹See Bernard S. Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1122-34 (2006).

²⁸⁰See John Armour & Jeffrey N. Gordon, *Systemic Harms and the Limits of Shareholder Value* Part IV.G.1 (Oct. 2012) (on file with the authors).

It is this policy concern that explicitly informs Delaware corporate law with its gross negligence standard for the duty of care.²⁸¹ This standard is violated only where it can be shown that directors were "recklessly indifferent" to the interests of the corporation²⁸² 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"²⁸³ 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 to generate significant negative externalities.²⁸⁴ In such contexts, dampening executive directors' incentives to take risks may represent a more defensible policy objective.²⁸⁵ For our purposes, if regulators make this election in favor of a more demanding standard of care, this could play a role in incentivizing managers to meaningfully engage with the TCF, Extend TCF, and TES Initiatives and, thereby, help foster a more ethical culture.

In the U.K., higher care standards are already in place, although the probability of their enforcement is generally thought to be very low.²⁸⁶ 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.²⁸⁷

It is worth briefly examining how the TCF, Extended TCF, and TES Initiatives could interact with this general standard. In order to understand

²⁸¹See, e.g., *Gagliardi v. Trifoods, Int'l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996) ("[I]t is in the shareholders' economic interest to offer sufficient protection to directors from liability for negligence, etc., to allow directors to conclude that, as a practical matter, there is no risk that, if they act in good faith and meet minimal proceduralist standards of attention, they can face liability as a result of a business loss."). 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. DEL. CODE ANN. tit. 8, § 102(b)(7) (2011).

²⁸²See *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 750 (Del. Ch. 2005), reprinted in 31 DEL. J. CORP. L. 349, 418 (2006).

²⁸³*Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006); *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 122 (Del. Ch. 2009); *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996).

²⁸⁴See Armour & Gordon, *supra* note 280, Part II.A.

²⁸⁵See *id.*, Part I.

²⁸⁶See John Armour, *Enforcement Strategies in U.K. Corporate Governance: A Roadmap and Empirical Assessment 21* (European Corporate Governance Inst., Working Paper No. 106/2008, Apr. 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1133542.

²⁸⁷See Companies Act, 2006, § 174.

the expectations generated by the care standard, recent Australian case law—applying a reasonable average director standard²⁸⁸—has begun to draw on the best practice guidance set forth in both corporate governance codes and trade association guidelines.²⁸⁹ 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 (ASIC) v. Rich*²⁹⁰ the court took into account observations on the roles of directors in U.K. reports on board composition regulation²⁹¹ and a report from the British Confederation of Industry on the responsibilities of British public companies.²⁹² More recently, the court in *ASIC v. Healey*²⁹³ 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.²⁹⁴

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 duty of care. 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 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, it is beyond this article's scope to address these broader corporate law issues. Furthermore, even in jurisdictions where the standard of care is demanding and the probability of

²⁸⁸See Australian Corporations Act § 180 (2001).

²⁸⁹See *Austl. Sec. & Inv. Comm'n v Healey* [2011] FCA 717, ¶ 192 (Austl.) (2003).

²⁹⁰*Id.*

²⁹¹See DEREK HIGGS, REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS 97-104 (2003), available at <http://www.ecgi.org/codes/documents/higgsreport.pdf>.

²⁹²See [2003] NSW 85, ¶¶ 69-71.

²⁹³See [2011] FCA 717, ¶¶ 194-96.

²⁹⁴See *id.* ¶ 194.

enforcement high, one would not expect to see many cases where directors—whether executive or non-executive—are found personally liable.²⁹⁵ Indeed, actual director liability is very rare in all jurisdictions.²⁹⁶ Of course, this does not mean that the threat of liability would not influence behavior.²⁹⁷

VII. CONCLUSION

There is little doubt that, for better or worse, culture and ethics play an important role in the governance of financial services firms.²⁹⁸ 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.²⁹⁹ When 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.³⁰⁰ 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.

²⁹⁵Even in Australia, where these two preconditions are arguably applicable – particularly because ASIC has the 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. See [2011] FCA 717, ¶ 583 (finding directors liable for failing to take reasonable steps to read and understand financial statements). *But see* Austl. Sec. & Inv. Comm'n v Healey (No. 2) [2011] FCA 1003, ¶¶ 190-91 (Austl.) (holding the majority of directors financially liable only for the plaintiff's costs incidental to the proceeding).

²⁹⁶See Black et al., *supra* note 279, at 1059-60.

²⁹⁷Both *positively* in ensuring that the TCF, Extended TCF, and TES Initiatives are taken seriously and *negatively* insofar as skilled executive and non-executive directors refuse to serve.

²⁹⁸See *supra* Part III.C.

²⁹⁹See *supra* Part IV.

³⁰⁰See *supra* Part V.

FX Global Code Updates 2018

U.S. Implementation Experience

Quadrilateral Panel Discussion

8 June 2018

“Last Look” Window Revisions

Principle 17 changes: (published December 2017)

- Market Participants should not conduct trading activity that utilises the information from the Client’s trade request during the last look window. Such trading activity would include (1) any pricing activity on the E-Trading platforms that incorporates information from the trade request and (2) any hedging activity that incorporates information from the trade request. Such activity would risk signalling to other Market Participants the Client’s trading intent and could move market prices against the Client. In the event that the Client’s trade requests were subsequently rejected, such trading activity could disadvantage the Client.

This guidance does not apply to [cover and deal arrangements]

Ethics of the FX Global Code

The Code is not law or regulation. It is “good practice” to which market participants are expected to adhere.

Legal professionals perform a critical role in support of Code-adhering institutions; the Code has also had the effect of refining our roles as legal professionals.

Adherence to the FX Global Code

- While adherence to the Code is voluntary, market participants are encouraged to deliver “Statements of Commitment” to each other
 - It may also be that central banks request adherence statements from trading counterparties and members of foreign exchange committees
 - There are currently at least 9 public registers globally for these Statements of Commitment
 - On May 29, the GFXC announced they will support a single Global Index of Public Registers
 - Statement of Commitment reads as follows:

*[Name of institution] (“Institution”) has reviewed the content of the FX Global Code (“Code”) and acknowledges that the Code represents a set of principles generally recognised as good practice in the wholesale foreign exchange market (“FX Market”). The Institution confirms that it acts as a Market Participant as defined by the Code, **and is committed to conducting its FX Market activities (“Activities”) in a manner consistent with the principles of the Code.** To this end, the Institution **has taken appropriate steps**, based on the size and complexity of its Activities, and the nature of its engagement in the FX Market, **to align its Activities with the principles of the Code.***
 - Regulators expected 12 month phase-in period from the May 2017 publication date for most institutions to be in a position to adhere to the Code. As of May 2018, GFXC announced over 200 market participants had issued Statements of Commitment.
-



EUROPEAN CENTRAL BANK

EUROSYSTEM

Torsti “Toto” Silvonen
Directorate Market Operations
ECB

Chair of the ECB’s Foreign Exchange
Contact Group

FX Global Code – status and way forward

Quadrilateral meeting of the
FMLC / FMLG / FLB / EFMLG

Frankfurt 8 June 2018

Outline

- 1 ECB's FXCG and ESCB Experts Group on the FX Global Code
- 2 Adherence to the FX Global Code – current status
- 3 Global FX Committee –global workstreams
- 4 FX Global code – 1-year anniversary

ESCB Experts Group on the FX Global Code (EGFX)

All ESCB central banks have committed to the FX Global Code in three waves

ECB + 28 EU Central Banks



ECB eligible FX Counterparties



ECB FX Contact Group Members

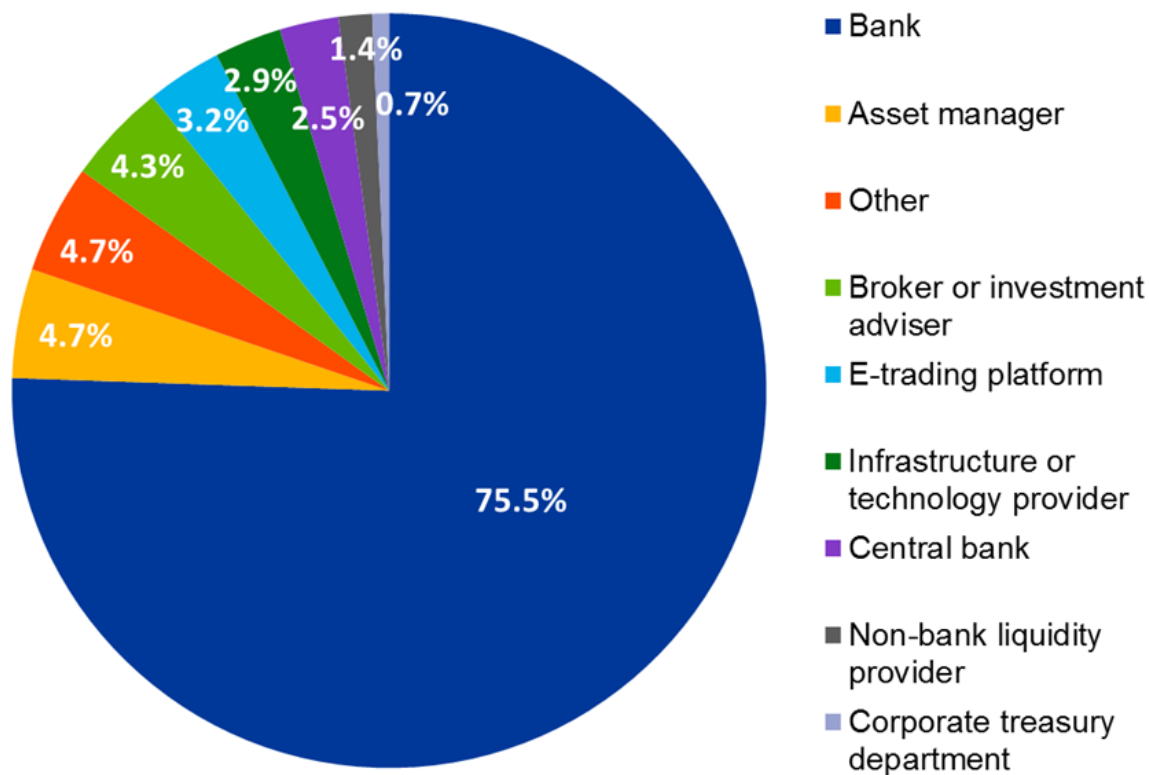


EGFX has reached out to 100+ associations to raise awareness of the FX Global Code.

Adherence to the FX Global Code – Current status

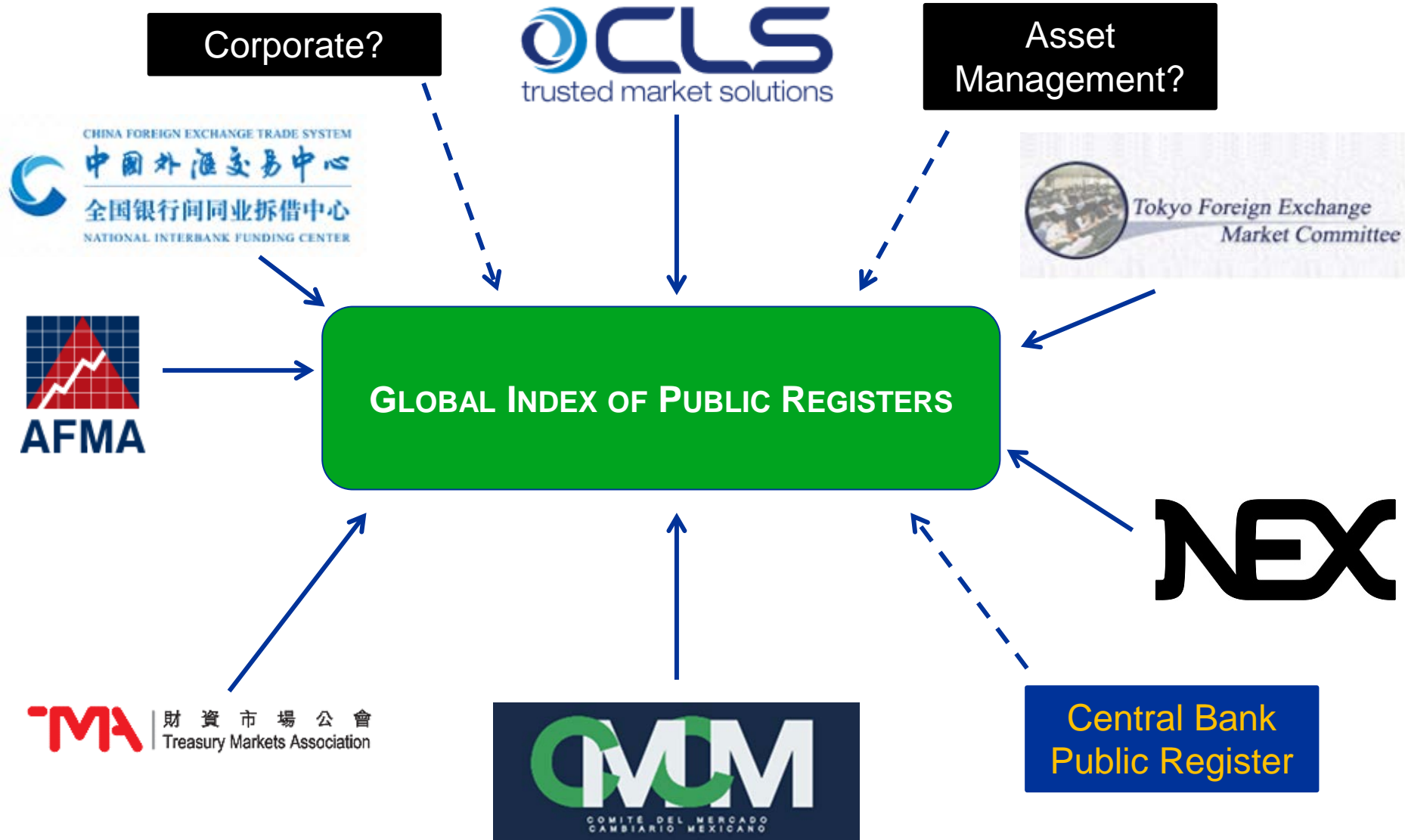
A critical mass has been created but further work remains

Well over 250 Statements of Commitment



Source: Global Index, Global Foreign Exchange Committee
Note: SoC by market participant type in the Global Index.

1. Global Index of Public Registers



Note: https://www.globalfxc.org/global_index.htm

2. Cover and deal

The working group will investigate in more detail the role that cover and deal trading models play in the FX market.

3. Disclosures

Given the importance the market's feedback placed on adequate disclosures providing transparency to the market, this working group will undertake further work on disclosures, including in regards to E-Trading Platforms.

4. Negative pre-hedging examples

GFXC members agreed to develop and consider additional negative examples related to Principle 11 of the Code on pre-hedging activity.

The FX Global Code – 1-year anniversary

A series of international events take place to raise awareness of and to bolster momentum for the Code.

The ECB encourages ESCB central banks to continue engaging with market participants in their local jurisdictions.

- Profit and Loss, Frankfurt 10 April (C. Beuve ECB)
- FX Global Code Briefing, London 10 May (R. Churm BoE)
- FX Invest, Frankfurt 15 May (C. Beuve ECB, I. Rahmouni-Rousseau BdF, M. Beechey Österholm Riksbank)
- Markets Forum, London 24 May (vice-Chair of GFXC D. Puth CLS, A. Boehler BNP Paribas)
- Bloomberg TV interview, London 24 May (D. Ramsden BoE)
- Global FX Committee meeting, Johannesburg 27 June (incl. ECB, BdF)
- FX Week webinar, 28 June (Chair of GFXC: S. Potter FRBNY)

Thank you for your attention!

The Euribor reform: latest developments

Fernando Conlledo and Moise Ba

**Quadrilateral meeting
Frankfurt, 8 June 2018**

Legal framework

- EU Benchmarks regulation (BMR), of 8 June 2016
 - ✓ Applicable from 1 January 2018
- Euribor considered a critical benchmark
 - ✓ Commission implementing Regulation (EU) 2016/1368 of 11 August 2016 establishing a list of critical **benchmarks**

Supervisors



**FSMA
(Belgium)**

- Provisions applicable to Critical Benchmarks
 - ✓ College of Supervisors established Sept 2016, (Art. 46)
 - ✓ Power to impose mandatory contributions to supervised institutions (Art. 23)

Administrators



**EMMI for
Euribor**

- Shall apply for authorisation by 1 January 2020

Banks



**Obligations as
supervised
contributors
(Art. 16)**

- Governance and control requirements
- To have in place effective systems and control to ensure the integrity and reliability of all contributions of input data

**Obligations as
users
(Art. 28.2)**

- Contingency Planning for the event of cessation or material changes of benchmarks
- Statement of IOSCO addressed to benchmark users (January 5, 2018)

Public consultation of the European Money Markets Institute (EMMI) on Hybrid Methodology for Euribor (March 26 to May 15, 2018)

- EMMI presents the Hybrid Methodology, which is composed of a three-level waterfall, and provides further details on the determination of each level respectively
 - ✓ Level 1. Submissions based solely on transactions
 - ✓ Level 2. Market data from recent days
 - ✓ Level 3. Combination of modelling techniques and/or expert judgement

Objective

Gather market opinion on certain features of the current publication process, as well as on other aspects, such as the inclusion and/or cessation of certain tenors

Current definition	New Definition
“The rate at which interbank deposits are being offered within the EU and EFTA countries by one prime bank to another at 11.00. a.m. Brussels time”	“The rate at which wholesale funds in euro could be obtained by credit institutions in the EU and EFTA countries in the unsecured money market”

Tentative timeline for the hybrid methodology for Euribor

2018			2019
May - July	Aug - Sept	October - November	Q4 at the latest
Testing phase of the new methodology with Euribor panel banks	Analysis and impact assessment	Second public consultation	Hybrid methodology launch
			Before 31.12.2019 EMMI will request authorization as Euribor Administrator

Transition from Ibors to
alternative RFRs:
the legal challenges and
market initiatives

ECB Working Group on euro Risk-Free Rates

September 2017: The ECB, FSMA, ESMA and the European Commission launched a Working Group on Euro Risk-Free Reference Rates (RFRs), split into 3 sub-Groups (Work Streams).

- **Goal:**
 - Identification and adoption of RFRs as alternative to the current benchmarks used in a variety of financial instruments and contracts in the euro area;
 - Safeguard the continuity of contracts;
 - Facilitate a gradual reduction of the current reliance on IBORs.
- **How:** bringing together representatives from both the public and private sectors to determine the most appropriate euro RFRs.
- **Context:** regulators across the world encouraging market participants to start using RFRs in new trades, and to switch over legacy positions as soon as possible to avoid disruption (ex: the FCA and the US Federal Reserve).

Focus on work stream #1A

□ Work stream #1A: Investigated legal framework per asset class and per Eurozone country

- **Work stream 1A \Leftrightarrow A mapping exercise !**
- By asset class: e.g., FRNs, Syndicated loans, business loans, retail loans, securitisation, OTC derivatives, exchange traded derivatives, SFTs, Deposits ...
- By providing insights in : Local laws that apply per asset class; Fall back arrangements that are already required by local law and included in contracts as such; Level of standardization across asset classes and/or countries; Level of customer protection and requirements for communication towards customers for changes in legacy contracts as set by law; Expected timelines to implement (alternative) RFR and RFR + term structure in legacy and new contracts ...
- Work stream # 1A seen as a starting point for a more thorough analysis and detailed proposals within WS #3

Focus on work stream #3

□ Work stream #3: Contractual robustness legacy and new contracts

- **The ECB** has now compiled responses by asset class for each implied euro area jurisdiction.
- From there onwards, Volunteers will conduct a thorough analysis of the compiled legal framework by asset class, using a predetermined structure, mainly focusing on:
 - Definition and Legal framework;
 - Fallback arrangements / Difficulty in quantifying estimated timelines to implement contractual fallback arrangements in new and legacy contracts in Eurozone as permanent and sustainable fallback arrangements are often not foreseen in the contractual terms;
 - Customer protection and global views on impact of the evolution affecting both new contracts and in legacy contracts;
 - Potential solutions and detailed adoption plans to highlight.

- Further reflection to share on current Fallbacks
 - **Potential inadequacies** of some existing fallback language
 - How to handle the use of current legacy fallback language?
 - Developing and incorporating **new (temporary) fallback language** in new contracts evolving over time after the alternative reference rates are defined.
 - The role of the trade associations (ISDA, ICMA, SIFMA, LMA) – Ibors Transition roadmap.
- **Timetable:**
 - **29 May – 15 June** : individual analysis of each asset class
 - **15 June**: deadline to submit the preliminary analysis of WS #3
 - **25 June**: meeting to discuss results and explore options.

Euro short term rate (ESTER)

Iñigo Arruga Oleaga (ECB; EFMLG)

inigo.arruga@ecb.europa.eu

Sarah J. Hlásková Murphy and Marek Svoboda (ECB)

Quadrilateral 2018, Frankfurt 7-8 June

- 1. IBORs and the euro area**
- 2. Particularities of the ECB Index**
- 3. Key legal issues in administration of ESTER**

IBORs and the euro area

- **After 40 years of general success represented by volumes and general industry and public knowledge, we witness an end of traditional IBORs across the globe: scandals, lower transaction numbers in the wholesale funding markets.**
- **In the euro area, no IBOR scandal, still high use but lower participation in IBOR (Euribor) panel: for banks, more risk than benefit?**
- **Difficulties for Eonia and Euribor (EMMI) progress into a post-traditional IBOR era, i. e. a post-Benchmark Regulation era; discontinuation of Eonia, no ad hoc legislation for Euribor *transition***

IBORs and the euro area

- **ECB steps-in including Ester**
- **and EU institutions and banking sector also step-in:**
- **ECB sets up a working group, together with the Financial Services and Markets Authority (FSMA), the European Securities and Markets Authority (ESMA) and the European Commission:**
- **identify risk-free rates as alternative to current benchmarks and explore smooth transition to these rates (careful transition planning; minimise disruption to markets and consumers ; safeguard continuity of contracts)**

IBORs and the euro area

- **Involvement of public authorities and a concerted effort by all market participants to facilitate a gradual reduction in the current reliance on IBORs.**
- **Transparency of the working group: public terms of reference and documentation**
- **Within this going-forward framework, ESTER is approaching: ...**

Key features I

- Sept 2017 GovC announced ECB will publish a **euro unsecured overnight interest rate** (now ESTER) by 2020.
- Outcome of public consultation on the technical parameters, methodology:
 - Sufficient data (MMSR) to produce a reliable daily rate based purely on deposit transactions conducted with financial counterparties
 - The rate should be a volume-weighted mean with trimming at a 25% level
 - Contingency rate procedure included
 - New rate should be published daily at the latest by 09:00 CET

Key features II

- ❑ **Re-publication if errors have significant impact on rate**
- ❑ **ECB intends to regularly publish time-lagged indicative data for the new rate in 2H 2018 once methodology approved.**
 - Commitment to keep market informed about the key features of the rate prior to its publication.**
- **The technical features are now going through the ExB/GovC decision making process.**

- **Work continuing in parallel on the underpinning legal acts for adoption by end 2018.**
 - **Input data collected on basis of ECB's MMSR Regulation and used to compile the new rate as part of ECB's monetary policy tasks**
BUT
 - **Data reporting requirements need to be made more stringent as to transmission times and data integrity**
 - **Administration and governance of the rate determination process needs separate ECB legal act, e.g. a Guideline.**

1. Interaction with EU Benchmark Regulation

- **ECB will source input data exclusively from statistical collections from MMSR reporting agents**
- **If the data is readily available to the ECB:**
 - **MMSR reporting agents should not be considered as contributors of input data**
 - **Code of conduct and governance and control requirements do not apply directly**
- **Caution: Commission is competent to interpret application of EU Benchmark Regulation**

2. Ensuring compliance with international best practice

- Aim of implementing IOSCO principles for financial benchmarks in the Eurosystem legal framework
- Need to adapt to the unique institutional legal framework of the ESCB
 - Principle 1: the administrator should retain primary responsibility for all aspects of the determination process
 - Options: ECB, Eurosystem, NCB sub-group?

