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## **Corporate Governance in the Aftermath of the Global Financial Crisis: Issues and Action**

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### **ABSTRACT**

Almost a decade has passed since the global financial crisis emerged; a crisis that has made companies, regulators and society more conscious of the possible failings in regulation, board function and shareholder behaviour. This paper discusses three interrelated corporate governance weaknesses linked to a financial crisis, and considers ways to reduce their impact in future. The first part discusses the role of regulatory and supervisory deficiencies as a primary cause of the crisis. It provides a concise overview of the flaws of the UK regulatory authority, and examines the reasons it fell short of the high professional standards in the execution of its supervisory obligations. Ways to improve the regulatory and supervisory authorities are also considered. In the next part, the paper examines the role played by the two primary internal organs of the company: the directors and the shareholders. It considers issues of directors' training, accountability and shareholder engagement and deliberates upon the improvements that can be introduced to enhance the role of directors and shareholders within the corporate governance arena.

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## I. INTRODUCTION

In the economic crisis of 2008 three issues stand out. To start with, there were deficiencies in the system of bank supervision by the regulatory authorities. Also, there was poor corporate governance within large institutions; boards of directors appeared to tolerate perverse incentives and seemed unable to comprehend and manage risk. Finally, shareholders appeared unwilling to exercise any governance rights; the majority behaved like “absentee landlords” failing to act when their institutions were heading for breakdown. All in all, the external and internal instruments used to pursue financial stability have greatly disappointed: this, sadly, is the one clear conclusion that can be reached approximately a decade since the emergence of the economic catastrophe of 2008.

Let us start with the first issue: supervisory, regulatory and enforcement authorities hold a central role in ensuring sound corporate governance and in enhancing confidence in the financial markets. Yet, restoring confidence in the market is a complicated affair; certainly, improving the supervisory and regulatory regime in itself without considering the two internal participants in corporate governance, is an inadequate response. Therefore, when reflecting more deeply upon the nature of the financial crisis two matters call for adjustment: change to the external supervision and regulation of large institutions and change to the internal corporate culture of the financial system. Conceptually, the correct approach lies in a strong regulatory regime able to scrutinize the strategies of financial institutions with scepticism, and capable of intervening effectively if and when the need arises. Still, in thinking of the 2008 crisis, although not the first of its kind regulators and supervisors appeared to have learnt few lessons from previous experiences. The Financial Services Authority, the former regulatory

authority in the UK, has been heavily criticised for failing to meet the required standards of watchfulness and direction in the execution of its supervisory duties.<sup>2</sup> Its procedures in supervising large financial institutions were generally insufficient and it systematically failed in its duties as regulator of the financial industry. Therefore, the first part of the paper provides a concise overview of the failings and flaws of the regulatory authority. It examines the reasons it fell short of the high professional standards in the execution of its supervisory approach. It also considers ways to improve the supervisory authority, particularly ways of reinforcing its integrity and resources. Then, this part examines the powers granted to the Financial Conduct Authority under the Financial Services Market Act 2000, which have not so far, been deployed properly. The proper use of the FMSA rules will benefit not only a firm's shareholders but also the broader economy; therefore a number of suggestions are put forward. The regulatory authority should periodically carry out a review of the current qualifications of senior directors in financial institutions, and should ensure that the existing approved person regime requirements are adequate.<sup>3</sup> It should exercise the power to approve the appointment of bank directors routinely and must also see that directors possess the required skills, knowledge and training to understand the financial implications of their institutions. Under resourcing is another vital issue deliberated here, primarily the inadequate supervisory staff resources.<sup>4</sup> Connected to this is the question of the supervisors'

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<sup>2</sup> The FSA's responsibilities have now been transferred to two new bodies, the 'Prudential Regulation Authority' and the 'Financial Conduct Authority'.

<sup>3</sup> A conclusion supported by the House of Commons Treasury Committee: House of Commons Treasury Committee, "Banking Crisis", *Oral Evidence*, April 2009, Vol. 1, House of Commons, London, The Stationery Office Limited, 34.

<sup>4</sup> According to the FSA's review of Northern Rock, "*we cannot provide assurance that the prevailing framework for assessing risk was appropriately applied in relation to Northern Rock, so that the supervisory strategy was in line with the firms risk profile.*": FSA Internal Audit Division Report, *The Supervision of