3. Addressing market expectations regarding transition

Seamless Transition	Market-led transition
Successor Rate	Cut-over transition

- Working Group on Risk Free Rates aims to define a path to **amend legal frameworks** (including through bilateral documentation, multilateral protocols and legislation) to embed EONIA replacement/EURIBOR fallback and define a transition plan **in legacy contracts**.
- Key legal challenges include:
 - Co-ordinating actions of lenders and swap-dealers around price-setting risks contravening competition law.



LIBOR / Alternative Reference Rates

Maria Douvas

Quadrilateral Presentation

June 2018

LIBOR Replacement

The Financial Stability Board & Financial Stability Oversight Counsel have identified LIBOR as systemically unsound due to the highly limited actual transactions supporting underlying submissions.

- The median daily volume of unsecured three-month U.S. dollar inter-bank borrowing is approximately \$1 billion, with many days < \$500 million

1 LIBOR Deemed Potentially Unsustainable by FCA

*“It is not only **potentially unsustainable**, but also **undesirable**, for market participants to rely indefinitely on **reference rates that do not have active underlying markets to support them**”*

– Andrew Bailey, FCA, July 2017

Regulatory and advisory bodies have identified flaws with LIBOR

Judgement Based

Lack of Transaction Data

Potential for Manipulation

2 Transition from LIBOR to Occur Over Next 1 to 4 Years

2018

December 28, 2017

LIBOR deemed a critical benchmark under European Benchmark Regulation, triggering FCA's ability to compel contribution

2019

*FCA may compel banks to submit towards LIBOR for a maximum 2Y period. **FCA has said that notwithstanding the ability to compel for 2 years, that it will not compel beyond 2021.***

2020

As of Nov. 24th, the FCA has confirmed that all 20 panel banks have agreed to support LIBOR until 2021.





2021

Uncertainty

4Y Period

Industry Global Streams

- Central Banks initiated working groups beginning in 2014 to address this issue and establish alternative reference rates compliant with IOSCO's Principles for Financial Benchmarks (published in 2013)
- In January 2018, IOSCO published a Statement on Matters to Consider in the Use of Financial Benchmarks setting out considerations users should take into account when selecting benchmarks, as well as in contingency planning

	 UNITED STATES	 UK	 EUROPEAN UNION	 JAPAN
Working Group	<ul style="list-style-type: none"> • Alternative Reference Rate Committee (ARRC) <ul style="list-style-type: none"> – Buy-Side Advisory Group 	<ul style="list-style-type: none"> • Working Group on Sterling Risk-Free Reference Rates 	<ul style="list-style-type: none"> • Working Group formed by FSMA, ESMA, ECB, and the EC 	<ul style="list-style-type: none"> • Study Group on Risk-Free Reference Rates
Sponsor Central Bank	<ul style="list-style-type: none"> • Federal Reserve Board 	<ul style="list-style-type: none"> • Bank of England ("BOE") 	<ul style="list-style-type: none"> • European Central Bank ("ECB") 	<ul style="list-style-type: none"> • Bank of Japan ("BOJ"), Japan Financial Services Agency (Observer)
Alternative Reference Rate Proposals / Selections	<ul style="list-style-type: none"> • Selected Secured Overnight Funding Rate "SOFR" (Jun 2017) ✓ 	<ul style="list-style-type: none"> • Selected Unsecured Reformed Sonia (Apr 2017) ✓ 	<ul style="list-style-type: none"> • Undecided New unsecured rate or overnight secured repo rate • EMMI considering alternatives for EURIBOR; EONIA submission methodology will not be enhanced ● 	<ul style="list-style-type: none"> • Selected Unsecured TONAR (Dec 2016) ✓

Source: Morgan Stanley Bank Resource Management

1. Additional jurisdictions that are currently in progress for selecting a fall-back rate are Australia, Singapore and Hong Kong

U.S. Alternative Reference Rates Committee (“ARRC”) Overview

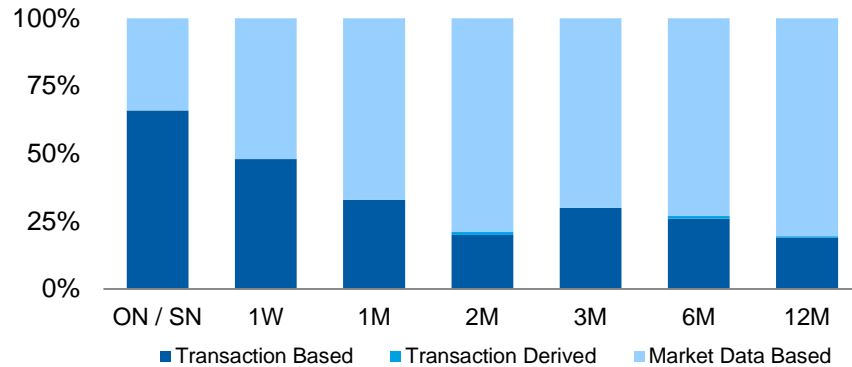
- **ARRC Formation:** In Nov 2014 the Federal Reserve Board (“FRB”) created the Alternative Reference Rates Committee (“ARRC”) to:
 1. **Identify a set of possible alternative reference rates** that comply with IOSCO Principles for Financial Benchmarks
 2. **Select one of these possible rates;** and
 3. **Identify an adoption plan** with means to facilitate the acceptance and use of the alternative rate
- **Membership:** Major over-the-counter derivative dealers, major clearing houses (LCH, CME), ISDA, and domestic prudential and market regulators, including the NY Fed, CFTC, SEC and CFPB
 - Expanded in 2018 to include cash market participants across loans, floating rate notes, securitizations and consumer products
- **Outreach Efforts:**
 - Public consultation and interim report on two proposed alternative rates and preliminary implementation plans (May 2016),
 - Roundtable event to seek feedback on potential alternative rates (June 2016), and
 - Roundtable to solicit input on the development of the “paced transition” plan for the derivatives market (Nov 2017)
 - Second report on the “paced transition plan” for the derivatives market and challenges for the cash and lending markets (March 2018)
- **Selection of Rate:** Secured overnight financing rate (“SOFR”) selected in June 2017
- **Current Focus:**
 - Implementation of “paced transition” plan
 - SOFR futures trading, bilateral & cleared SOFR swaps (2018)
 - Development of cash/loan fallback in the event of a permanent LIBOR cessation (2018)
 - Interaction with ISDA on development of LIBOR fallback (including ISDA’s market consultation regarding the spread methodology to be applied in a fallback following permanent cessation of LIBOR)

SOFR – Increased Focus on Observable Transactions

On June 22, 2017, the ARRC selected the Secured Overnight Financing Rate (“SOFR”) as the alternative rate for USD LIBOR. SOFR commenced publication on April 3, 2018.

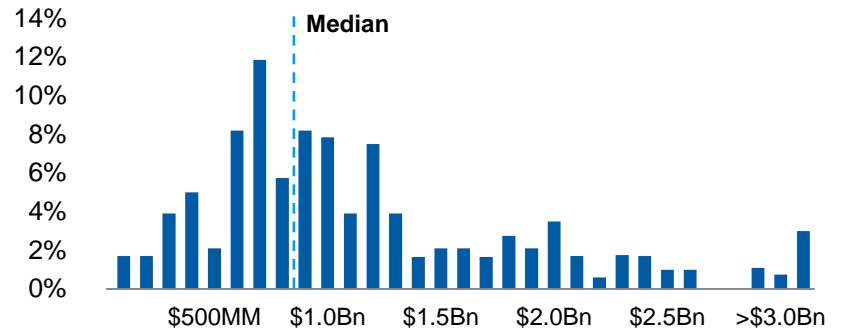
1 Most LIBOR Submissions Based on Expert Judgement

Submissions Types (%)



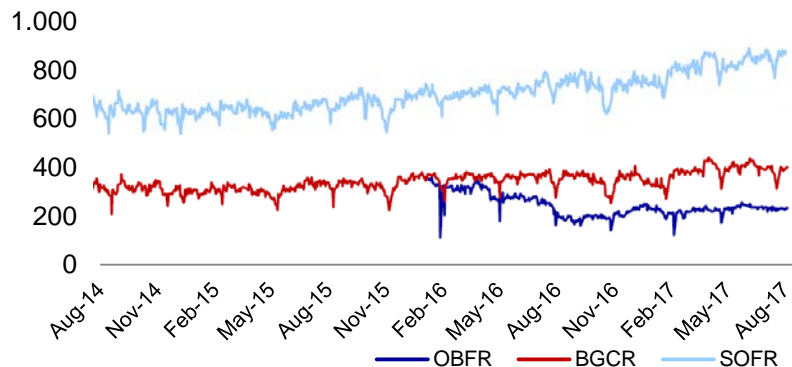
2 Low Level of Transactions Supporting ~\$200Tn Contracts

Days with Observed 3M LIBOR Volume (%)



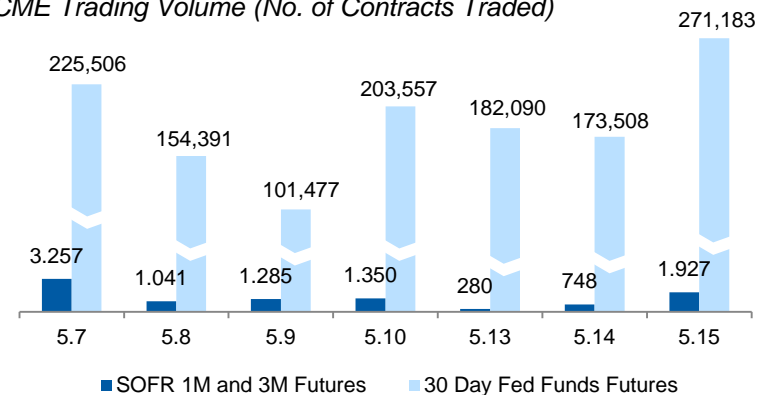
3 SOFR is Fully Transaction Based...

Aggregate Volume (\$Bn)



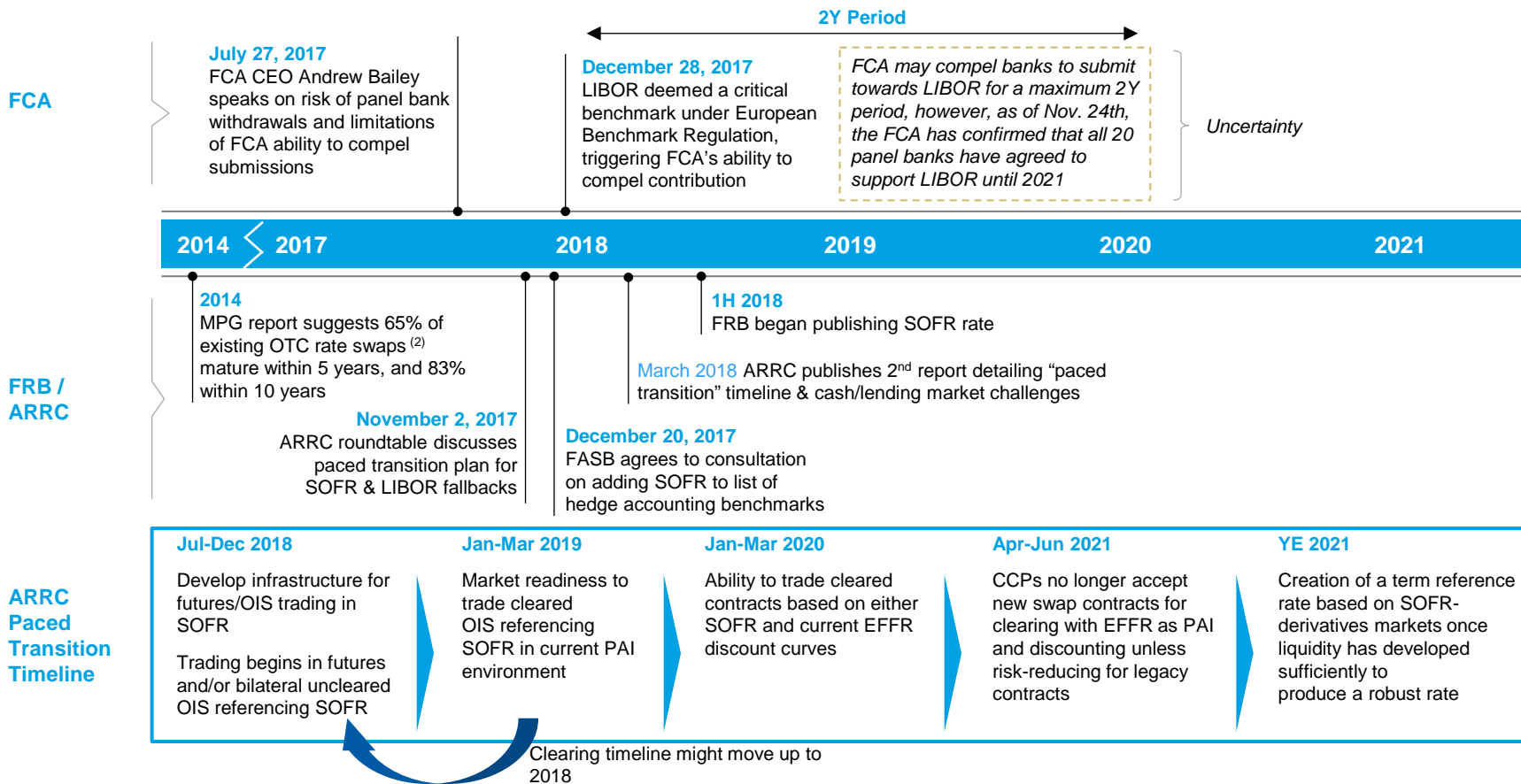
4 ...SOFR Derivative Trading Commenced; Breadth (products) and Depth (liquidity) Expected in the Coming Months

CME Trading Volume (No. of Contracts Traded)



Sources: "Introducing the Secured Overnight Financing Rate (SOFR)" Joshua Frost, FRBNY, November 2, 2017
 "Introductory Remarks" Governor Jerome Powell, Federal Reserve System, November 2, 2017

Tentative Transition Timeline in the U.S. Derivatives Market



Derivatives Market / ISDA

The derivatives market is furthest forward in plan for migration from LIBOR to SOFR:

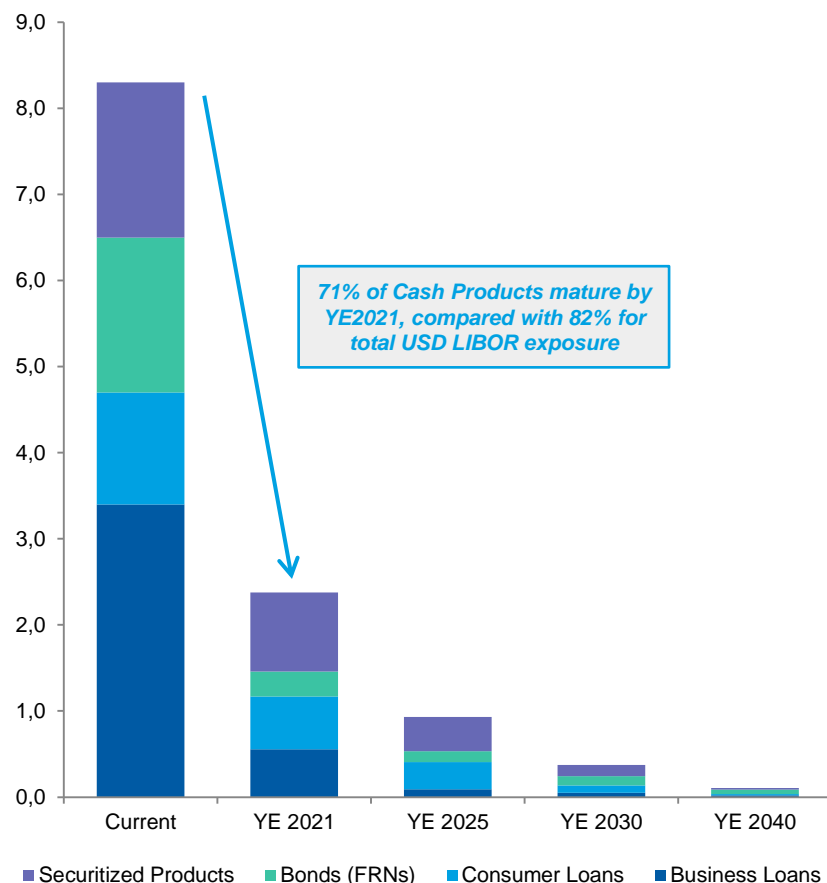
- **ISDA LIBOR Fallback WG.** Considering different methodologies for fallbacks to central bank committee “risk free rates” + spread in the event of a permanent cessation of LIBOR
 - Commencing in June, ISDA will conduct a broad survey of the market to develop consensus for one of several options
 - Purpose of spread is to adjust for the fundamental difference between the “risk free rates” (overnight rates) and LIBOR (which is a forward looking rate that takes into account credit risk)
- **Implementation of Fallback.** ISDA 2006 Definitions will be amended to include fallback for new trades and a protocol will be implemented to amend legacy LIBOR transactions
 - Open question as to how LIBOR swaps governed by local master agreements (e.g., French and German local master swap agreements) will be amended to incorporate LIBOR fallback
- **Term Rate Challenge.** The Official Sector Steering Group (OSSG) has been clear that the industry cannot wait for a term rate to develop before fallbacks to “risk free rate” + spread are incorporated in LIBOR swaps
 - Expectation that the derivatives market will move to an OIS market with term rates potentially used for cash markets (and hedges to cash markets)
- **Regulatory Challenges.** The ARRC Regulatory WG has developed a list of regulatory challenges of both voluntary conversions of LIBOR swaps to SOFR swaps and amendment of LIBOR swaps to incorporate fallback, including Title VII of Dodd Frank (applicability of uncleared margin rules, mandatory clearing and trade reporting) and tax

Transition Challenges in the Cash Market

Derivatives makeup roughly 90% of all USD LIBOR exposures. However, cash products have material LIBOR exposures as well.

Cash Market Roll-Down Over Time

\$Tn Outstanding



Source: "Second Report," Alternative Reference Rates Committee, March 2018
 1. Securitized Products include MBS & CMOs, CLOs, ABS and CDOs

Typical Contract Language Varies Across Cash Products

	Fallback Rate	Consent Required
Business Loans	<ul style="list-style-type: none"> Obtain bank quotes → Alternative Base Rate <ul style="list-style-type: none"> Prime Rate EFFR plus fixed spread 	<ul style="list-style-type: none"> Bilateral Loans: Agreement between borrower and lender Syndicated Loans: Unanimous consent
Bonds (FRNs)	<ul style="list-style-type: none"> Obtain bank quotes → Fixed Rate at last published LIBOR set 	<ul style="list-style-type: none"> Unanimous consent among bondholders
Securitized Products (1)	<ul style="list-style-type: none"> Agency MBS and CMO: Issuer selection Non-agency MBS and ABS: Bank poll → Fixed Rate at last published LIBOR set CLO: Final LIBOR set 	<ul style="list-style-type: none"> Agency MBS and CMO: Unanimous consent Non-agency MBS and ABS: Unanimous consent CLO: Unanimous consent (typically called after 1-2 years)
Mortgages / Consumer Loans	<ul style="list-style-type: none"> Alternative Base Rate plus / (minus) spread <ul style="list-style-type: none"> Spread component undefined 	<ul style="list-style-type: none"> Chosen by noteholder

SECTION IV

Appendix

Methodology/Publication of SOFR

On 12/8/17, Fed issued final notice on its methodology and publication of SOFR and 2 additional subset repo rates

Timing: Publication commenced in April 2018

Methodology:

- Volume weighted median (rejected volume-weighted “mean” approach)
- Specials to be trimmed by excluding all FICC cleared bilateral trades with rates below the 25th volume-weighted percentile
- Rejected concerns about quarter end spikes and the need for a “smoothing” mechanism (on the basis that market needs an accurate view of daily pricing)

Daily Publication Time & Publication Information:

- 8:00 am, ET (and will explore feasibility of an earlier publication time)
- Summary statistics for the 1st & 99th % to accompany rate publication

Revisions to Rate Publication:

- Revisions to be made if errors > 1 BP (b/c Fed will round SOFR and the other 2 rates to the nearest whole BP, this is effectively 2 BP)
- Periodic review of threshold to ensure that revisions are rare
- Fallback to primary dealer data in case market data unavailable from primary sources
 - FRBNY to commence collection of primary dealer data each afternoon (in addition to current daily morning collection)
 - Primary dealer data to be provided for each of overnight tri-party UST repo, overnight UST GCF repo and FICC cleared bilateral UST repo:
 - Aggregate borrowing activity (excluding inter-affiliate and Fed trades)
 - Weighted average rate of borrowing

Additional Global Developments for Other IBORs

- Although the FSB recommendations were directed at LIBOR, TIBOR and EURIBOR, other members have also taken steps to reform their existing rates in line with the advice given by the FSB and the IOSCO Principles

	Australia	Brazil	Canada	Hong Kong	Mexico	Singapore	South Africa	Switzerland
Administrator	<ul style="list-style-type: none"> Australian Securities Exchange ("ASX") 	<ul style="list-style-type: none"> Brazilian Stock Exchange (CETIP/BM & FBOVESPA) 	<ul style="list-style-type: none"> Thomson Reuters 	<ul style="list-style-type: none"> Treasury Markets Association ("TMA") 	<ul style="list-style-type: none"> Banco de México ("BdM") 	<ul style="list-style-type: none"> Association of Banks in Singapore ("ABS") 	<ul style="list-style-type: none"> South African Futures Exchange ("Safex") 	<ul style="list-style-type: none"> National Working Group
Sponsor Central Bank	<ul style="list-style-type: none"> Reserve Bank of Australia ("RBA") 	<ul style="list-style-type: none"> Brazilian Central Bank ("BCB") 	<ul style="list-style-type: none"> Bank of Canada 	<ul style="list-style-type: none"> Hong Kong Monetary Authority ("HKMA") 	<ul style="list-style-type: none"> Banco de México ("BdM") 	<ul style="list-style-type: none"> Monetary Authority of Singapore ("MAS") 	<ul style="list-style-type: none"> South African Reserve Bank ("SARB") 	<ul style="list-style-type: none"> SARON, an overnight GC Repo Rate (Feb 2016)
IBOR	<ul style="list-style-type: none"> Bank Bill Swap Rate ("BBSW") 	<ul style="list-style-type: none"> DI rate 	<ul style="list-style-type: none"> Canadian Dollar Offered Rate ("CDOR") 	<ul style="list-style-type: none"> Hong Kong Interbank Offered Rate ("HIBOR") 	<ul style="list-style-type: none"> The Interbank Equilibrium Interest Rate ("TIIE") 	<ul style="list-style-type: none"> Singapore Interbank Offered Rate ("SIBOR") 	<ul style="list-style-type: none"> Johannesburg Interbank Average Rate ("JIBAR") 	<ul style="list-style-type: none"> TOIS
Reference Rate Update	<ul style="list-style-type: none"> Transactions-based methodology recommended, expected to occur in early 2018 Proposed to strengthen fall back arrangements 	<ul style="list-style-type: none"> Methodology was reviewed in July 2016 DI rate anchored on the Selic rate A monitoring group exists at the BCB to discuss other initiatives 	<ul style="list-style-type: none"> No changes currently being made to the CDOR Assessing a transaction-based non-benchmark rate for certain secondary BA transactions 	<ul style="list-style-type: none"> Ongoing assessment & consultation paper Potential to reform HIBOR May take a "waterfall" of information input 	<ul style="list-style-type: none"> BdM staff have recommended TIIE reforms to align with IOSCO Principles Committee to begin operating in 2018 	<ul style="list-style-type: none"> Considering enhancements to methodology and alternative benchmarks Roadmap to be released by working group by year end 	<ul style="list-style-type: none"> SARB publishing report in early 2018 May refine SABOR to become main unsecured overnight rate 	<ul style="list-style-type: none"> Termination of the TOIS fixing 12/29/17; SARON replaced TOIS in advance Transition from CHF LIBOR not determined at this time

MORRISON | FOERSTER

MORRISON & FOERSTER LLP
REGISTERED ASSOCIATED OFFICES OF
ITO & MITOMI

8 June, 2018

Quadrilateral Meeting

EXPERIENCES AND LEGAL ISSUES AROUND THE BENCHMARK REFORM

IN JAPAN

TOKYO MULTIPLE RATE APPROACH – TIBOR AND

TONA

Akihiro Wani

Morrison & Foerster, Tokyo

Financial Law Board

a. JBA TIBOR or TIBOR+ (Tokyo Inter-bank Offered Rate)

1. Designed in line with the Principles for Financial Benchmarks issued by the Board of Directors of IOSCO dated July 17, 2013

Launched on 24 July, 2017 (complete)

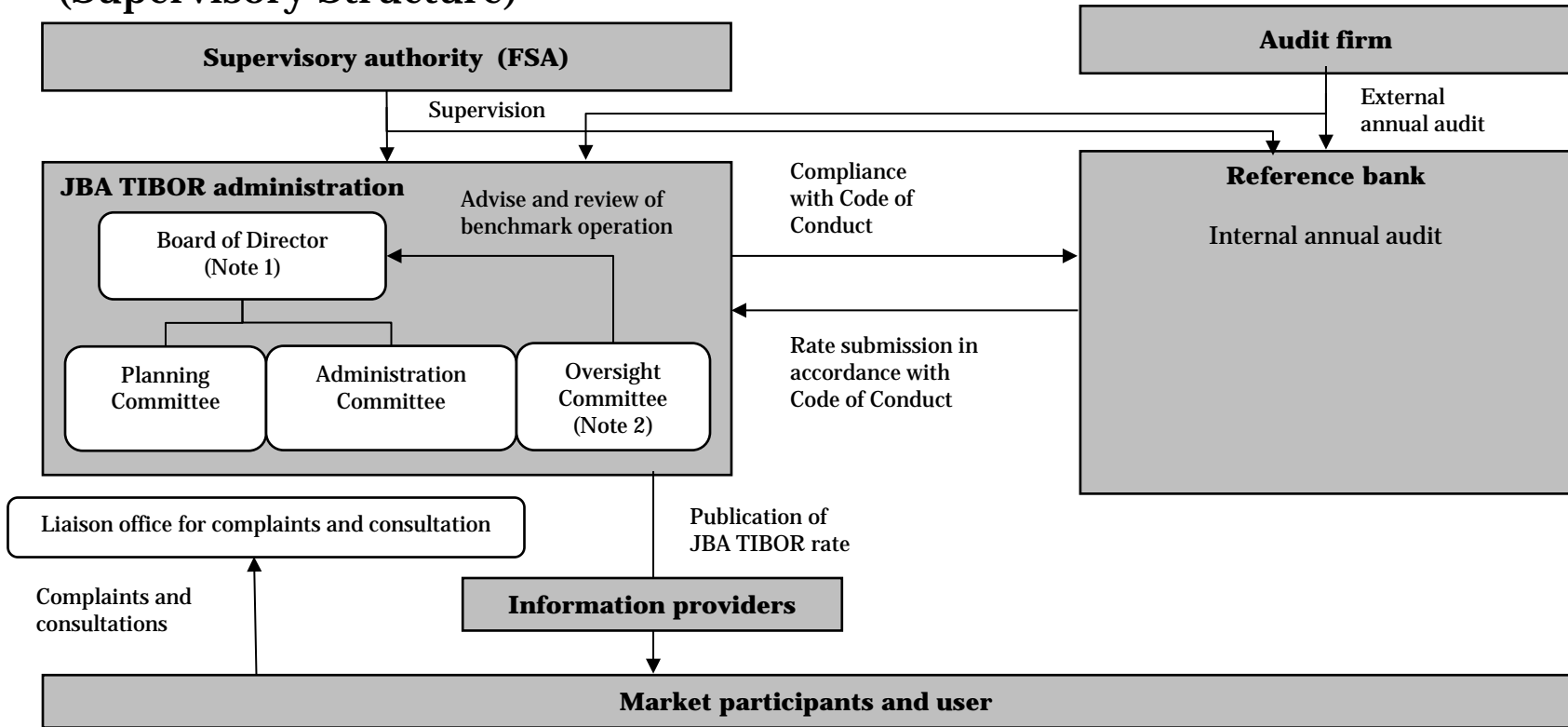
Definition: Average of interest rates which reference banks deem as prevailing market rates assuming transactions between prime banks (emphasis added) on the Japan unsecured call market as of 11:00 a.m., for five (i.e. 1 week, 1 month, 3 months, 6 months and 12 months). Although TIBOR is defined in a traditional way, it is basically the funding cost of the reference banks.

* Currently consisting of Japanese Yen TIBOR market and Euroyen TIBOR market.

Administrator: JBA Tibor Administration (JBATA), a subsidiary of the Japan Bankers Association.

JBATA processes the calculation of the interest rates submitted by the reference banks and does not gather direct transaction data by itself.

(Supervisory Structure)



(Note 1) The majority of directors are composed of lawyers, accountants and scholars elected from those who do not belong to financial institutions (e.g. Banks).

(Note 2) All members of the Oversight Committee are composed of lawyers, accountants and scholars.

(“JBA TIBOR reform” by JBATA)

Regulations: JBATA and the reference banks are regulated by the Financial Instruments and Exchange Act and the Financial Services Agency (FSA), including the control of the conflict of interests and external audit of reference banks. Such regulations were newly introduced in 2014.

The market manipulation activity is also prohibited.

2. Waterfall Methodology

How to obtain data from the inactive markets under the negative interest policy of the Bank of Japan? The methodology stated on the next page shows the efforts by JBATA to make TIBOR+ be linked with the real transaction data as much as possible without resorting to expert judgment.

So far TIBOR+ has never used the 4th Level data, namely the Expert Judgement since its launch.

Waterfall methodology for Japanese yen TIBOR

1st Level Use data in the observable unsecured call market.

1-1	Actual Unsecured Call transactions	<ul style="list-style-type: none"> Rates in observable actual transactions data are weighted averaged by the transaction value to arrive at a reference rate.
1-2	Committed Quotes of Unsecured Call transactions	<ul style="list-style-type: none"> Of Committed Quotes presented by brokers based on which transactions are committed to be executed, those relating to offered rates are weighted averaged to arrive at a reference rate.
1-3	Indicative Quotes of Unsecured Call transactions	<ul style="list-style-type: none"> A change from the previous business day in the mean rate of quotes presented by brokers, is referenced. (A change from the previous day in the mean rate of quotes is added/deducted to/from the reference rate submitted on the previous day to arrive at the reference rate of the day.)
1-4 (1)	Linear Interpolation	<ul style="list-style-type: none"> If a reference rate of an adjacent tenor is calculated in line with the sub-tier [1-1], the linear interpolation method is applied to arrive at a reference rate.
1-4 (2)	Retroactive Use of actual transactions data	<ul style="list-style-type: none"> Date back day by day up to three business days, and if a reference rate is calculated in line with the sub-tier [1-1] in a business day, that reference rate is determined as a reference rate of the day.
1-4 (3)	Linear interpolation based on retroactively used actual transactions data	<ul style="list-style-type: none"> If a reference rate of an adjacent tenor is calculated in line with the sub-tier [1-1] or [1-4(2)], the linear interpolation method is applied to arrive at a reference rate.

2nd Level Use data in the observable Japan Offshore Market and Interbank NCD market.

2-1	Data in the Japan Offshore Market, Data in the Interbank NCD market	<ul style="list-style-type: none"> The treatment under the sub-tiers from [1-1] to [1-4(3)] are applied mutatis mutandis in this order to actual transactions, etc.
-----	---	--

3rd Level Use data in the observable NCD market (other than the Interbank NCD market), large-term deposits, short-term government bonds market, GC repos market and OIS market.

	Data in the NCD market (other than the Interbank NCD market), Large Term Deposits, short-term government bonds market, GC repos market and OIS market	<ul style="list-style-type: none"> With respect to the following data, reference a change from the previous business day. (Respective changes from the previous business day in the following data (1) to (5) are added to, or deducted from, the reference rate submitted on the previous day in accordance with the method predetermined by JBATA to arrive at a reference rate of the day.) <ol style="list-style-type: none"> (1) Actual transactions in the NCD market (other than the Interbank NCD market) (2) Actual transactions in large-term deposits (3) Quoted in the short-term government bonds market (4) Quotes in the GC repos market (5) Quotes in the OIS market
--	---	---

4th Level Expert Judgment.

	<ul style="list-style-type: none"> A rate is submitted based on expert judgement by a Person Responsible for Rate Submission and Staff Performing Rate Submission Tasks at reference banks.
--	--

3. Member Banks

Under Japanese law, neither the Financial Services Agency (FSA) or JBATA has the authority to force the banks to submit the rates. The world of “moral suasion” by FSA is here. The banks submit rates as a kind of “pro bono activity”.

JBATA does not charge any license fees for the use of TIBOR+ by the users.

4. Japanese Yen TIBOR and Euroyen TIBOR

The consolidation of JPY TIBOR and Euroyen TIBOR into one Japanese Yen TIBOR in the near future is considered.

5. EU Benchmark Regulations and TIBOR

b. TONA (Tokyo Overnight Average Rate)

1. Japanese Yen Risk Free Rate

Major Candidates:

(1) Uncollateralized overnight call rate

- with some credit risk of the parties reflected, but not so much
- enough market depth
- a benchmark is calculated and published by the Bank of Japan

(2) GC repo rate

- credit risk of the parties being excluded but affected by the supply and demand of the bond market
- enough market depth, but the market continuity may be affected because of the introduction of T+1 settlement cycle of JGBs in May 2018 (so far no impact).

(3) OIS rate

- lack of sufficient transaction volume

Winner: Uncollateralized overnight call rate (TONA)

2. Calculation

Data are supplied by 3 call-loan brokers (Ueda Yagi Tanshi Co., Ltd., Central Tanshi Co., Ltd. and The Tokyo Tanshi Co., Ltd.) and the call rate is calculated by The Bank of Japan on weighted average basis.

3. Challenges – In Japan the Risk Free Rate is not yet so popular due to the existence of TIBOR. Because corporate users are accustomed to using interest rate benchmarks with tenors.

1) What would be the best practice of TONA?

2) Succession Plan for Japanese Yen LIBOR

Deadline: By the end of 2021, when Japanese Yen LIBOR disappears?

3) How to construct a rate for each tenor corresponding to Japanese Yen LIBOR, based on TONA?

OIS approach or listed interest rate futures approach?

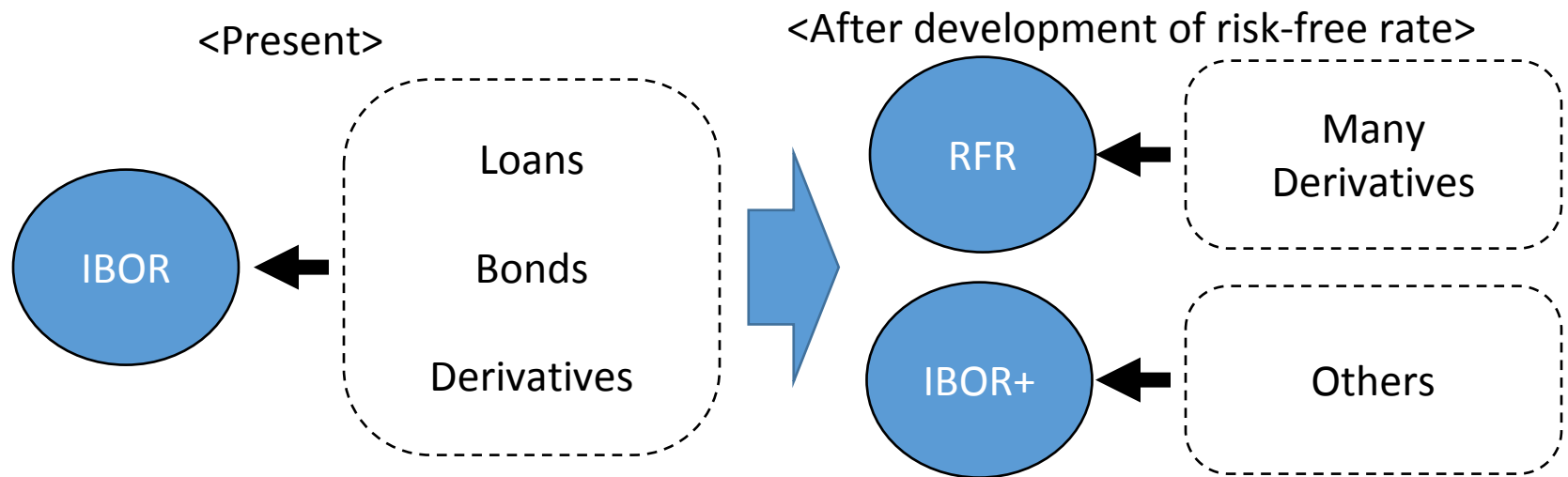
4) Compliance system and costs for introduction

c. Multiple Rate Approach

(1) Financial Stability Board – Reforming Major Interest Rate Benchmarks (July 2014)

“Ideal model for the users of the Benchmark users”

Image of the Use of Interest Rate Benchmarks in the FSB Report



(Study Group on Risk Free Reference Rates “Public Consultation on Identification and use of a Japanese Yen Risk-Free Rate, March 2016 at page 3)

(2) Challenges

- Support by the markets is the key to success. Wide recognition by the market participants is necessary.
- Timing – almost around the same time of the implementation of Basel III
- Too strong leadership and intervention by the regulators may not work.
- The costs for the implementation of the Risk Free Rate – For whom the benchmark exists?

(3) Japan is moving toward the adoption of the multiple rate approach. How about other jurisdictions? EURIBOR? No future for LIBOR?

- End -

MORRISON | FOERSTER

MORRISON & FOERSTER LLP
REGISTERED ASSOCIATED OFFICES OF
ITO & MITOMI

Experience and legal issues around the benchmark reform in the U.K.



Kate Gibbons, Clifford Chance LLP

Registered Charity Number: 1164902.

"The FMLC" and "The Financial Markets Law Committee" are terms used to describe a committee appointed by Financial Markets Law Committee, a limited company ("FMLC" or "the Company"). Registered office: 8 Lothbury, London, EC2R 7HH. Registered in England and Wales. Company Registration Number: 8733443.

LIBOR GBP



Timeline of Sterling Risk-Free Rates

March

Bank of England presents final design of reformed SONIA

July

Andrew Bailey head of the FCA, raises question about the future of ICE LIBOR saying FCA would no longer compel banks to make LIBOR submissions from end of 2021 and suggests that LIBOR may be phased out in 2021

November

The FCA issued a statement saying “All 20 panel banks have provided support till end of 2021”

April

Bank of England takes over the end to end administration of SONIA, including its calculation and publication. New floating rate option for ISDA-GBP-WMBA-SONIA-COMPOUND published on 23 April 2018

2015

March

Bank of England convened the Working Group on Sterling Risk-Free Reference Rates.

2017

April

Working Group recommends SONIA as its preferred alternative RFR

October

Reformed SONIA will take effect on 23rd April 2018

2018

January

EU Benchmark Regulation comes into effect
The Working Group mandate and membership was extended to promote a broad-based transition to SONIA across sterling bond, loan and derivatives markets

June

ISDA consultation paper on potential calculation methodologies for credit spreads and alternative term structures due to be published.

Extract from the Bank of England website



December 2017 Bank of England and FCA announced that from January 2018 the market-led Working Group on Sterling Risk Free Rates will have an extended mandate and broader participation

- The Working Group’s new mandate will be to catalyse a broad based transition to SONIA over the next 4 years across sterling bond, loan and derivatives markets so that SONIA is established as the primary sterling interest rate benchmark by the end of 2021.
This reflects concerns about the sustainability of LIBOR beyond 2021 and follows a recent public consultation which confirmed strong support for SONIA as the preferred alternative to sterling LIBOR
- For this next phase of work, it is clear that active engagement will be needed from participants across all relevant sectors and markets. Membership of the Working Group will therefore be broadened to include investment managers, non financial corporates, and other sterling issuers, infrastructure firms and trade associations, alongside banks and dealers
- A key near-term priority for the Working Group will be to make recommendations relating to the potential development of term SONIA reference rates. This work is already under and a public consultation is planned for the first half of 2018.

Revamped UK Working Group on £RfR



Chair – private sector

François Jourdain (Barclays)

Working Group membership

Working Group advisory members, and representatives from ISDA, LCH Ltd., the Bank and the FCA

Subgroups	Objectives of work
Futures	<ul style="list-style-type: none"> • Agree upon and publish a possible specification for SONIA referencing futures contract(s) to be traded on electronic trading platform(s), which facilitates the transition away from GBP LIBOR and maximizes usage across a broad set of market participants • Consider mechanisms to ensure that the SONIA futures contract achieves critical liquidity
Term reference rate	<ul style="list-style-type: none"> • Identify and assess relevant potential use cases for term SONIA market reference rates and the significance of each rate • Identify and review potential data inputs and calculation methodologies for term SONIA reference rates • Make recommendations about whether, for which applications and for what tenors term SONIA reference rates may be appropriate Propose measures with the aim of avoiding systemic reliance on these indices • Agree on design criteria for potential administrators and data providers to develop term reference rates
Pensions and insurance adoption	<ul style="list-style-type: none"> • Focus on promoting strategies to adopt SONIA and to convert legacy products • Publish key recommendations for wider consultation to facilitate broader transparency regarding their work
Bonds	<ul style="list-style-type: none"> • Focus on benchmark transition issues in bond markets
Syndicated loans	<ul style="list-style-type: none"> • Focus on benchmark transition issues in loan markets

Potential Issues with RFRs

Value transfer

Operational
issues

Overnight rates v
Term rates

- Forward looking
v backward
looking rate
- Predictability of
payment
- Currency

Consistency
across currencies
and products

Transition
Concurrence

Comparative product challenges

Issues	Derivatives	Loans	Vanilla bonds	Securitisations	Comments
Existing documentary fallbacks	ISDA standard GBP-LIBOR-Reference Banks – failing which bank quotes	LMA documents (only applicable for LMA loans): <ul style="list-style-type: none"> Reference Banks Cost of Funds 	No uniform approach, but likely to result in rate becoming fixed at last available ICE LIBOR	As for vanilla bonds	
Potential Documentary Solutions	<p>ISDA working on fallbacks for IBORs to be included in the 2006 ISDA Definitions. These fallbacks will apply to trades entered into after the fallbacks are incorporated into the 2006 Definitions.</p> <p>ISDA considering mechanisms to amend legacy contracts referencing IBORs for which fallbacks have been amended – including a protocol</p> <p>Draft ISDA Benchmarks Supplement – to facilitate compliance with Art 28(2) of EU Benchmark Regulation (robust written fallback plans)</p>	New LMA clause - optional provision to allow amendments to be made with a lower consent threshold (majority lender only)	Some (not universal) attempts to include new fall back provisions and lower voting thresholds	AFME negative consent proposal i.e. language being widely included that permits the issuer (via an agent) to propose a new reference rate with a resumption of investor consent in the absence of investor objections.	
Some Transitional Challenges	<ul style="list-style-type: none"> Identify appropriate credit spread methodology and term structure (ISDA Consultation, June 2018) minimize/eliminate value transfer at time fallback is applied minimize market disruption minimize/eliminate potential for manipulation. 	<ul style="list-style-type: none"> Need to amend all legacy contracts Need to deal with new payment mechanics, e.g. calculation dates, day count fractions Need to calculate value transfer All Lenders or majority lenders (as required) may not agree Competition issues Need to match reference rate changes with relevant derivatives Need to coordinate across currencies in multicurrency facilities Changes to IT/Infrastructure 	<ul style="list-style-type: none"> Need to amend all bonds. May not get requisite majority Need to deal with new payment mechanics, e.g. calculation dates, day count fractions Need to calculate value transfer Investors may not agree Competition issues Risk Factors MIFID II product governance concerns Need to match reference rate changes with relevant derivatives Changes to IT/Infrastructure 	<ul style="list-style-type: none"> As for vanilla bonds 	

OUR INTERNATIONAL NETWORK

- 32 OFFICES IN 21 COUNTRIES



- | | | | |
|------------|------------|-----------|------------------|
| Abu Dhabi | Hong Kong | Paris | Warsaw |
| Amsterdam | Istanbul | Perth | Washington, D.C. |
| Barcelona | London | Prague | |
| Beijing | Luxembourg | Rome | Riyadh* |
| Brussels | Madrid | São Paulo | |
| Bucharest | Milan | Seoul | |
| Casablanca | Moscow | Shanghai | |
| Dubai | Munich | Singapore | |
| Düsseldorf | Newcastle | Sydney | |
| Frankfurt | New York | Tokyo | |

*Clifford Chance has a co-operation agreement with AbuImed Alshikh Alhagani Law Firm in Riyadh.
Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.

Brexit: Update and key issues for firms



Oliver Moullin, Managing Director and General Counsel
Association for Financial Markets in Europe (AFME)

Registered Charity Number: 1164902.

"The FMLC" and "The Financial Markets Law Committee" are terms used to describe a committee appointed by Financial Markets Law Committee, a limited company ("FMLC" or "the Company"). Registered office: 8 Lothbury, London, EC2R 7HH. Registered in England and Wales. Company Registration Number: 8733443.

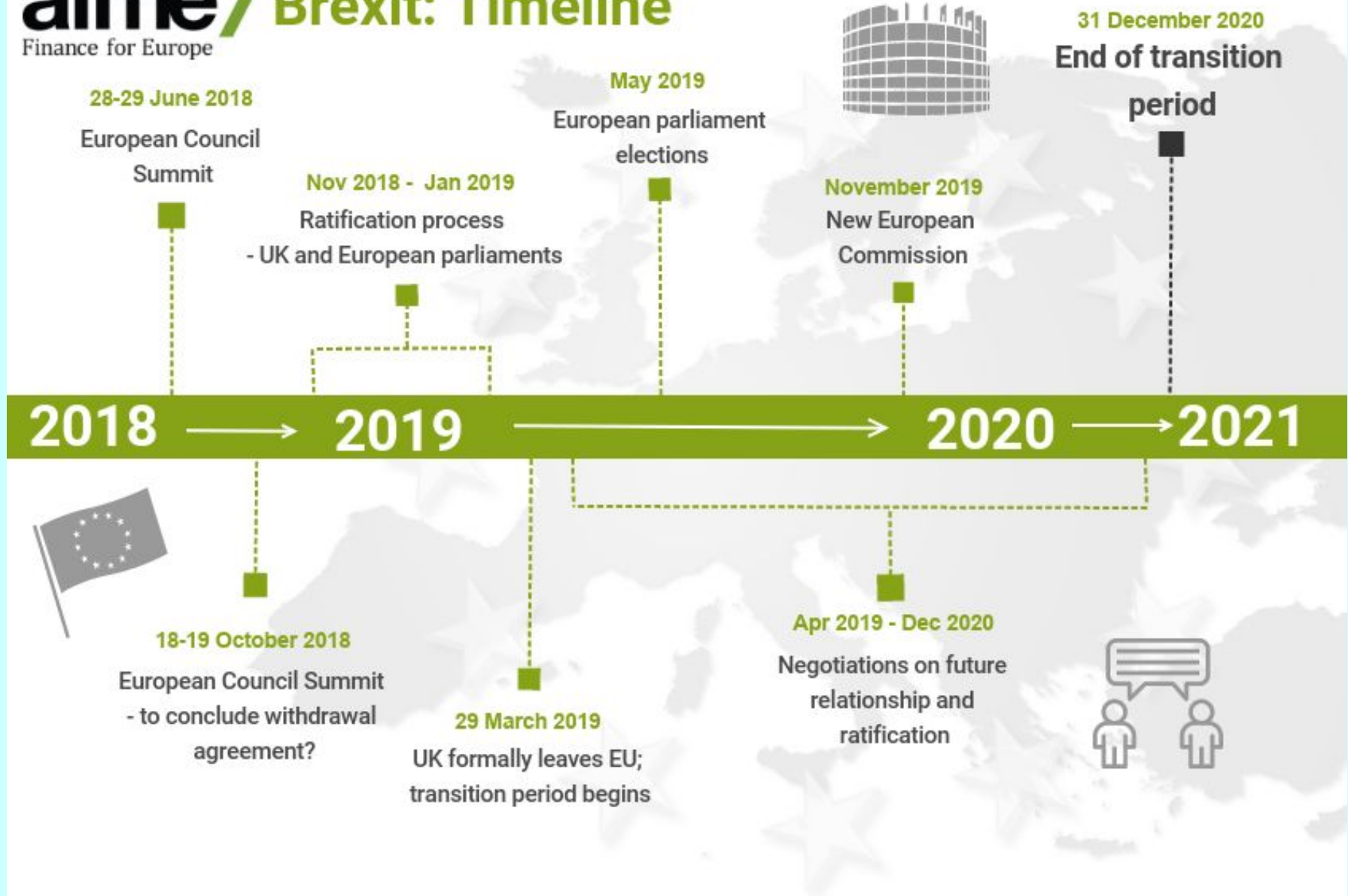
Where are we?

- Political agreement on a transition period as part of the Withdrawal Agreement
- Slow progress of negotiations ahead of the June European Council summit
- No clarity on the framework for the future relationship
- Lack of assurances to address cliff edge risks

Timeline

afme / Brexit: Timeline

Finance for Europe



Transition period

- A transition period is vital to provide time for firms, regulators and markets to adapt and ensure an orderly withdrawal
- The agreement on transition will only be legally certain when the Withdrawal Agreement is ratified.
 - UK regulators permitting firms to assume transition based on powers to grant temporary permissions in a no deal scenario
 - EU27 regulators lack similar political cover/powers and are therefore requiring firms to continue to plan on the basis of no transition

Future relationship

- EU27 Guidelines “allowing market access to provide services under host state rules”; “improved equivalence”
- UK Prime Minister and Chancellor of the Exchequer: mutual market access based upon mutual recognition of regulation
- AFME has not proposed a model for the future relationship. We believe that it is important to consider the following key principles in the negotiations:
 - 1) providing legal and operational certainty for market participants;
 - 2) supporting market efficiency and open markets to support growth;
 - 3) supporting market integrity, financial stability and alignment of regulation; and
 - 4) pursuing close supervisory cooperation.

What does this mean for the banking sector?

- Loss of passporting and lack of certainty on future market access →
 - UK-based firms establishing/building up EU27 operations
 - EU27-based firms need licence for branches in the UK

- Likelihood of greater fragmentation of groups within Europe, impacting on clients and markets

- Key areas/challenges:
 - Timing to build up capabilities
 - Approach to booking models and outsourcing
 - Repapering clients
 - Cliff edge risks

- At the same time continued regulatory change
 - Risk Reduction Measures package; IPU, MIFID implementation, Investment Firms review, equivalence review, Banking Union, Capital Markets Union etc
 - Withdrawal Bill and changes to EU legislation?

Cliff edge risks

- While banks are implementing plans to minimise disruption for clients, we have identified a number of risks which require public intervention to ensure financial stability and an orderly withdrawal, including:
 - Continuity of existing contracts
 - Continuity of access to financial markets infrastructure
 - Transfers of personal data
 - Recognition of resolution actions
 - Settlement finality
- We hope that these are discussed in the joint ECB/BoE working group and addressed through the Withdrawal Agreement or other means
- AFME has published a number of papers highlighting these issues.

Contractual continuity

- Implications for existing contracts – to what extent continuing to perform regulated activities in the EU?
- Large volume and value of existing cross-border contracts could be affected e.g. derivatives, loans, insurance. £26 trillion gross notional value of derivatives could be impacted
- For derivatives, firms may no longer be able to perform certain common “life cycle” events which are important to continue to service clients under existing contracts, e.g. extending existing positions and trade compressions.
- Transferring contracts has many challenges and would have a significant impact on clients and the market
- We believe that a solution is needed to enable existing contracts to be run down over time.

Access to market infrastructure

- It is essential to avoid any gap in access to financial market infrastructure e.g. CCPs.
- CCPs need to be recognised under EU regulation to enable EU27 firms to clear through UK CCPs and to avoid EU27 firms suffering increased capital requirements.
- When the UK becomes a third country the European Commission is able to make an equivalence determination, but it is essential to have certainty that there will be no gap while equivalence is assessed.

Cross-border data flows

- The GDPR prohibits transfers of personal data outside the EEA save where an adequacy determination has been made or certain other safeguards are put in place.
- The ability to transfer data between the EU and UK is essential to support cross-border trade and for banks to comply with regulatory requirements e.g. AML and market abuse.
- There are limitations in the “safeguards” that can be put in place
- We therefore believe that the Commission and UK should:
 - Start discussions in preparation for adequacy decisions; and
 - Commit to a transitional solution while adequacy is determined.

Recognition of resolution actions

- Bank Recovery & Resolution Directive (BRRD) provides for automatic recognition of a resolution action (e.g. bail-in) throughout the EU.
- Absent an agreement providing for recognition to continue, potential impact on the continued eligibility of existing English-law governed debt for loss absorbing capacity (MREL).
- The SRB has estimated €100bn of outstanding debt could be impacted.
- Continued mutual recognition of resolution actions would be the best solution, failing which unilateral recognition or other action to maintain eligibility of existing debt.
- Impact on contractual recognition of bail-in requirements (article 55 BRRD)

Settlement Finality



- UK leaving scope of Settlement Finality Directive (SFD) has implications for payment and settlement systems, including CCPs
- Some EU Member States will no longer be required to ensure protection of settlement finality and enforceability of collateral in UK-based systems
- Potential impact on ability of EEA-based clearing members to access UK CCPs even if they are recognised under EMIR
- Important to enable designation of UK-based systems to avoid disruption

Conclusion

- Political and legal uncertainty continues
- Banks are implementing plans
- Clarity is required as a matter of priority on solutions to mitigate cliff edge risks and support an orderly withdrawal

F

M

L

C



The Association for Financial Markets in Europe advocates stable, competitive and sustainable European financial markets that support economic growth and benefit society.

London

39th Floor
25 Canada Square
London, E14 5LQ
United Kingdom

Tel: +44 (0)20 3828 2700

Brussels

Rue de la Loi 82
1040 Brussels
Belgium

Tel: +32 (0)2 788 3971

Frankfurt

Skyper Villa
Taunusanlage 1
60329 Frankfurt am Main
Germany

Tel: +49 (0)69 5050 60 590

www.afme.eu

Firms' planning for Brexit

Quadrilateral meeting of the FMLC/ FMLG/
FLB/ EFMLG



7th & 8th June 2018

Caroline Boon

Scope

- Design, build, resourcing
- Engagement with clients
- Transfer mechanisms
- March 2019

Firms' planning for Brexit: design

- **Assumptions:** Transition?
- **Design strategies**
 - Rely on existing structural footprint
 - Rely on regulatory exemptions
 - Obtain branch licences
 - Set up a new EU entity
 - EU cross border merger
 - Buy an existing market participant
- **Legal Structure**
 - Subsidiary / Broker dealer / Branch
 - Balance sheet and prudential regulatory impacts

Firms' planning for Brexit: build

- Regulatory analysis
- Booking Models
- Implementation Timeline
- Technology

Firms' planning for Brexit: resourcing

- **Resourcing:** existing presence, new hires appropriate entity management
- **Outsourcing:** permitted activities, operational continuity and resilience
- **Operational efficiency**

Engagement with clients

Client example	Banking requirements
Japanese car manufacturer	<ul style="list-style-type: none">• Global foot print with manufacturing plant in UK• Supply chain throughout Asia and Europe• Requires access to capital market funding in US, UK and Europe
UK asset manager	<ul style="list-style-type: none">• Offers broad range of global and regional equity funds to UK investors• Requires exchange access and capability to transact in Europe• Investment vehicles in Ireland and Luxembourg
European energy supplier	<ul style="list-style-type: none">• Purchases energy from European nuclear and renewable sources• Sells to UK domestic energy supplier• Raises financing in US and Asia• Global supply chain with cash management, hedging and clearing in Europe
European sovereign	<ul style="list-style-type: none">• Significant wholesale funding requirements• Requires access to investor base in US, UK and Asia as well as risk management products traded and cleared in the UK

Transfer mechanisms

- As part of the planning process firms need to determine the most suitable transfer mechanism to legally transfer clients products and contracts
- There are a number of legal processes available to enact the move, but not all transfer methods are suitable for all products
- Options include
 - Part VII FSMA (Financial Services and Markets Act 2000) Banking Business Transfer
 - Cross border merger
 - Novation of contracts
 - Ts and Cs change
 - Transfers to an affiliate under existing contractual right
 - Updates to product terms and conditions
 - New documentation

What is a Part VII?

- UK court process
- It allows the transfer of a large number of separate legal relationships with customers and others to be made via a court order rather than requiring individual novation agreements. Customer protection is ensured through regulatory and court scrutiny
- Available only to licenced banks

What are the benefits of a Part VII?

- Allows for existing contractual relationships to be transferred to and/or replicated without the need for “re-papering”
- Legally the contract is treated as continuing rather than being terminated and a new contract created
- Grandfathering for EMIR margining and clearing purposes is expected to be preserved
- Under a Part VII a client’s existing contractual arrangements will be deemed migrated and/or replicated automatically to the new entity
- Clients do not need to re-execute current contractual arrangements or sign any new agreements

What documents does the client receive?

- Contracts include those under English-law, as well as other governing laws where supported by legal advice
- Clients could expect the following documentation:
 - a notification of a firm’s intention to pursue a Part VII Transfer instructions
 - Information as to how a client might participate; and
 - a notification once the scheme has been sanctioned, along with instructions of how to access a copy of the court order

March 2019

- Execution of plans
- Future relationship

Brexit & Netting Opinions

Chandra Bhargavan
Frankfurt am Main, 7-8 June 2018

The status quo:

A very significant number of master agreements with regard to derivatives and securities financing transactions entered cross-border between EU counterparties are currently governed by English law.

Why is that?

A number of pieces of EU legislation provide certain benefits in relation to contractual arrangements between EU counterparties which are subject to Member State law:

Examples:

- (a) As the UK is part of the EU, any English court judgement is **automatically** recognised and enforced across Member States.

- With Brexit, English law would become a third-country law and as a consequence, English court judgements would not be **automatically** recognised in EU countries.

Note that:

- this does not mean an English court judgement will not be recognised and enforced by EU courts after Brexit;
 - it does not mean English law agreement become less 'valid';
 - it does not mean EU counterparties will not be able to continue to use English law master agreements.
- It could mean more expenses, uncertainty and delay from extra steps
 - e.g. a recognition process by the domestic EU court before enforcement can take place.

(b) the positive position under the Winding-up Directive (WUD).

Article 25 WUD:

*“Netting Agreements shall be **governed solely** by the law of the contract which governs such agreements.”*

- Some Member States require that the governing law be the law of a Member State.

Article 10 WUD:

“The law of the home Member State shall determine in particular the rules relating to voidness, voidability or unenforceability of legal acts detrimental to all the creditors”.

Article 30 WUD:

“Article 10 does not apply as regards the rules relating to the voidness, voidability or enforceability of legal acts detrimental to the creditors as a whole, where the beneficiary of these acts provides proof that:

- *the act detrimental to the creditors as a whole is subject to the law of a Member State other than the home Member State, and*
- *that law does not allow any means of challenging the act in the case in point.*

What is the issue?

Article 30 WUD is a defence against an action for avoidance in certain EU countries.

Since the English law governed master agreement is the preferred choice for EU banks, the claw back risk is hence also assessed according to English law i.e.

- in addition to examining the claw back risk according to the specific requirements of the particular Member State, an additional determination is also often done from an English law perspective, to assess the likelihood of any avoidance challenge succeeding.
- With Brexit, since English law will no longer be the law of a Member State for purposes of Article 30 WUD, the additional analysis from the governing law perspective would not be feasible.

Why is that relevant?

- Article 296 of the Capital Requirements Regulation (CRR) sets out the legal perimeters for recognition of close-out netting as risk-reducing.
- Those legal perimeters require written and reasoned legal opinions that in the event of a legal challenge of the netting agreement, the bank's claims and obligations would not exceed the close-out amount.
- The netting opinions may not be able to rely on the Art 30 WUD safeharbour and may accordingly be less robust (from the claw back risk angle) for Art 296 CRR purposes.

Examples of disclaimers already appearing in netting opinions:

- ❑ “We express no opinion on potential adverse effects on some of our conclusions reached herein, notably in respect of Agreements governed by English law and subject to the jurisdiction of English courts, of a potential exit of the United Kingdom from the European Union.”
- ❑ “.. we note that the question of “Brexit” is of particular importance in relation to the potential defence from “claw-back” which applies under Article 16 of the Insolvency Regulation and Article 30 of the Winding-up Directive), so long as the “act” in question is subject to the law of a Member State.”

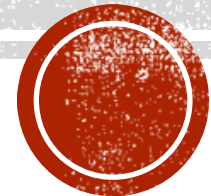
ISDA initiatives.

1. ISDA will be publishing a new ISDA Master Agreement which will be subject to Irish and French laws respectively (in addition to its current documentation offerings subject to New York and English law);
2. ISDA has issued a high level overview of the implementation of Art. 30 Winding-up Directive (and Collateral Directive) in various Member States.

Hence,

- The choice of an ISDA Master Agreement subject to the law of a Member State would also be available post-Brexit.
- EU parties will also be able to do an additional Art 30 WUD analysis, where necessary, from the perspective of the law of another Member State law (as governing law of the netting agreement).

OVERVIEW OF US REGULATORY DEVELOPMENTS AFFECTING FINTECH



**CHINEDU R. EZETAH
JUNE 8, 2018**

FINTECH REGULATION THROUGH THE LENS OF VIRTUAL CURRENCY AND DLT

- FinTech is a pretty broad field of services, businesses and technology
 - Financial Stability Board defines “FinTech” very broadly as “technology-enabled innovation in financial services that could result in new business models, applications, processes or products with an associated material effect on the provision of financial services”
- FinTech businesses in the U.S (whether established financial institutions or technology companies, or new start-ups) generally have to navigate multiple federal and state consumer and investor protection laws and other regulations that apply to the products or services that they offer. As a result, some notable highlights include
 - U.S. FinTechs increasingly explore corporate and operating models, such as partnership arrangements with Banks, designed to limit the scope of federal or state level regulatory obligations (a 2015 decision of the U.S. Court of Appeals for the Second Circuit in *Madden v. Midland Funding, LLC* creates certain uncertainties regarding the FinTech-Bank partnership model)
 - A 2017 proposal by the Office of the Comptroller of the Currency for Special-Purpose-None-Bank Charters for FinTech companies that engage in any activity that is traditionally a banking service or product generated some interest and some controversy
 - A 2018 SIFMA proposal for a FinTech Regulatory Sandbox by the Financial Stability Oversight Council
 - Eager anticipation that Treasury Department’s forthcoming report on regulating non-banks will address regulation of FinTechs
- The category of FinTech that is currently dominating the news and the attention of US regulators is Virtual Currencies (of which **Cryptocurrencies** like Bitcoin, Ether, Ripple, Litecoin, among others, are the best known), and the **Distributed Ledger Technology** underlying most Virtual Currencies (of which **Blockchain** is the best known)

All views expressed in this material and the presentation are my personal views and do not reflect the views or position of my employer or any association that I am affiliated with



VIRTUAL CURRENCY REGULATION

- The regulatory environment for Virtual Currencies in the U.S. is complex and involves multiple Federal Agencies and State Banking regulators
- The complexity is highlighted by the fact that currently a given Cryptocurrency (e.g., a hypothetical “**Crypto-X**”) is, at once, “Property” to one Regulator, “Currency” or “Money” to another, “Commodity” to yet another and could be a “Security” to another regulator, therefore, Crypto-X is potentially subject to concurrent and overlapping regulatory regimes and obligations
 - At a high level, the outcome is a fragmented patchwork of regulations in which:
 - State Banking regulators oversee Virtual Currency spot exchanges largely through state money transfer laws
 - Financial Crimes Enforcement Network (FINCEN) monitors Virtual Currency transfers for anti-money laundering abuses (FINCEN is an arm of the U.S. Department of the Treasury that is primarily responsible combating money laundering and terrorist financing)
 - The Internal Revenue Service (IRS) treats Virtual Currencies as property subject to capital gains tax (IRS is an arm of the U.S. Department of the Treasury that is responsible for collecting taxes, administering the tax laws and pursuing erroneous or fraudulent tax filings)
 - The Commodity Futures Trading Commission (CFTC) regulates Virtual Currencies as commodities and regulates Virtual Currency derivatives (CFTC is the Federal Agency that primarily regulates commodity derivatives markets - futures, options and swaps)
 - The Securities Exchange Commission (SEC) has relied on facts and circumstances analysis in determining Virtual Currencies/Tokens so far issued in Initial Coin Offerings to be Securities and subject to securities regulations (SEC is the Federal Agency that primarily regulates the securities and securities-based-swaps markets)



Regulation as Commodities under the U.S. Commodity Exchange Act

- The CFTC determined in 2015 that Virtual Currencies are “Commodities” under the U.S. Commodity Exchange Act (in a matter relating to Coinflip). A Federal Court in New York recently upheld that determination in *Commodity Futures Trading Commission v. McDonnell et al.*, March 6, 2018
- Based on the determination that Virtual Currencies are “Commodities” under the U.S. Commodity Exchange Act, the CFTC
 - maintains only an anti-fraud and anti-manipulation enforcement authority over Virtual Currency exchanges that deal solely on spot sale and delivery of Virtual Currencies, but
 - maintains a comprehensive regulatory and enforcement Jurisdiction over Virtual Currency derivatives and futures activity and markets
- In exercise of that Commodity regulatory authority, CFTC
 - has created a Task Force in its Enforcement Division that is dedicated to anti-fraud and anti-manipulation enforcement in Virtual Currency markets and has issued several consumer alerts
 - has vigorously brought several enforcement actions against alleged fraudulent or Ponzi Schemes (Coin Drop Markets, My Big Coin Pay Inc., Gelfman Blueprint Inc, CabbageTech, Corp) and unregistered Cryptocurrency exchanges (Coinflip, BitFinex) or unregistered commodity pool operators, while a number of CFTC registered exchanges have listed Cryptocurrency futures or binary options (CME, CBOE, Cantor Exchange) and swaps (TeraExchange and LedgerX)
 - has proposed guidance on what would be required for a cryptocurrency transaction to be eligible as a “spot” transaction and therefore only subject to its Anti-Fraud/Manipulation Enforcement Authority (but exempt from its comprehensive regulatory oversight Jurisdiction). (Under the proposal, a factor that will weigh in CFTC’s determination is whether a customer has the ability to take possession and control of the entire quantity of Cryptocurrency purchased), and
 - recently (May 21, 2018) issued Staff Advisory No. 18-14 providing guidance to exchanges and clearinghouses on certain requirements that must be taken into account when listing virtual currency derivatives contracts, including, certain key areas that require particular attention such as (A) enhanced market surveillance; (B) coordination with CFTC staff; (C) large trader reporting; (D) outreach to stakeholders; and (E) DCO risk management



Regulation as Securities under U.S. Securities Laws

- For the SEC, whether or not a Virtual Currency is a Security depends on the facts and circumstances
- In 2015, the SEC determined that Tokens issued in Initial Coin Offerings are “Securities” which must comply with securities laws registration requirements or related exemptions, and that the Cryptocurrency exchanges and administrators involved in such activities may be subject to securities exchange or broker-dealer registration requirements (*DAO Report/ Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934*)
 - In coming to that determination, the SEC applied the US Supreme Court’s Howey test (SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946)) for determining what meets the “investment contract” prong of the definition of Securities under the Securities Exchange Act of 1934, i.e.,
 - an investment of money [“money”, in this context, is broadly construed by US courts and is not limited to fiat currency]
 - in a common enterprise
 - with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others
- The Cryptocurrency industry has advanced a view that certain Tokens are “Utility” (or Consumption) Tokens and are therefore not Securities. In a testimony before a US Congressional Committee earlier this year, SEC Commissioner Clayton warned against ICO structures that elevate form over substance by simply highlighting the “utility” features of the Token
- In exercise of that Securities regulatory authority, SEC
 - has set up a new Cyber Unit within its Enforcement Division that is focused on misconduct involving initial coin offerings,
 - has vigorously brought several enforcement actions against alleged fraudulent or Ponzi Schemes (Bitcoin Savings and Trust; REcoin Group; AriseBank; Titanium Blockchain; Centra Tech) and unregistered exchanges (BitFunder, BTC Trading Corp), and
 - is currently considering an application to list Bitcoin ETFs. (The SEC had previously noted a number of investor protection issues relating the volatility of the Cryptocurrency markets, the vulnerability of the underlying spot markets to fraud and manipulation, and uncertainties regarding compliance with customer assets custody rules in the context of a Bitcoin ETF)



Regulation under U.S. Anti-Money Laundering Laws

- In March 2013, FINCEN issued a guidance clarifying that its position is that Virtual Currencies are subject to the same rules as other fiat currencies
- FINCEN therefore determined that administrators and exchangers (but not users) of Virtual Currencies are required to register and be regulated as money services businesses by FINCEN, including submitting to FINCEN's anti-money laundering surveillance, reporting and compliance program requirements
- In a letter to a US Congressional Committee (February 13, 2018), FINCEN also took the position that developers that operate certain ICOs (such as where a developer sells convertible Virtual Currency) may be engaging in money transmitter activity and therefore within the regulatory jurisdiction of FINCEN
- FINCEN has brought a number of enforcement actions against virtual currency exchangers and administrators, including, in one instance against a foreign located Virtual Currency business, BTC-e, and one of its operators, for alleged that violation of US Anti-Money Laundering laws



Treatment as Property for tax purposes

- In 2014, IRS clarified that Virtual Currencies will be treated and taxed as “Property” (and not currency) for federal tax purposes
- Participation in Virtual Currency exchanges is done pseudonymously, which presents challenges in monitoring compliance with Tax Laws
- In November 2017 the IRS obtained court summons to cause Coinbase to disclose approximately 13,000 its customers (including, their taxpayer IDs, names, birth dates, addresses, and historical transaction records)
- In March 2018, IRS issued a notice to remind taxpayers that income from Virtual Currency transactions is reportable on their income tax returns (IRS Notice-2018-71, March 23, 2018)
- In 2017 a Cryptocurrency Tax Fairness Act was proposed in US Congress and is still pending



Regulation as money transmitter businesses

- 49 States (with the only exclusion being Montana) regulate money transmitter businesses. Most State money transmitter licensing requirements include, among other requirements, maintaining surety bonds and minimum capital requirements
- A start-up company that will operate a Virtual Currency business predominantly online would need to methodically review the money transmitter laws and definitions of all States and determine what Licenses it must obtain
 - A few examples of State money transmitter licensing statutes include
 - New York: N.Y. Banking Law (in 2015, NY adopted a Bitlicense scheme specifically for Virtual Currency businesses that do not have a state banking charter)
 - California: Money Transmission Act
 - Ohio: Money Transmitters Act
 - North Carolina: Money Transmitters Act
 - Oklahoma: Financial Transactions Act
 - Wyoming: Money Transmitters Act
- The definitions of money transmitter, licensing requirements and the resulting regulatory obligations are not consistent across all States, which presents a challenge to a Virtual Currency business that operates in multiple states
- The Uniform Law Commission (ULC) drafted a model statutory framework that States may adopt for their regulation of Virtual Currency business activities to ensure some uniformity
- In 2017 the Conference of State Bank Supervisors announced a Vision 2020 initiative which is designed to increase harmonization of licensing and regulatory requirements. (Many market participants believe that Vision 2020 initiative is a tactical response by States to OCC's Special-Purpose-None-Bank Charter proposal)



OCC's Special-Purpose-None-Bank Charter proposal

- The Office of the Comptroller of the Currency (OCC) is an independent bureau within U.S. Department of Treasury that is the primary prudential regulator of national banks
- OCC has not yet issued prescriptive guidance on regulation of Virtual Currencies, but has proposed Special-Purpose-None-Bank Charters for FinTech companies that engage in any activity that is traditionally a banking service or product
 - Under the federal preemption rules, a Virtual Currency business that opts to obtain such Special-Purpose-None-Bank Charter may not have to seek money transmitter businesses licenses from States. The State of New York and the Conference of State Bank Supervisors filed separate suits challenging the authority of the OCC
- The OCC is yet to make a final decision on whether to proceed with the proposal



DISTRIBUTED LEDGER TECHNOLOGY (DLT)

- Technologies by themselves are generally not regulated in the US (with the exception of technologies that have potential military or weaponry application, which are subject to certain Export Controls). Rather, US Regulators regulate the users of Technology and the products or services linked to them
- For now, that is the case for DLT. Whether that will continue to be the case in the future is an open question given that some of the potential applications that have been mentioned would involve systemically important infrastructure or functions. Examples include:
 - US Congress: potential application of DLT to secure US digital infrastructure against Cyberattacks
 - FRB: potential application of DLT in Payments, Clearing, and Settlement systems
 - CFTC – potential application of DLT in enabling real time access to derivatives data for its systemic risk oversight of the derivatives market
 - ISDA Digital Common Domain Model: aims to create a standard digital representation of trade lifecycle events as a first step in preparing for application of Blockchain and DLT in the digitization of derivatives trading



Cboe Futures Exchange Bitcoin Futures



Lisa Shemie

Chief Legal Officer – Cboe FX Markets & Cboe
SEF

June 8, 2018

Agenda

- ❖ Introduction – Cboe Futures Exchange Overview
- ❖ What is Bitcoin?
- ❖ Overview of Gemini Exchange
- ❖ Interactions with the CFTC
- ❖ Contract Specifications Overview
- ❖ Product Benefits
- ❖ What's Next?
- ❖ Questions?

Cboe Futures Exchange (CFE) Overview



- ❖ CFE is an all-electronic designated contract market that is regulated by the CFTC. CFE is owned by Cboe Global Markets and all trades are cleared by The Options Clearing Corporation.

Cboe Volatility Index (VX) Futures

- The Cboe Volatility Index® (“VIX®”) is an up-to-the-minute market estimate of expected volatility that is calculated by using real-time prices of options on the S&P 500® Index listed on Cboe Exchange.

Cboe Russell 2000 Volatility Index (VU) Futures

- The Cboe Russell 2000 Volatility Index is based on real-time prices of options on the Russell 2000 Index, listed on Cboe Exchange and is designed to reflect investors’ consensus view of future (30-day) expected market volatility of the Russell 2000 Index.

S&P 500 Variance (VA) Futures

- Exchange-traded contracts based on the realized variance of the S&P 500 Composite Stock Price Index (S&P 500).

Cboe/CBOT 10-Year US Treasury Note Volatility Index (VXTY) Futures

- Based on real-time mid-quotes of options on 10-Year US Treasury Note futures listed on the Chicago Board of Trade.

Cboe Bitcoin (XBT) Futures

- Cash-settled contracts that are based on the Gemini auction price for bitcoin in US dollars.

What is Bitcoin?

- ❖ Bitcoin is a digital asset based on the decentralized, open source protocol of the peer-to-peer Bitcoin computer network (“Bitcoin Network”)
- ❖ The Bitcoin Network hosts the decentralized public transaction ledger, known as the Blockchain, which records all bitcoin transactions
- ❖ Bitcoin vs. bitcoin
 - “Bitcoin” refers to the Bitcoin Network
 - “bitcoin” refers to the actual coins or units of cryptocurrency
- ❖ The CFTC classifies bitcoin as a commodity under the Commodity Exchange Act

- ❖ Founded by Cameron and Tyler Winklevoss
- ❖ The Gemini Exchange is a facility of the Gemini Trust Company, LLC, which is regulated by the New York State Department of Financial Services (“NYSDFS”)
- ❖ All USD deposits with Gemini are held at banks insured by the FDIC
- ❖ All activities of Gemini are subject to examination and supervision by the NYSDFS
- ❖ Currently offers trading in bitcoin/USD, ether/USD, ether/bitcoin, Zcash/USD, Zcash/bitcoin, and Zcash/ether



- ❖ Extensive discussions with the CFTC over 4+ months prior to launch
 - CFE Product Development, Legal and Regulatory groups involved from onset of discussions
- ❖ Enhancements to product design and settlement as a result of dialogue with the CFTC
- ❖ The CFTC engaged in a “heightened review”
- ❖ Extensive information sharing agreement with Gemini
 - CFE pursuing additional information sharing agreements at request of the CFTC
- ❖ Since launch, CFE’s Regulatory group receives Gemini Exchange market data to conduct surveillance reviews and also provides this data to the CFTC
- ❖ Continued regular communication with CFTC, including participating on a recent panel convened by its Market Risk Advisory Committee on the self-certification process

Post-launch: CFTC Regulation of Virtual Currencies



- ❖ CFE has continued regular communication with the CFTC, including participating on a recent panel convened by its Market Risk Advisory Committee on the new product self-certification process
- ❖ In May 2018 the CFTC issued an advisory on virtual currency derivative products listed on designated contract markets (such as CFE) and swap execution facilities
 - The advisory included CFTC staff's current thinking on its regulation of virtual currencies, encouraging market participants to, among other things, consult with CFTC staff prior to submitting new product filings, reflecting the process undertaken by CFE prior to its launch of its bitcoin future

- ❖ CFE launched the first US bitcoin futures contract (XBT futures) on December 10, 2017.



Summary Product Specifications for XBT Futures	
Contract Multiplier	1 bitcoin
Final Settlement Date	2 business days prior to the third Friday of the month
Final Settlement Value	The official auction price for bitcoin in USD determined by the 4 pm ET Gemini Exchange Auction
Reportable Position Level	5 contracts
Transaction Fee	\$0.50 for Customers/ \$0.25 for Trading Privilege Holders
Type of Trading Hours	Monday- Friday
Extended ¹	5:00 p.m. (previous day) to 8:30 a.m. and 3:30 p.m. to 4:00 p.m.
Regular ¹	8:30 a.m. to 3:15 p.m.

¹ All times are Chicago.

- ❖ Price discovery and price transparency
- ❖ Designed to reflect economic exposure related to the price of bitcoin
- ❖ An exchange-listed, regulated and surveilled bitcoin product
- ❖ Risk management tool for cryptocurrency-holding participants
- ❖ Access to the bitcoin sector without needing to have a digital wallet
- ❖ Settlement directly to the Gemini auction price for bitcoin, rather than an average price determined by an index
 - The Gemini auction has a 5% collar compared to the Winklevoss Blended Bitcoin Index (WBBI)
 - All orders on the Gemini Exchange must be 100% pre-funded
 - Successful settlements of January, February, March, April and May XBT Futures

What's Next?

- ❖ Cboe Bitcoin XBT Futures ETFs/ETPs?
- ❖ Other Cryptocurrency Futures Contracts?
- ❖ Options?



Cboe Global Markets
400 South LaSalle Street
Chicago, IL 60605
www.cboe.com

Cboe[®]

Virtual Currencies in Japan

Makoto Chiba

Bank of Japan

June 7-8, 2018

Introduction

- It is reported that **transactions of virtual currencies (VCs) by individual investors have been active in Japan.**
- **VCs are not regarded as payment instruments but as speculative commodities.**
 - ✓ Some merchants accept Bitcoin as a means of payments.
 - ✓ Partly because of high volatility in prices, it must be difficult to use them as daily payment instruments.


Backgrounds of the VCs regulation

Anti-Monetary Laundering

- ✓ G7 Summit (2015) declaration
- ✓ FATF guidance (2015)

Customer Protection

- ✓ Mt.Gox bankruptcy (2014)

 Payment Service Act (PSA) was amended in 2016
(enacted in April 2017)

Definition of VCs

Can be used for payment to unspecified parties

Can be electronically recorded and transferred

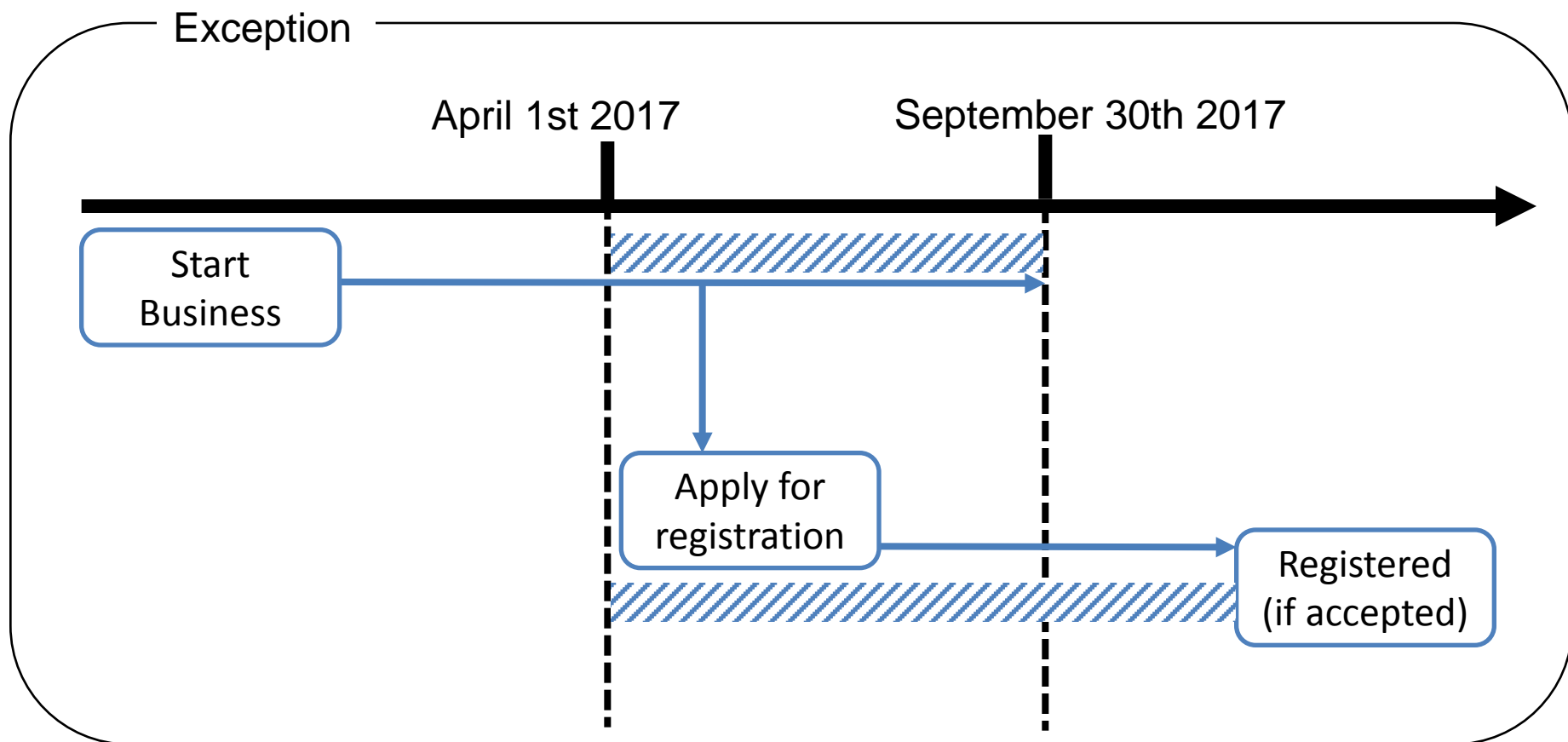
Not a legal currency or
legal currency denominated asset

Japan has legally defined virtual currencies as a type of payment instruments, but **they are NOT legal tender.**

Regulations for VC Exchanges (VCEs)

- **Implementation of registration system**

- ✓ After April 2017, VCEs are required to register with JFSA.



Regulations for VCEs – Cont'd

- **Regulation on anti-monetary laundering and counter-terrorism financing.**
 - ✓ Customer due diligence
 - ✓ Record keeping
 - ✓ Suspicious transaction reporting

- **Regulation for customer protection**
 - ✓ Adequate business and computer system management structure
 - ✓ Information provision to customers
 - ✓ Segregation of customers' assets

Coincheck incident

January 2018

Hacking of Coincheck system.

- "NEM" worth \$530 million has been stolen.
- 260,000 customers suffered losses.

February

Coincheck submitted a report on their business.
JFSA implemented on-site inspection.

March

JFSA issued a business improvement order.

- ✓ Coincheck issued full refund in YEN to all 260,000 of its customers.
- ✓ Monex announced purchase of Coincheck.

After Coincheck incident

As of May 1 2018

Registered VCEs :
16 Firms

- Money Partners
- BITPoint Japan
- QUOINE
- DMM Bitcoin
- bitFlyer
- bitARG
- bitbank
- Exchange Tokyo
- SBI Virtual Currencies
- Bitgate
- GMO Coin
- BITOCEAN
- BitTrade
- FISCO
- BTCBOX
- Tech Bureau
- Xtheta

Self-regulatory body

VCEs whose applications are pending :
8 Firms

- Last Roots
- Bcrements
- everybody's bitcoin
- BMEX
- Blue Dream Japan
- ETERNAL LINK
- FSHO

Coincheck

Monex
Group

Application Withdrawn : 8 Firms

- bit station
- RAIMU
- bit Express
- Mr. Exchange
- Tokyo Gate Way
- CAMPFIRE
- Payward Japan
- deBit

On-site Inspection (JFSA)

Business suspension orders : 5 firms
Business improvement orders : 7 firms



Makoto Chiba

Director – Head of Legal Studies Group
Institute for Monetary and Economic Studies

Bank of Japan

makoto.chiba@boj.or.jp

***New Legislation in Japan on Electronic
Payment Intermediate Services***

Anderson Mori & Tomotsune
Kunihiko Morishita

8 June 2018

Background

- Worldwide development of FinTech (including Japan)
- PSD2 (Revised Payment Services Directive) in EU
https://ec.europa.eu/info/law/payment-services-psd-2-directive-eu-2015-2366_en
 - Adopted in November 2015
 - EU countries had to transpose PSD2 into national law by 13 January 2018
- Japanese FSA formed a Financial System Council WG (Working Group) in December 2015; the final Report by the WG was published in December 2016.
 - The Report suggested to set up a framework to pursue open innovation between service providers and banks, while securing user protection

Amendments to the Banking Act

- A bill to amend the Banking Act was passed by the Diet on 26 May 2017; the amended Act and the relevant subordinate regulations have become effected on 1 June 2018

- The Amended Banking Act:
 - Defines the services (“Electronic Payment Intermediate Services”);
 - Introduces a registration system for service providers;
 - Provides supervisory framework over the service providers; and
 - Require banks to take certain actions.

Definition of the Services/Service Provider

- “Electronic Payment Intermediate Service Provider”
 - (i) Payment Initiation Service Provider (PISP)
 - communicating payments/remittance orders to banks
 - (ii) Account Information Service Provider (AISP)
 - obtaining account information from banks under entrustment of depositors (“account aggregation service”)

Regulation

- Registration System - “Electronic Payment Intermediate Service Providers” must be registered pursuant to the Banking Act
- Service Providers are required to enter into a contract with each bank, which shall provide certain matters, including: (i) the allocation of indemnity liability in cases where users suffer damage, (b) the measures for proper handling of user information, and (c) the measures for safety management. These matters must be made public.

Banks' Obligations

- Banks must prepare and publish the standards required for the “Electronic Payment Intermediate Service Providers” which will be connected to them (e.g., standards regarding security, compliance, etc.)
- Banks intending to establish an “open API (Application Programming Interface)” arrangement (i.e., to allow “Electronic Payment Intermediate Service Providers” to provide services without obtaining the users’ ID/PW information) must endeavor to establish a system to enable such arrangement within 2 years from the promulgation of the Banking Act amendments

ANDERSON
MŌRI &
TOMOTSUNE

■ Contact

Kunihiko Morishita

Tel: 03-6775-1020

Fax: 03-6775-2020

E-mail: kunihiko.morishita@amt-law.com

Anderson Mori & Tomotsune

Otemachi Park Building, 1-1-1 Otemachi

Chiyoda-ku, Tokyo 100-8136, Japan

<https://www.amt-law.com>

AN OVERVIEW OF EU/UK REGULATORY DEVELOPMENTS RELATING TO FINTECH



Barnabas Reynolds, Shearman & Sterling LLP

Registered Charity Number: 1164902.

"The FMLC" and "The Financial Markets Law Committee" are terms used to describe a committee appointed by Financial Markets Law Committee, a limited company ("FMLC" or "the Company"). Registered office: 8 Lothbury, London, EC2R 7HH. Registered in England and Wales. Company Registration Number: 8733443.

AGENDA

An overview of EU/UK regulatory developments relating to Fintech



1 INTRODUCTION

4 DIGITAL CURRENCIES AND INITIAL COIN OFFERINGS

7 PROPOSED EU DIGITAL SERVICES TAX

2 CROWDFUNDING

5 LEGAL ISSUES

8 THOUGHTS ON HOW TO APPROACH FINTECH REGULATION

3 AUTOMATED INVESTMENT ADVICE

6 GDPR AND BLOCKCHAIN TECHNOLOGY

9 WHAT'S COMING UP?

INTRODUCTION

HUNDREDS OF USE CASES

FINANCIAL SERVICES USE CASES	ADDITIONAL USE CASES
<ul style="list-style-type: none"> • Trade execution and settlement, including for swaps, derivatives, repos, etc. • Payment systems, cash remittances • Transfer agency • Loans and escrow • KYC/AML checks (verified “digital identities”) • Trade finance (e.g., letters of credit) • Asset finance • Loan syndication • Proxy and other voting • Tax reporting and collection 	<ul style="list-style-type: none"> • Medical records • Supply chains • Disbursement tracking (e.g., international aid transfers) • Art sales and provenance • Real estate transactions • Fractionalization of almost anything (time shares, etc.) • Royalty payments • Insurance payouts • Voting

CROWDFUNDING

PROPOSED EU REGULATION OF EUROPEAN CROWDFUNDING SERVICE PROVIDERS



- The European Commission’s proposal will introduce an EU label for crowdfunding service providers (CSPs)
- CSPs that want to benefit from the ECSP passport will be subject to authorization and ongoing supervision by ESMA and rules on prudential management, conflicts of interest, investor protection, transparency and marketing communications
- All payments for crowdfunding transactions will be required to take place through entities authorized under the Payment Services Directive, which will bring such payments within scope of the EU's AML rules
- Leaves national regimes in place for purely domestic platforms but CSPs authorised under a domestic regime will not obtain an EU passport
- MiFID II will specifically exclude CSPs from its scope - national regimes that place CSPs within scope of MiFID II will need to be adjusted

Crowdfunding service

“the matching of business funding interest of investors and project owners through the use of a crowdfunding platform and which consist of any of the following: (i) the facilitation of granting of loans; (ii) the placing without firm commitment of transferable securities issued by project owners and the reception and transmission of client orders with regard to those transferable securities”

CROWDFUNDING

UK Clarification of banking regulatory perimeter

- The Financial Services and Markets Act 2000 (Carrying on Regulated Activities By Way of Business) Order 2001 has been amended to clarify the position of borrowers who raise funds through peer-to-peer lending platforms
- Subject to a number of conditions, if a borrower using peer-to-peer lending uses the capital of, or interest on, money received by way of deposit solely to finance its other business activities, this is to be regarded as evidence indicating that the borrower is not carrying on the business of accepting deposits
- Clarifies that only firms whose core business involves borrowing through a peer-to-peer platform would need to obtain a banking license and be regulated as a "deposit taker"
- Resolves uncertainty for businesses borrowing via peer-to-peer platforms (and for the platforms themselves) by clarifying the circumstances in which those borrowers would be considered to be carrying on the regulated activity of accepting deposits

AUTOMATED INVESTMENT SERVICES

AUTOMATED INVESTMENT SERVICES

Regulatory response: FCA expectations

The FCA carried out reviews into firms offering automated online discretionary investment management and firms providing retail investment advice exclusively through automated channels focused on suitability assessments and service disclosures.

“While this is an evolving market, **our rules on suitability of advice apply regardless of the medium through which the service is offered.** Assessment of suitability is the firm’s responsibility and our rules and principles apply equally to emerging automated offerings.”

DIGITAL CURRENCIES AND THE ICO

CRYPTOCURRENCIES

Regulatory response: cryptocurrency derivatives

- Virtual currencies are not currently under FCA jurisdiction provided they are not part of other products or services regulated by the FCA
- Cryptocurrency derivatives are capable of being “**financial instruments**” under MiFID II, including futures, contracts for difference and options that reference cryptocurrencies or tokens
- The FCA does not consider cryptocurrencies to be currencies or commodities for MiFID II regulatory purposes
- Firms conducting regulated activities in cryptocurrency derivatives must comply with all applicable rules in the FCA Handbook and directly applicable EU regulations
- It is likely that **dealing in, arranging transactions in, advising on or providing** other services that amount to regulated activities in relation to derivatives that reference either cryptocurrencies or tokens issued through an ICO, will require authorisation by the FCA

FCA statement on the requirement for firms offering cryptocurrency derivatives to be authorised 6
April 2018



Cryptocurrencies use cryptography to secure and verify transactions and to control the creation of new units

CRYPTOCURRENCIES

Regulatory response: cryptocurrency derivatives

- Online platforms offering cryptocurrency derivatives are within the scope of MiFID II and must be authorised and comply with conduct of business rules and the EMIR trade reporting obligation
- Cryptocurrency derivatives are prohibited from being **advertised for offer via electronic means** under French law which applies to certain financial instruments
- AMF's legal analysis: on the one hand, to determine the legal qualification of the notion of "derivative" in the context of cryptocurrency derivatives and on the other, to consider whether a cryptocurrency could be legally regarded as an eligible underlying
- The notion of "derivative" is not defined in EU legislation per se. Under the MiFID framework, there is only a list of derivatives, followed by a list of eligible underlyings
- The AMF concludes that a cash-settled cryptocurrency contract may qualify as a derivative, irrespective of the legal qualification of a cryptocurrency

AMF statement on the requirement for firms offering cryptocurrency derivatives to be authorised

22 Feb 2018

VIRTUAL CURRENCIES

Regulatory response: virtual currencies

Under German legislation:

- VCs are financial instruments
- VCs are not legal tender or e-money

The term VCs is used to describe all virtual, digital, alternative or cryptocurrencies, e.g. Bitcoin, Litecoin, Ripple

AUTHORISATION REQUIRED	NO AUTHORISATION
<ul style="list-style-type: none"> • Buying and selling VCs in own name for the account of others – principal broking 	<ul style="list-style-type: none"> • Using VCs instead of cash when engaging in everyday exchange transactions
<ul style="list-style-type: none"> • Operating a multilateral trading facility (MTF) 	<ul style="list-style-type: none"> • Mining VCs if no issue or placement of the VCs • Mining is the transaction processing, recording, and security for most digital currencies and also the way in which new coins are created
<ul style="list-style-type: none"> • Trading on own account – currency exchanges that offer to exchange legal tenders against VCs or VCs against legal tender 	<ul style="list-style-type: none"> • Sale and acquisition of VCs

VIRTUAL CURRENCIES

Regulatory response: what about AML, KYC and CTF?

- EU 5th Money Laundering Directive, adopted in May 2018, extends the scope of the EU's AML/CTF framework to include:
 - Exchange services between VCs and fiat currencies (traditional currency associated with a Central Bank)
 - Custodian wallet providers
- Financial Intelligence Units (in the U.K., the National Crime Agency) will be able to request access to information on all VCs, regardless of whether one of the above service providers are involved
- Aims to enable national regulators to monitor the use of VCs for money laundering and CTF purposes
- Recognition by the EU authorities that the measures will not address the issue of anonymity of VCs because the above service providers are not necessary for users to be able to transact
 - European Commission will be assessing whether a central database registering VC users' identities and wallet addresses accessible to FIUs should be established, including using self-declaration forms for VC users



VIRTUAL CURRENCIES

Regulatory response: what about AML, KYC and CTF?

Key Definitions in the Fifth Money Laundering Directive

Virtual Currency

“a digital representation of value that is not issued or guaranteed by a central bank or a public authority, is not necessarily attached to a legally established currency and does not possess a legal status of currency or money, but is accepted by natural or legal persons as a means of exchange and which can be transferred, stored and traded electronically”

Custodian Wallet Provider

“an entity that provides services to safeguard private cryptographic keys on behalf of its customers, to hold, store and transfer virtual currencies”

ICO - MARKET PRACTICE AND STATISTICS

- More than **\$2.5 billion** has been raised in token sales in 2017, compared to less than \$240 million for all of 2016
- For funding blockchain companies, token sales have outpaced traditional VC in 2017
- Tokens are offered in exchange for fiat currency or other tokens (typically Bitcoin or ether)
- Tokens are often pre-sold privately to select investors prior to the public offering or ICO
- Issuers may also use SAFTs and/or convertible promissory notes that are convertible into preferred stock of the issuer and/or tokens upon the Token Generation Event or Token Sale
 - SAFT (Simple Agreement for Future Tokens) is an investment contract that funds development of a network by selling a right to acquire tokens to be used on the network
- Tokens also often issued as compensation to service providers and employees



ICOS - THRESHOLD QUESTIONS TO CONSIDER

REGULATORY	CONTRACTING AND COMPLIANCE
<ul style="list-style-type: none">• What is the purpose of the token? Why would someone buy or hold it?• What is this token ... “security,” “commodity,” “currency,” “property”, a hybrid of more than one of these?• What is this platform ... “exchange,” “money transmitter”?• What is this intermediary ... “broker,” “money transmitter,” “investment adviser,” “commodity trading adviser”?• What is this project ... an “issuer,” “investment company,” “commodity pool”?• NOTE: Answers may vary to each of these questions across jurisdictions	<ul style="list-style-type: none">• Who is being compensated in connection with the token offering, why and how?• How does the token intersect with its existing ownership, contractual covenants, and representations (e.g., limitations on new equity, debt or business lines)?• What about existing D&O / E&O insurance coverage, will it extend to the new business?• How will AML/KYC considerations be handled?• How will cyber and other security considerations be addressed?

ICO - UTILITY TOKENS

- Application-specific tokens (appcoins, utility tokens, etc.) can have characteristics different from “securities” or “currency”
- An application-specific token has non-incidental utility intrinsic to the platform or ecosystem issuing or hosting the token
- A widely cited October 2017 whitepaper (“The SAFT Project: Toward a Compliant Token Sales Framework”) describes a series of utility examples, including rights to:
 - access, use, license, customize or program the system
 - buy or sell products on or through the system (e.g., “coupons”)
 - participate in the administration or governance of the system (e.g., “membership”)



ICO - SECURITY TOKENS

- Traditional securities of all kinds (debt, equity, convertibles, warrants, notes) are being moved by some issuers to blockchain distributed ledgers
- What is more common – and more complicated – is that developers are building application-specific tokens that, in addition to non-incident utility, also have features similar to equity, debt and other investment contracts, which cause them to be treated as securities
- For example, application-specific tokens may:
 - Be redeemed for a portion of net revenues in a given year at designated times
 - Give a pro rata portion of a percentage of revenues from contracts entered into on the platform to holders
 - Be coupon-bearing
 - Provide the holder with a right to participate in additional investment opportunities



ICO - EXISTING REGULATORY APPROACH



- There is no EU harmonised regulatory framework governing ICOs
- Whether an ICO falls within the regulatory perimeter is determined on a case-by-case basis

ICO TOKEN CATEGORY	DESCRIPTION	POSSIBLE APPLICABLE REGULATION
Security (or Asset) Token	Token represent assets (debt or equity claim on the issuer)	<ul style="list-style-type: none">• EU Prospectus Directive• MiFID II• EU Market Abuse Regulation (depending on trading venue used)
Payment Token	Token is intended to function as a means of payment and can already be transferred	<ul style="list-style-type: none">• AML / CTF rules• Payment Services Directive• E-Money Directive
Utility Token	Token's sole purpose is to confer digital access rights to an application or service	

ICO - REGULATORY PERIMETER ISSUES

“Firms involved in ICOs must give careful consideration as to whether their activities constitute regulated activities. If their activities constitute a regulated activity, firms have to comply with the relevant legislation and any failure to comply with the applicable rules would constitute a breach.”

“Depending on how they are structured, ICOs may fall outside of the scope of the existing rules and hence outside of the regulated space. However, where the coins or tokens qualify as financial instruments it is likely that the firms involved in ICOs conduct regulated investment activities, such as placing, dealing in or advising on financial instruments or managing or marketing collective investment schemes. Moreover, they may be involved in offering transferable securities to the public.”



“Some ICOs feature parallels with Initial Public Offerings (IPOs), private placement of securities, crowdfunding or even collective investment schemes. Some tokens may also constitute transferable securities and therefore may fall within the prospectus regime.

Businesses involved in an ICO should carefully consider if their activities could mean they are arranging, dealing or advising on regulated financial investments. Each promoter needs to consider whether their activities amount to regulated activities under the relevant law. In addition, digital currency exchanges that facilitate the exchange of certain tokens should consider if they need to be authorised by the FCA to be able to deliver their services.”

ICO - REGULATORY PERIMETER ISSUES



Is a token a financial instrument?

- If the token is a financial instrument under MiFID II, then the processes of creating, distributing or trading the token may involve MiFID activities or services, e.g., placing, dealing in or advising on regulated financial instruments
- This could trigger an authorisation requirement, depending on exemptions
 - In practice, the exemptions from dealing on own account for non-market makers or the ancillary services exemption will almost always apply to the issuer
- MiFID-authorized firms must comply with organisation requirements, conduct of business rules, transparency rules and other MiFID II rules, e.g., the product governance rules, could be relevant
- MiFID-authorized firms also fall into the EU AML rules and will need to carry out customer due diligence checks
- The proposed EU prudential regime for investment firms may lead to lighter regulatory obligations, depending on the size and activities of the firm

ICO - REGULATORY PERIMETER ISSUES

Financial instrument

- Transferable securities
- Units in collective investment undertakings
- Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, emission allowances or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash
- Options, futures, swaps, forwards and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event
- Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market, a MTF, or an OTF, except for wholesale energy products traded on an OTF that must be physically settled
- Derivative instruments for the transfer of credit risk
- Financial contracts for differences
- Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in point 6 of this Section and not being for commercial purposes, which have the characteristics of other derivative financial instruments
- Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of default or other termination event, as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market, OTF, or an MTF
- Emission allowances consisting of any units recognised for compliance with the requirements of an Emissions Trading Scheme

ICO - REGULATORY PERIMETER ISSUES



Is a token a transferable security?

If a token is a transferable security, an approved prospectus must be prepared before the offer to the public or the admission to trading of such securities on a regulated market situated or operating in the EU, unless exclusions or exemptions apply

The EU Prospectus Directive and incoming Prospectus Regulation define securities by reference to the MiFID II definition of transferable securities (excluding money market instruments with a maturity of less than 12 months)

Transferable securities

“those classes of securities which are negotiable on the capital market, with the exception of instruments of payment, such as: (a) shares in companies and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares; (b) bonds or other forms of securitised debt, including depositary receipts in respect of such securities; and (c) any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures”

ICO - REGULATORY PERIMETER ISSUES

Is a token part of an alternative investment fund or UCITS?



An ICO could qualify as an AIF if it is used to raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy.

If the ICO is an AIF, the firm responsible for managing or marketing the fund may need to be authorised under AIFMD, including capital requirements, operational and organisational rules and transparency requirements.

It seems unlikely that an ICO would qualify as a UCITS but would an ICO be able to invest in an ICO?

Alternative Investment Fund

“collective investment undertakings, including investment compartments thereof, which raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors”

UCITS

“an undertaking: (a) with the sole object of collective investment in transferable securities or in other liquid financial assets referred to in Article 50(1) of capital raised from the public and which operate on the principle of risk-spreading; and (b) with units which are, at the request of holders, repurchased or redeemed, directly or indirectly, out of those undertakings’ assets”

ICO - REGULATORY PERIMETER ISSUES



Is a trading platform a “trading venue”?

Where trading of the tokens is undertaken, there is the potential for the trading platform to fall within the scope of MiFID II if it meets the criteria of a regulated market, MTF or OTF

Regulated market

“a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments – in the system and in accordance with its non-discretionary rules – in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorised and functions regularly and in accordance with Title III of this Directive”

MTF

“a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with Title II of this Directive”

OTF

“a multilateral system which is not a regulated market or an MTF and in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system in a way that results in a contract in accordance with Title II of this Directive”

ICO - REGULATORY RESPONSE

AMF proposals to introduce a new ICO framework

- Following a recent consultation the AMF has decided to develop a specific legal framework for ICOs
- The AMF had presented 3 possible regulatory actions
 1. Introduce best practice guide without changing existing legislation
 2. Extend the scope of existing EU legislation to treat ICOs as public offerings of securities
 3. Propose new legislation adapted to ICOs
- Outcome of the consultation - what will the new framework likely look like?
 - Information document necessary to inform buyers of tokens of minimum information on the project related to the ICO and its advancement, rights conferred by the tokens, accounting treatment of funds raised during the ICO, identification of legal entity responsible for the offer, its managers and founders and their competences
 - Information document to be approved by the AMF
 - Rules ensuring the escrow of funds raised and on AML/CTF

LEGAL ISSUES

LEGAL ISSUES

Conceptual issues relating to DLT/Blockchain

- Decentralised blockchain systems
 - What is the legal status of these systems? What form of business type would they fall into? If no legal personality, how will they contract with third parties?
 - Liability: do blockchain operators have unlimited liability where no business entity has been formed?
 - Ownership: can a contribution of cryptocurrency be deemed to be an ownership stake in the same way as shares?
- Litigation and dispute resolution
 - Jurisdiction: which laws apply and which forum should be used to resolve disputes related to a decentralized network spread across multiple jurisdictions?
 - How can blockchain-enabled assets be recovered if stolen (are they even “property” capable of being “owned”)?

LEGAL ISSUES

Conceptual issues relating to DLT/Blockchain

- “Permissionless” (public) blockchains have no central administering authority to decide disputes
- Identifying a person or entity to hold responsible for e.g. operational defects, corrupted messages or defective code
- “Breach of contract” requires a legally binding contract
- A contract evidenced only electronically on a distributed ledger may be difficult to prove existence or content in court
- Enforcement of a court judgment or arbitration award of a transaction using DLT or blockchain may be difficult, e.g. it may be impossible to unwind a transaction (even if desired by the direct parties) without a quorum of all participants

LEGAL ISSUES

Governing law – Rome 1

- Rome 1 provides for the governing law of contractual obligations where there is a conflict of laws and stipulates the governing law for certain types of contracts as well as where there is an absence of choice of law
- However, it is based on legal concepts that do not cater for some of the FinTech products or which would be difficult to apply in their current formulations - e.g. “habitual residence”, “financial instrument” and “characteristic performance”
- Rome 1 states that where there is an absence of choice, the governing law of “a contract concluded within a multilateral system which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments, as defined [in MiFID II] in accordance with non-discretionary rules and governed by a single law” will be *the law that governs that system*
- Where Rome 1 does not specifically set the governing law, the contract will be “governed by the law of the country where the party required to effect the *characteristic performance* of the contract has his habitual residence”
- Where it is clear from all the circumstances of the case that the contract is manifestly more closely connected with a country other than that indicated through the characteristic performance test or stipulated for the specific contract type, the law of that other country shall apply
- Where the law cannot be determined according to the above rules, the contract shall be governed by the law of the country with which it is most closely connected

LEGAL ISSUES

Governing law – Rome 1

For contracts between a consumer and a “professional”, the contract is governed by the law of the country where the consumer has his *habitual residence*, provided that the professional:

- pursues his commercial or professional activities in the country where the consumer has his habitual residence, or
- by any means, directs such activities to that country or to several countries including that country

and the contract falls within the scope of such activities

BUT the above consumer provisions do not apply to, among other specific contract types:

- Rights and obligations which constitute a financial instrument and rights and obligations constituting the terms and conditions governing the issuance or offer to the public and public take-over bids of transferable securities, and the subscription and redemption of UCITS in so far as these activities do not constitute provision of a financial service; and
- A contract concluded within a multilateral system as defined in MiFID II

LEGAL ISSUES

Recognition and enforceability under EU law

- Some of enforceability problems may be assisted by the EU Regulation on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters
- However, the extent of its assistance will depend on:
 - The circumstances of the case in question;
 - The interpretation of the relevant court; and
 - Where the relevant parties are located – it is less helpful in a non-EU cross-border situation

Jurisdiction

- If the parties agree to a court having jurisdiction to settle disputes, that agreement overrides the other provisions
- The agreement must be either:
 - “evidenced in writing” - any communication by electronic means which provides a durable record of the agreement
 - “in a form which accords with practices which the parties have established between themselves” – which arguably includes any coding in a blockchain system
 - “in a form which accords with a usage of which the parties are or ought to have been aware and which in [the particular] trade or commerce is widely known to, and regularly observed by, parties to contracts of the type involved in the particular trade or commerce concerned”

LEGAL ISSUES

Recognition and enforceability under EU law

Jurisdiction (cont.)

- Without an agreement on jurisdiction, the ability to pinpoint the applicable jurisdiction in a cross-jurisdiction blockchain environment becomes more complex
- Under the EU Regulation, a person domiciled in a member state may be sued in that particular member state
- Where a defendant is not domiciled in a member state, where applicable, the national laws of the relevant member state are used to determine jurisdiction
- However, these provisions will only work if a person or entity can be identified - and if the other person to an agreement cannot be identified, there is unlikely to be a legally binding contract which is enforceable in law

Recognition and enforceability

- If it is possible to get a judgment, then the EU Regulation provides that a judgement made in one member state is recognised and enforceable in another member state
- Outside of the EU, judgements will not be as easily recognised and enforced

GDPR

GDPR AND BLOCKCHAIN TECHNOLOGY



- It was reported that many tech companies have either pulled out of the EU or have shut down their sites to EU users due to the obligations imposed by GDPR
- For blockchain there is (again) no single approach given the variety of structures used and the variety of use cases
- The extent of the obligations will depend on the degree of personal data that a blockchain system processes, e.g. whether a data impact assessment is needed

Non-personal data, e.g. letters of credit, bills of lading

Non-specialised system that can be used to process any type of data

System designed to process personal data, e.g. proof of identification

GDPR AND BLOCKCHAIN TECHNOLOGY

Personal data



- **Personal data** is any information relating directly or indirectly to a living natural person which actually identifies the person or makes them identifiable

Examples of personal data

- **Public key (if visible)**
 - Every transaction on a blockchain is published and linked to a public key
 - Re-use of the public key may enable individuals to be “singled out” even though not identified
 - The possibility of identifying the individual exists because the information is held by the service provider or someone is able to connect the key to an individual, e.g. through their IP address – i.e. the data can be traced back to an individual
- **Encrypted data**
 - Data could be traced back to an individual through effort or if a decryption key is held by someone
- **Hashing**
 - Viewed as a pseudonymisation technique because it permits records to be linked
 - Full anonymisation required for data not to be traced back to an individual which means the data is processed to irreversibly prevent identification
 - Hashing allows verification/authentication in a blockchain system – data inputted into the system goes through an algorithm to create the hash, which is unique to that particular data
 - Whether the hash is personal data depends on whether the original document contains personal data
- **IP addresses**
 - This could result in all sorts of items being classed as personal data

GDPR AND BLOCKCHAIN TECHNOLOGY

Data controller and data processor

- In a blockchain system, it may be difficult to identify who the data controller is and who the processor is
- For decentralized systems with no central operator or administrator of the system and the system is operated by all users on a peer-to-peer basis, each user in the blockchain may be a data controller (uploads data onto the ledger) and a data processor (storing data – the user will have the entire ledger on his computer)
- More than one party may qualify as controller for a category of processing
- Challenge lies in developing governance arrangements to define the responsibilities of each participant

GDPR AND BLOCKCHAIN TECHNOLOGY

Applicable law and enforcement

Jurisdiction and applicable law

- For cross-border decentralised blockchains, with users (controllers and processors) around the globe, the applicable law would need to be analysed on a transaction-by-transaction basis
- The data protection law may not correspond to the contractual law

Enforcement

- GDPR has introduced heavy fines for non-compliance
- Enforcing the provisions to certain blockchains that are not owned or controlled by any individual person or firm will be challenging

GDPR AND BLOCKCHAIN TECHNOLOGY

Key definitions



Personal data

“any information relating to an identified or identifiable natural person (‘data subject’); an identifiable natural person is one who can be identified, directly or indirectly, in particular by reference to an identifier such as a name, an identification number, location data, an online identifier or to one or more factors specific to the physical, physiological, genetic, mental, economic, cultural or social identity of that natural person”

Controller

“means the natural or legal person, public authority, agency or other body which, alone or jointly with others, determines the purposes and means of the processing of personal data; where the purposes and means of such processing are determined by Union or Member State law, the controller or the specific criteria for its nomination may be provided for by Union or Member State law”

Processor

“means a natural or legal person, public authority, agency or other body which processes personal data on behalf of the controller”

GDPR AND BIG DATA

- Big data by its very nature may not be exact
 - GDPR requires that the accuracy of personal data in the possession of an organisation must be maintained and protected
- Big data is analysed and processed to reveal patterns and relationships
 - GDPR states that “the data subject shall have the right not to be subject to a decision based solely on automated processing, including profiling, which produces legal effects concerning him or her or similarly significantly affects him or her”
 - Exemptions exist: consent, authorised by law, necessary for performance of a contract
 - Profiling is “any form of automated processing of personal data consisting of the use of personal data to evaluate certain personal aspects relating to a natural person, in particular to analyse or predict aspects concerning that natural person’s performance at work, economic situation, health, personal preferences, interests, reliability, behaviour, location or movements”
- Big data may mean that data is processed for purposes other than for which it was collected
- Big data may involve processing of personal data in excess of what is needed in order to process it

PROPOSED EU DIGITAL SERVICES TAX

PROPOSED EU DIGITAL SERVICES TAX

Long-term comprehensive solution – first proposed directive



- Companies would be required to pay corporate income tax in each EU member state where they have a “significant digital presence”
- Would catch a multinational entity: (i) receiving more than EUR 7m in revenues in a member state; (ii) having more than 100,000 users in a member state; or (iii) creating more than 3,000 business contracts for digital services in a given tax year
- Proposes a "profit split" method which would require amendments to EU tax treaties with non-EU countries - some commentators have said it is unlikely the US would agree such amendments
- Reaction of Member States to the proposal
 - Welcomed by France, Germany, Italy and Spain
 - Ireland is opposed, among other member states, particularly smaller, lower-tax jurisdictions
 - The U.K., having initially welcomed the EU proposal and having explored a similar proposal of its own in its March 2018 *Corporate tax and the digital economy: position paper update*, has recently cooled on the idea and is calling for a global approach. This reflects faultlines within the OECD, as considered in the OECD’s March 2018 *Tax Challenges Arising from Digitalisation* paper

PROPOSED EU DIGITAL SERVICES TAX

Interim solution – second proposed directive

- Proposes a 3% revenue-based digital services tax on the provision of digital services where the main value is created through user participation
- Proposed threshold: firms with over EUR 750m worldwide turnover with EU revenues above EUR 50m from digital services
- Taxable services consist of:
 - Placing on a digital interface of advertising targeted at users of the interface, e.g. Facebook, Google, YouTube
 - The transmission of data collected about users which has been generated from users' activities on digital interfaces, e.g. Facebook and Google
 - “Intermediation services” consisting of the making available of multi-sided digital interfaces to users which allow users to find other users and interact with them and which may also facilitate the provision of underlying supplies of goods or services directly between users, e.g. Airbnb and Uber

F

M

L

C

PROPOSED EU DIGITAL SERVICES TAX

Interim solution – second proposed directive

- Exemptions from the DST include:
 - Communication or payment services
 - Supply by an EU trading venue or an EU systematic internaliser of any investment services and activities as defined in MiFID II
 - Supply by a regulated crowdfunding service provider (cf. Commission’s proposal to regulate these entities) of any investment services and activities as defined in MiFID II
 - The transmission of data by a trading venue, systematic internaliser or regulated crowdfunding service provider (under the Commission’s proposed ECP Regulation – see slide 6)
 - Provision of digital services intra-group
 - Video/audio streaming – e.g. Netflix and Spotify
 - E-commerce platforms – e.g. Amazon

PROPOSED EU DIGITAL SERVICES TAX

Interim solution – second proposed directive



Investment services and activities

- Reception and transmission of orders in relation to one or more financial instruments
- Execution of orders on behalf of clients
- Dealing on own account
- Portfolio management
- Investment advice
- Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis
- Operation of an MTF or OTF

PROPOSED EU DIGITAL SERVICES TAX



Interim solution – second proposed directive

- Wide scope of the “multilateral interface” concept may catch a variety of financial services:
 - Third country trading venues / dealers
 - Text only covers EU trading venues and firms acting as systematic internalisers
 - Some EU firms are members of third country trading venues or other securities and derivatives trading platforms which may be within the scope of the DST
 - Given the volumes traded on these platforms, the impact could be very significant
 - Other trading venues, such as betting exchanges and cryptocurrency exchanges
 - Order routing services:
 - Would an investment firm which routes client orders to trading venues, affiliates or third parties for execution be making available a multi-sided digital interface?
 - CCPs and other post-trade service providers - e.g. providers of portfolio compression services - they match "users" with each other
 - Peer-to-peer marketplaces of all kinds that are not regulated ECPs under the proposed ECP Regulation

THOUGHTS ON HOW TO APPROACH REGULATING FINTECH

THOUGHTS ON HOW TO APPROACH REGULATING FINTECH



1. Principles-based approach to regulation
 - Allows for innovation and growth
 - Focuses on achieving the right regulatory outcomes
 - Does not prescribe the minutiae of the rules and processes
 - Easily adaptable rules which protect investors, consumers and the financial markets
2. Neutral to technological change
 - Ensures fair competition
 - Eliminates barriers to new products and providers
 - Applies existing regulatory rules to new products and services
3. If any gaps are identified in regulation which cannot be filled by adapting existing rules, create a new legislative framework for licencing of new category of entities or activities
 - lighter touch regulation
 - First focusing on crypto custodians, dealers and trading venues

WHAT'S COMING UP?

WHAT'S COMING UP?

EU



- By Q4 2018, the Commission is to assess whether EU regulatory action is required on crypto-assets and ICOs
- By end 2018, EBA to report on authorisation and regulatory perimeter issues relating to FinTech firms, assessing the state of play across the EU, including on conduct of business requirements for FinTechs in relation to the impact on consumer protection. The EBA will recommend best practices and guidance, where appropriate, and potentially recommend EU-wide legislation to ensure a proportionate, technologically neutral and harmonised approach to licensing of FinTech firms and to enhance cross-border activities
- The EBA is expected to publish a series of thematic reports on FinTech's impact on incumbent business models and new prudential risks and opportunities for incumbent institutions – timing has not been clarified
- Outsourcing to cloud service providers
 - By Q2 2018, stakeholders to develop cross-sectoral self-regulatory codes of conduct to facilitate switching between cloud service providers
 - By Q1 2019, the European Supervisory Authorities to examine whether there is a need for new or additional guidelines
 - By Q2 2019, the Commission will encourage and facilitate the development of standard contractual clauses for cloud outsourcing by financial institutions

WHAT'S COMING UP?

EU



- ESMA will assess whether stricter measures are required for CFDs with a cryptocurrency as an underlying. It is instigating the use of its product intervention powers under MiFID II for CFDs, including imposing an EU-wide leverage limit on the opening of a CFD by a retail client to 2:1 where the CFD has a cryptocurrency as the underlying
 - The U.K. FCA supports ESMA's use of its powers and expects to consult on whether these measures should apply on a permanent basis in the U.K.
- The EC is expected to consult on the digitization of regulated information about companies listed on EU regulated markets, including the possible implementation of a European Financial Transparency Gateway based on DLT
- BY Q1 2019, the European Commission will report on best practices for regulatory sandboxes due to a concern about preventing the fragmentation of standards across EU

WHAT'S COMING UP?

UK



- In Summer 2018, the U.K. Government Cryptoassets Task Force, consisting of HM Treasury, the Bank of England and the FCA, to publish its report on the risks virtual assets may pose to the financial system, the potential benefits of the underlying DLT and potential regulatory measures
- The Digital Currency Treasury Committee enquiry will report on its findings
- In 2018, the FCA will consult on revisions to its crowdfunding rules, originally introduced in 2014 – the FCA regulates loan-based crowdfunding and investment-based crowdfunding as well as the payment services provided in donation-based and pre-payment/rewards based crowdfunding
- Blueprint for a global sandbox (initiated by the U.K. FCA)
- Several projects in progress to lower compliance costs:
 - Machine readable Rules
 - Machine executable reporting
 - Shared platforms, potentially for: collateral management, fraud management, loans processing, trade finance, RegTech, identity management, and transaction monitoring
- By end 2019, the Fintech Delivery Panel to develop final industry standards on what financial services firms will need from FinTechs before entering into partnership arrangements – sponsored by Barclays, Lloyds Banking Group, HSBC, RBS and Santander, which have committed to implementing them
- U.K. regulators are also considering the treatment of cloud service providers, particularly, whether a failure by one of the largest preferred providers might cause systemic risk in the financial sector
- The U.K. Information Commission Office (responsible for GDPR implementation) is also reported to be considering setting up a sandbox

AI and Machine Learning in Financial Services



Joanna Perkins, Financial Markets Law Committee

Registered Charity Number: 1164902.

"The FMLC" and "The Financial Markets Law Committee" are terms used to describe a committee appointed by Financial Markets Law Committee, a limited company ("FMLC" or "the Company"). Registered office: 8 Lothbury, London, EC2R 7HH. Registered in England and Wales. Company Registration Number: 8733443.

AI—introduction

- At the heart of AI lies “machine learning” – the capacity for machines to learn and take independent decisions.
- This evolution in technical ability impliedly raises questions about intention and causation because machines can develop independent behaviours.
- This can lead to some very unpredictable outcomes (i.e. the Google Brain neural net, tasked with keeping its communications private, independently developed its own encryption algorithm).
- “Real world” applications of AI include: 3D environment processing for driverless vehicles; text analysis for a user-friendly internet experience; speech analysis (e.g. Siri or Alexa); Data mining for customer targeting; virtual environment processing for videogames.
- In the financial markets, any application which benefits from the use of algorithms for improved speed and efficiency will be able to derive advantage from AI which, improves the speed and efficiency of “meta decision-making” (i.e. making decisions about making decisions).

AI—some use-cases in finance

- Credit scoring
- Insurance risk assessment and pricing (InsureTech)
- Client-facing chat bots
- Capital optimisation
- Organisational risk management and stress-testing
- Market impact analysis
- Trading execution
- Portfolio management
- Regulatory compliance (RegTech)
- Supervision (SupTech)
- Fraud detection
- Data quality assurance

AI—legal issues

- Given that most civil breaches of duty and criminal offences can only be established if some element of **causation**, **fault**, **intention** and/or **foreseeability** is present, A.I. is likely to pose new challenges for claimants and prosecutors looking to establish their case.
- These issues become more complex with AI powered devices because machines can take independent decisions. It becomes harder to attribute either cause or fault to a human being.
- AI systems “learn” from themselves. Their behaviours are increasingly less directly attributable to human initiation or intervention.
- Consider the example of driverless cars, which are programmed to look after their occupants and the safety of pedestrians. The car may have to make a choice between saving a pedestrian and saving the occupants of the vehicle. It may learn to judge the least worst outcome based on its own complex processing history and it may independently decide to act on the basis of this judgment. Is the developer responsible and, indeed, liable for the final result?
- Some commentators have recommended mandatory registers to measure and record machine sophistication. These registers could be used to evidence situations in which it is foreseeable by the developer that some unintended harm may result, even if it is not clear ahead of time what that harm may be and on whom the machine may cause it to fall. Legal doctrine would need to adapt to permit the imposition of liability on the developer in these circumstances and the adaptation would not be uncontroversial.

AI—future regulation

- In November 2017, the Financial Stability Board published an influential paper on *Artificial intelligence and machine learning in financial services: Market developments and financial stability implications*.
- The FSB’s research suggested that fraud detection, capital optimisation and portfolio management were all activities likely to utilise machine learning at the present time as part of efforts to improve credit and risk assessment in particular.
- The paper concluded that the lack of “interpretability” or “auditability” of AI—which prevents the regulator understanding and predicting how human decisions are, or will be, responsible for market outcomes—could increase risk within the financial system. It identified the main areas of non-compliance risk as being data privacy, conduct risks and cybersecurity.
- The FSB did not propose any areas for standard-setting or regulation. Instead it called for monitoring and period reassessment of the risks.

Conclusion / The End



Financial Markets Law Committee

contact@fmlc.org

+44 (0)20 7601 5118



**Legal issues related with ICOs – an
initial contribution.**

**URÍA MENÉNDEZ
PROENÇA DE CARVALHO**

Pedro Ferreira Malaquias

Quadrilateral meeting of the FMLC / FMLG / FLB / EFMLG
Frankfurt, 8 June 2018

Agenda.

1. ICOs – the concept.
2. What is a token?
3. Some legal issues related with ICOs.

ICOs – the concept

What is an ICO?

- ICOs may take many forms and, as such, are hard to define.
- “*An initial coin offering (ICO), also known as a token sale, token generating event, or initial token offering, is an event in which an organization sells digital tokens for the purpose of obtaining public capital to fund software development, business operations, business development, community management, or other initiatives*”(Stellar Development Foundation and The Luxembourg House of Financial Technology).
- The structure of an ICO is based on the offer of digital tokens or coins utilizing blockchain technology.

ICOs – the concept

Blockchain

A blockchain, originally block chain, is a continuously growing list of records, called blocks, which are linked and secured using cryptography. Each block typically contains a cryptographic hash of the previous block, a timestamp, and transaction data. By design, a blockchain is resistant to modification of the data. It is "an open, distributed ledger that can record transactions between two parties efficiently and in a verifiable and permanent way". For use as a distributed ledger, a blockchain is typically managed by a peer-to-peer network collectively adhering to a protocol for inter-node communication and validating new blocks. Once recorded, the data in any given block cannot be altered retroactively without alteration of all subsequent blocks, which requires collusion of the network majority.

(Wikipedia)

ICOs – the concept

- **I**nitial – perhaps...
- **C**oin – really?
- **O**ffering - true

ICOs – the concept

All-Time Cumulative ICO Funding



	2014	2015	2016	2017	2018
ICO Size (\$mn)	30	9	256	5 482	7 056
Average	4	1	6	16	26
Median	2	1	1	8	14
Max	18	5	152	262	850
Min	0	0	0	0	0
Std. Dev.	7	2	23	28	77
Number of ICOs	7	7	43	343	271

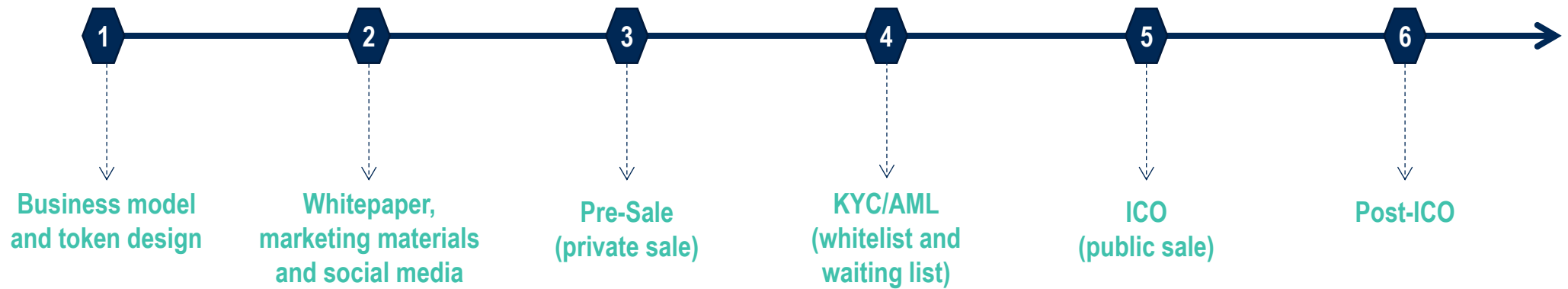
Top Ten ICOs of 2018

Position	Project	Total Raised
1	Telegram ICO (Pre-sale 1 & 2)	\$1,700,000,000
2	Petro (Private Pre-Sale)	\$735,000,000
3	Dragon	\$320,000,000
4	Huobi token	\$300,000,000
5	Bankera	\$150,949,194
6	Basis	\$133,000,000
7	Envion	\$100,000,000
8	Elastos	\$94,100,000
9	Flashmoni	\$72,000,000
10	Neuromation	\$71,669,400

Source: Coindesk.

ICOs – the concept

Usual main stages of an ICO.

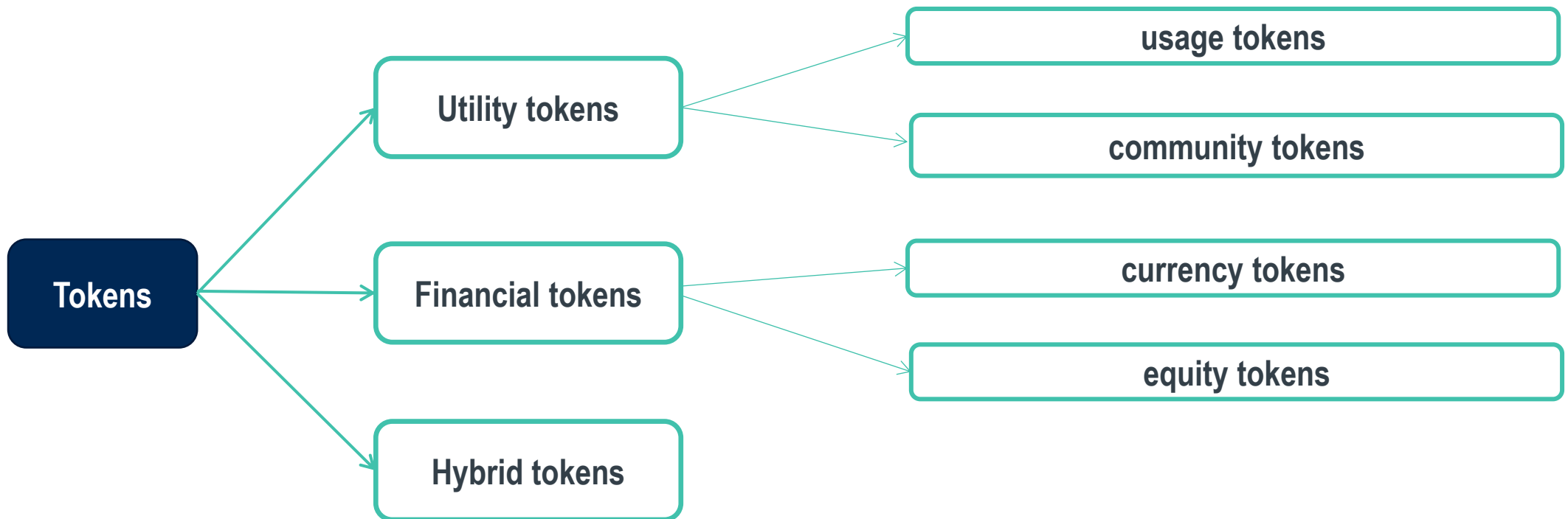


Agenda.

1. ICOs – the concept.
2. What is a token?
3. Some legal issues related with ICOs.

What is a token?

- A token is a cryptographically secured digital representation of a certain factual and legal situation. A token exhibits the characteristics of a digital voucher and grants the participants a right of some kind. The particular right represented by the token varies.



Agenda.

1. ICOs – the concept.
2. What is a token?
3. Some legal issues related with ICOs.

Some legal issues related with ICOs: overview.

- Commitment to the public and liability
- Consumer protection
- Crowdfunding
- Financial laws and regulations

Some legal issues related with ICOs: financial laws and regulations in particular.

- Financial laws and regulations in particular:

Securities

AML/CFT

Derivatives

Payment Services

Portfolio Management

Others

Some legal issues related with ICOs: approaches followed worldwide.

- Countries where ICOs have been banned.
- Countries where ICOs may or may not be subject to a specific legal framework already in force (e.g. public offerings).
- Countries where ICOs are subject to a legal framework specifically designed to ICOs.

URÍA MENÉNDEZ

PROENÇA DE CARVALHO



www.uria.com

BARCELONA · BILBAO · LISBOA · MADRID · PORTO · VALENCIA · BRUXELLES · FRANKFURT · LONDON · NEW YORK · BOGOTÁ · BUENOS AIRES · CIUDAD DE MÉXICO · LIMA · SANTIAGO DE CHILE · SÃO PAULO · BEIJING

Some legal issues relating to the implementation of anti-money laundering policies at banking group level

Presentation to EFMLG

Asmaa CHEIKH

Director

LEGAL DEPARTMENT – FINANCIAL AND BANKING REGULATIONS

7 & 8 JUNE 2018

I. INTRODUCTION

II. RELATED ISSUES FOR DISCUSSION

- A. Group-wide policies for sharing information for AML/CFT purposes (art. 8 and 45 of the 4th AMLD)
- B. Legal impediments to exchange of information and additional measures to manage ML/TF risk effectively (art.45 (5) 4th AMLD) at group level
- C. Type of additional measures and minimum actions (art. 45 (6) and final report by the ESAs on measures to mitigate ML/TF risk where a third country law does not allow the application of group-wide policies and procedures)



III. Q&A

I. Introduction

Regulatory Context

- On 26 June 2015, Directive (EU) 2015/849 named 4th AMLD on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing entered into force. The 4th AMLD recasts the existing 3rd Anti-Money Laundering Directive (EU) 2005/60/EU and the Corresponding Implementing Directive (Commission Directive 2006/70/EC)
- This Directive aims, *inter alia*, to bring European Union legislation in line with the International Standards adopted by the Financial Action Task Force (FATF) on 16 February 2012
- EU Members States had to implemented the 4th AMLD by 26 June 2017 into national law. In France, the Directive has been implemented by ordonnance No. 2016-1635 of 1 December 2016 reinforcing the French anti-money laundering and terrorist financing system from title VI French monetary and financial code
- On the 6th December 2017, the European Supervisory Authorities (ESAs) published a final report on a draft RTS related to the measures credit and financial institutions shall take to mitigate the risk of money laundering and terrorist financing where a third country law does not permit the application of group-wide policies and procedures

II. RELATED ISSUES FOR DISCUSSION

A. Group-wide policies for sharing information for AML/CFT purposes (art. 8 and 45 of the 4th AMLD)

Key provisions

- Article 8 of Directive (EU) 2015/849 requires obliged entities to put in place AML/CFT policies and procedures to mitigate and manage effectively the ML/TF risks to which they are exposed. These policies and procedures have to cover specific procedures on the intra-group exchange of information
- These policies may include model risk management practices, customer due diligence, suspicious transactions reporting, record-keeping, internal control etc.
- Article 45 Directive (EU) 2015/849 requires obliged entities that are part of a group to ensure that group-wide AML/CFT policies and procedures are implemented effectively and consistently at group level, (ie. across all branches and majority- owned subsidiaries) to the extent that local law permits it

* Article 45 further provides that where obliged entities have branches and subsidiaries located in third countries where the minimum requirements are less strict than those of the EU, their branches and subsidiaries implement the EU requirements

II. RELATED ISSUES FOR DISCUSSION

B. Legal impediments to exchange of information and additional measures to manage ML/TF risk effectively (art.45 (5) 4th AMLD) at group level

Key provisions

- Article 45 (5) provides that where third country laws do not permit that AML/CFT policies and procedures are effectively implemented (eg. the sharing of customer – specific information within the group conflicts with local data protection or banking secrecy requirements), obliged entities must take **additional measures** to handle the subsequent ML/TF risk and inform the relevant authorities
- If the additional measures are not sufficient, the relevant authorities shall exercise additional supervisory actions including requiring that the group terminates business relationships and where necessary requesting the group to close down its operations in the third country
- The ESAs produced final RTS specifying the type of additional measures and the minimum actions to be taken by credit and financial institutions to mitigate the risk of money laundering and terrorist financing where a third country law does not permit the application of group-wide policies and procedures (art, 45(6) 4th AMLD)

II. RELATED ISSUES FOR DISCUSSION

C. Type of additional measures and minimum actions (final report by the ESAs on measures to mitigate ML/TF risk where a third country law does not allow the application of group-wide policies and procedures)

RTS

- Final RTS: consistent and harmonized approach to manage the ML/TF risk to which credit or financial institutions are exposed as a result of their operations in third countries in case of local legal impediments to the implementation of group-wide AML/CFT policies
- Minimum actions and additional measures (art. 9 RTS)
- Compliance issues (eg, art. 9 (h) and (g) RTS)
- The approach should be proportionate

Q&A





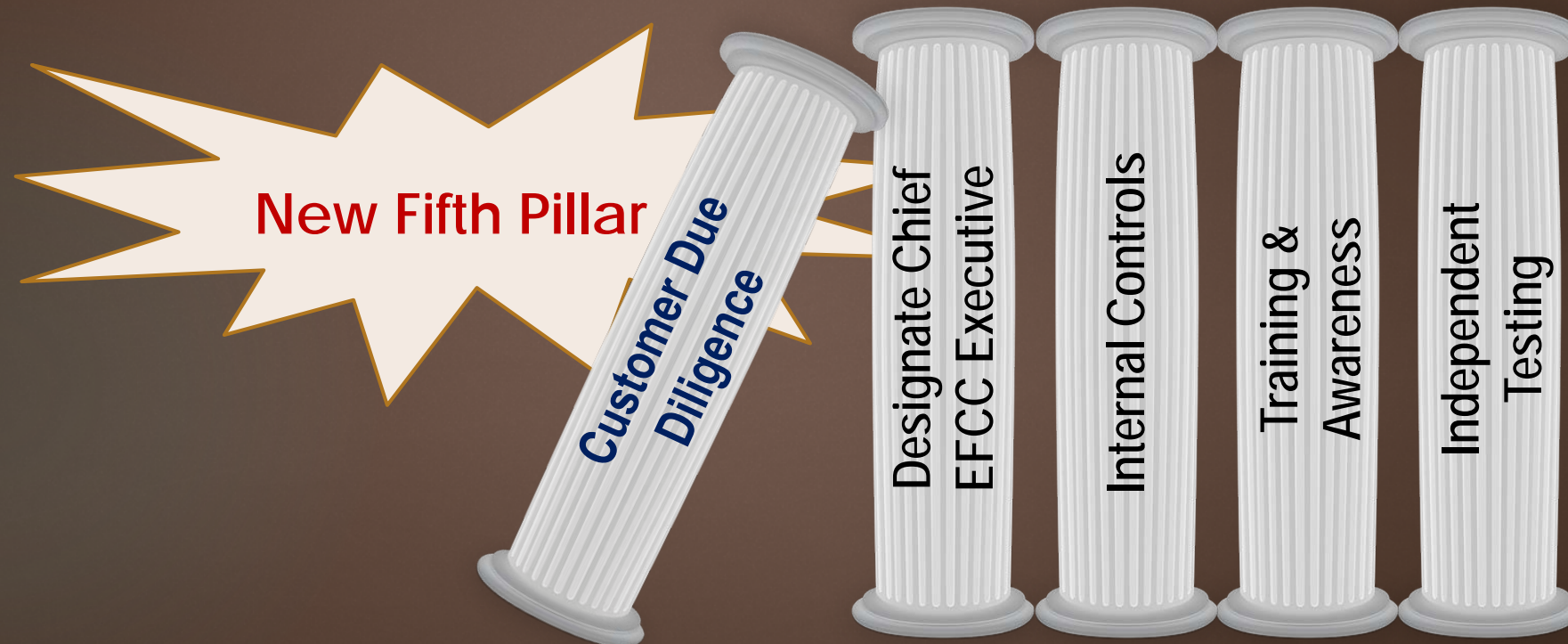
New Fifth Pillar: Customer Due Diligence (Beneficial Ownership)

June 8, 2018

I. History, Purpose and Overview

New Fifth Pillar: Customer Due Diligence

- ▶ In 2016, The Financial Crimes Enforcement Network (FinCEN), a bureau of the U.S. Department of the Treasury issued the Customer Due Diligence (CDD) Final Rule
 - ▶ The Rule adds a 5th pillar to Anti-Money Laundering (AML) Program requirements: the CDD pillar
 - ▶ The Rule became effective May 11, 2018



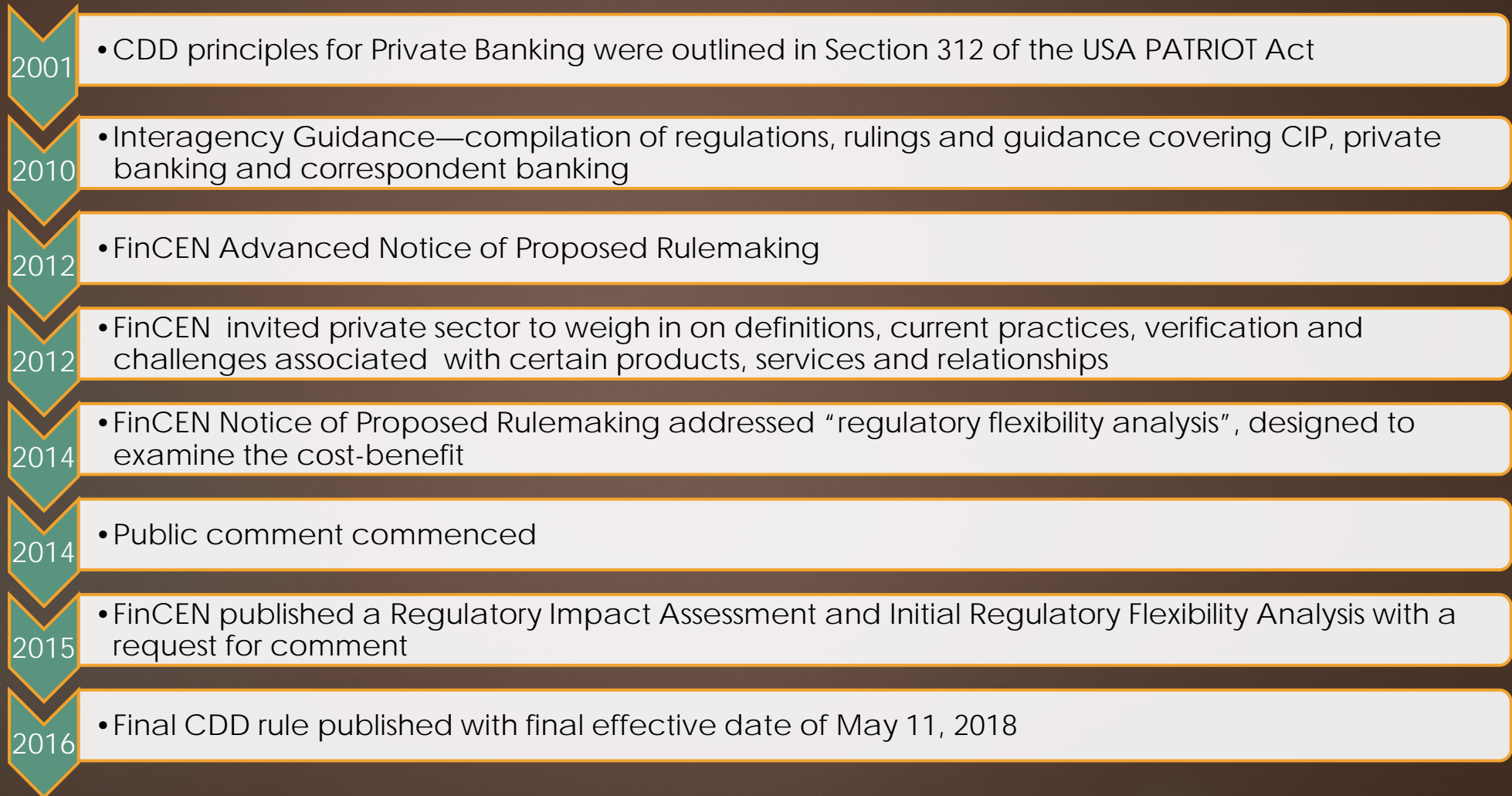
Purpose

The CDD Rule is intended to help Financial Institutions avoid illicit transactions by improving understanding of the potential risks each customer presents.

According to FinCEN, clarifying and enhancing CDD requirements will advance the purposes of the BSA in six ways:

1. Assisting investigations by law enforcement;
2. Advancing counter-terrorism and broader national security interests;
3. Improving a financial institution's ability to assess and mitigate risk;
4. Facilitating tax compliance;
5. Promoting clear and consistent expectations and practices; and
6. Advancing the Department of the Treasury's broad strategy to enhance financial transparency of legal entities.

The Path Towards a Final CDD Rule



4 Key Elements of Customer Due Diligence

I. Customer Identification and Verification



Current CIP

II. Beneficial ownership identification and verification



NEW! 31 CFR 1010.230

Appropriate risk-based procedures for conducting ongoing customer due diligence, to include, but not be limited to:

III. Understanding the nature and purpose of customer relationships to develop a customer risk profile; and

IV. Conducting ongoing monitoring to identify and report suspicious transactions and, on a risk-basis, to maintain and update customer information



Amends BSA to add "5th Pillar" but viewed as restating existing expectations
[31 CFR 1020.210]

II. Requirements

Overview of Beneficial Ownership Requirement

- ▶ Must identify and verify the identity of beneficial owners of all legal entity customers (other than those excluded) for each new account at the time a new account is opened (other than accounts that are exempted)
- ▶ Beneficial Ownership has two mutually exclusive prongs: control and ownership
- ▶ Compliance is achieved by obtaining certification in the form of FinCen Appendix A or the equivalent information with certification of the accuracy of the information
- ▶ May rely on beneficial ownership supplied by the customer, provided Financial Institution has no knowledge of facts that would reasonably call into question the reliability of the information
- ▶ Verification of identity of the beneficial owners should contain the elements required for verification under CIP, but FIs may rely on copies of IDs provided by the person opening the account
- ▶ Updates to beneficial ownership should be event-driven as part of normal monitoring, not as a categorical requirement on a continuous or periodic basis. Applies to all legal entity customers, including existing customers.

Who is the Beneficial Owner?

Under the final rule, FIs are required to verify the identity of UBOs of each legal entity customer at the time a new account is opened. The final rule employs a two-pronged approach to define beneficial ownership of legal entity customers: (1) ownership prong AND (2) control prong.

1. Ownership Prong

- To satisfy the ownership prong, the rule requires covered FIs to identify an UBO that “directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, owns 25% or more of the equity interests of a legal entity customer.”
- FinCEN “does not expect financial institutions or customers to undertake analyses to determine whether an individual is a beneficial owner under the definition”
- In its rule summary, FinCEN commented that covered FIs are generally able to rely upon ownership information provided by the customer, and are not required to affirmatively investigate if equity holders are attempting to evade the reporting threshold, so long as the FI has “no knowledge of facts that would reasonably call into question the reliability of the information.
- If no one meets the 25% ownership level, can be completed as “N/A”

2. Control Prong

- Identify “[a] single individual with significant responsibility to control, manage, or direct a legal entity customer.”
- The rule provides examples of corporate roles that generally satisfy the control prong, including the Chief Executive Officer, Chief Financial Officer, and Treasurer of a legal entity. FinCEN acknowledged that legal entities vary in structure and organization in its 2016 Frequently Asked Questions, stating more broadly that any “high level official in the legal entity, who is responsible for how the organization is run, and who will have access o a range of information concerning the day-to-day operations of the company” would ultimately satisfy the control prong.
- Must identify at least one controlling party for each legal entity customer at the time a new account is opened, but have the discretion to identify more as appropriate based on risk.

Even if no one meets the 25% ownership level, you must still identify a control person.

Obtaining and Verifying the Information

Information identifying beneficial owners may be obtained either from an individual seeking to open a new account on behalf of a legal entity customer (whether or not that individual is a beneficial owner within the above definitions), or from another CFI that has collected the information, so long as the reliance is reasonable, the other CFI is also subject to compliance with the New Regulations and regulated by a federal functional regulator, and the CFIs have entered into a contract setting forth certain required terms.

Certification Form: FinCEN has provided a standard "[Certification Form](#)." CFIs may, but are not required to, use this form to comply with the New Regulations. This Certification Form includes spaces to collect the name, date of birth, address, and social security number (or, for foreign individuals, passport number) of each applicable beneficial owner.

FinCen FAQ Question 4: Identification and Verification: Methods

Q. What means of identity verification are sufficient to reliably confirm beneficial ownership under the CDD Rule?

A. Covered financial institutions must verify the identity of each beneficial owner according to risk-based procedures that contain, at a minimum, the same elements financial institutions are required to use to verify the identity of individual customers under applicable Customer Identification Program (“CIP”) requirements. This includes the requirement to address situations in which the financial institution cannot form a reasonable belief that it knows the true identity of the legal entity customer’s beneficial owners. Under the CIP rules, a financial institution’s CIP must include procedures for responding to circumstances in which the financial institution cannot form a reasonable belief that it knows the true identity of a customer. These procedures should describe: (1) when the institution should not open an account; (2) the terms under which a customer may use an account while the institution attempts to verify the customer’s identity; (3) when it should close an account, after attempts to verify a customer’s identity have failed; and (4) when it should file a Suspicious Activity Report in accordance with applicable laws and regulations.

Although the CDD Rule’s beneficial ownership verification procedures must contain the same elements as existing CIP procedures, they are not required to be identical to them.

For example, a covered financial institution’s policies and procedures may state that the institution will accept photocopies of a driver’s license from the legal entity customer to verify the beneficial owner(s)’ identity if the beneficial owner is not present, which is not permissible in the CIP rules. (See Question 6.)

A financial institution’s CIP must contain procedures for verifying customer identification, including describing when the institution will use documentary, non-documentary, or a combination of both methods for identity verification. Covered financial institutions may use the same methods to verify the identity of the beneficial owner of a legal entity customer. In addition, in contrast to the CIP rule, the CDD Rule expressly authorizes covered financial institutions to use photocopies or other reproduction documents for documentary verification. Documentary verification may include unexpired government-issued identification evidencing nationality or residence and bearing a photograph or similar safeguard, such as a driver’s license or passport.

Non-documentary methods of verification may include contacting a beneficial owner; independently verifying the beneficial owner’s identity through the comparison of information provided by the legal entity customer (or the beneficial owner, as appropriate) with information obtained from other sources; checking references with other financial institutions; and obtaining a financial statement.

Financial institutions should conduct their own risk-based analysis to determine the appropriate method(s) of verification and the appropriate documents or types of photocopies or reproductions to accept in order to comply with the beneficial owner verification requirement.

Additional required procedures include:

- maintaining and updating customer information, and conducting ongoing monitoring to identify suspicious activities.
 - During the course of such ongoing monitoring, covered financial institutions must update beneficial ownership information if new information relevant to the customer risk profile is detected.



III. Scope: What is a “Legal Entity Customer”

What is “Legal Entity Customer”?

14

- Corporation
- Limited Liability Company
- Similar entity created by the filing of a public document with a Secretary of State or similar office, or formed under the laws of a foreign jurisdiction
- This includes limited partnerships, business trusts created by a filing with a state office, and general partnerships

Exempt Legal Entity Customers:

15

- **A FI regulated by a federal functional regulator or a bank regulated by a State bank regulator;**
- A person described in 31 CFR § 1020.315(b)(2) through (5);
- An issuer of a class of securities registered under section 12 of the Securities Exchange Act of 1934 or that is required to file reports under section 15(d) of that Act;
- **An investment company, as defined in section 3 of the Investment Company Act of 1940, that is registered with the Securities and Exchange Commission under that Act;**
- **An investment adviser, as defined in section 202(a) (11) of the Investment Advisers Act of 1940, that is registered with the Securities and Exchange Commission under that Act;**
- **An exchange or clearing agency, as defined in section 3 of the Securities Exchange Act of 1934, that is registered under section 6 or 17A of that Act;**
- **Any other entity registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934;**
- A registered entity, commodity pool operator, commodity trading advisor, retail foreign exchange dealer, swap dealer, or major swap participant, each as defined in section 1a of the Commodity Exchange Act, that is registered with the Commodity Futures Trading Commission;
- A public accounting firm registered under section 102 of the Sarbanes-Oxley Act;
- A bank holding company, as defined in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841) or savings and loan holding company, as defined in section 10(n) of the Home Owners' Loan Act (12 U.S.C. 1467a(n));
- A pooled investment vehicle that is operated or advised by a FI excluded under paragraph (e)(2) of this section;
- **An insurance company that is regulated by a State; and**
- A financial market utility designated by the Financial Stability Oversight Council under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.
- **A foreign FI established in a jurisdiction where the regulator of such institution maintains beneficial ownership information regarding such institution;**
- A non-U.S. governmental department, agency or political subdivision that engages only in governmental rather than commercial activities; and
- Any legal entity only to the extent that it opens a private banking account subject to 31 CFR § 1010.620.
- Trusts; however, statutory trusts created by filing with the Secretary of State, or similar office, do fall under the definition of a legal entity customer, and thus the CDD Rule applies.

Entities Excluded from Ownership Prong

- A pooled investment vehicle that is operated or advised by a FI that is not excluded from the definition of legal entity customer.
- Any legal entity that is established as a nonprofit corporation and has filed its organizational documents with the appropriate State authority as necessary.
 - Such entities include charitable, nonprofit, not-for-profit, nonstock, public benefit or similar corporations.

FinCen FAQ Question 24: Definition of Legal Entity Customer: Publicly Traded Companies and Entities Listed on Foreign Exchange

Q. Are companies publicly traded in the United States and entities listed on foreign exchanges excluded from the definition of legal entity customer and, therefore, excluded by the Rule?

A. Companies traded publicly in the United States are excluded from the definition of legal entity customer. Specifically, the Rule excludes from the definition of legal entity customer certain entities that are considered “exempt persons” under 31 CFR 1020.315(b). This includes any company (other than a bank) whose common stock or analogous equity interests are listed on the New York Stock Exchange, the American Stock Exchange (currently known as NYSE American), or NASDAQ stock exchange.

The Rule also excludes a U.S. entity when at least 51 percent of its common stock or analogous equity interest is held by a listed entity.

These U.S. companies are excluded from the Rule because they are subject to public disclosure and reporting requirements that provide information similar to what would otherwise be collected under the Rule. Companies listed on foreign exchanges are not excluded from the definition of legal entity customer. Such companies may not be subject to the same or similar public disclosure and reporting requirements as companies publicly traded in the United States and, therefore, collecting beneficial ownership information for them is required.

FinCen FAQ Question 25: Collection of beneficial ownership information: Legal entities listed on foreign exchanges

Q. May covered financial institutions take a risk-based approach for collecting beneficial ownership information from legal entity customers listed on foreign exchanges?

A. No. Financial institutions may not take a “risk-based approach” to collecting the required beneficial ownership information from legal entity customers that are listed on foreign exchanges, because such institutions are not excluded from the definition of legal entity customer. However, as they may with regard to other legal entity customers, whether listed or not, covered institutions may rely on the public disclosures of such entities, absent any reason to believe such information is inaccurate or not up-to-date.

FinCen FAQ Question 26: Foreign FI

19

Question 26: Foreign financial institutions. Does the exclusion for foreign financial institutions from the Rule's definition of "legal entity customer" depend on whether the beneficial ownership requirements applied by such institution's foreign regulator match U.S. requirements?

A. No. For purposes of beneficial ownership identification, the Rule excludes from the definition of "legal entity customer" a foreign financial institution created in a non-U.S. jurisdiction when the foreign regulator for that financial institution collects and maintains information on the beneficial owner(s) of the regulated institution.

The rule does not require covered financial institutions to research the specific transparency requirements imposed on a foreign financial institution by its regulator and compare them with those imposed on U.S. financial institutions by U.S. Federal functional regulators. However, if the foreign regulator does not collect and maintain beneficial ownership information on the foreign financial institution it regulates, then U.S. financial institutions will have to collect and maintain beneficial ownership information on accounts opened by foreign financial institutions in compliance with the Rule. As with any exclusion, covered financial institutions may rely on the representations of its legal entity customer as to whether an exclusion applies, provided that they have no knowledge of facts that would reasonably call into question the reliability of such representation. (See Question 21.)

For purposes of existing customer due diligence requirements, covered financial institutions that maintain correspondent accounts for foreign financial institutions are already required to establish and maintain specific risk-based due diligence procedures and controls for such accounts that include consideration of all relevant factors, and are required to identify beneficial ownership for certain high-risk foreign banks. These correspondent accounts will continue to be subject to these existing requirements rather than the requirements set forth in the AML Program requirements contained in the Rule.

FinCen FAQ Question 21: Verification of claims of exclusion from the definition of “legal entity customer”

Q. What methods should covered financial institutions use to verify eligibility for exclusion from the definition of a “legal entity customer”?

A. Several types of legal entity customers are excluded from the collection and verification requirements of the Rule, under section 1010.230(e)(2), because, for example, their regulators require the reporting of beneficial ownership information or such information is publicly available. A financial institution may rely on information provided by the legal entity customer to determine whether the legal entity is excluded from the definition of a legal entity customer, provided that it has no knowledge of facts that would reasonably call into question the reliability of such information. Whether a financial institution has such knowledge would depend on the facts and circumstances at the time an account is opened. Covered financial institutions must establish and maintain written risk-based procedures reasonably designed to identify and verify the identity of the beneficial owners of all legal entity customers at the time a new account is opened, unless the customer is otherwise excluded from the definition of legal entity customer. Covered financial institutions are expected to address and specify, in their risk-based written policies and procedures, the type of information they will obtain and reasonably rely upon to determine eligibility for exclusions.

IV. Scope: What is an "account"

What is an Account (and what isn't) under the regulation

1) Account means a formal banking relationship established to provide or engage in services, dealings, or other financial transactions including a deposit account, a transaction or asset account, a credit account, or other extension of credit. Account also includes a relationship established to provide a safety deposit box or other safekeeping services, or cash management, custodian, and trust services.

(2) Account does not include:

- (i) A product or service where a formal banking relationship is not established with a person, such as check-cashing, wire transfer, or sale of a check or money order;
- (ii) An account that the bank acquires through an acquisition, merger, purchase of assets, or assumption of liabilities; or
- (iii) An account opened for the purpose of participating in an employee benefit plan established under the Employee Retirement Income Security Act of 1974.

FinCen FAQ Question 10: Identification and Verification: Certification when a single legal entity opens multiple accounts

Q. If a legal entity customer opens multiple accounts at a covered financial institution (whether or not simultaneously), must the financial institution identify and verify the customer's beneficial ownership for each account?

A. Generally, covered financial institutions must identify and verify the legal entity customer's beneficial ownership information for each new account opening, regardless of the number of accounts opened or over a specific period of time. However, an institution that has already obtained a Certification Form (or its equivalent) for the beneficial owner(s) of the legal entity customer may rely on that information to fulfill the beneficial ownership requirement for subsequent accounts, provided the customer certifies or confirms (verbally or in writing) that such information is up-to-date and accurate at the time each subsequent account is opened and the financial institution has no knowledge of facts that would reasonably call into question the reliability of such information. The institution would also need to maintain a record of such certification or confirmation, including for both verbal and written confirmations by the customer.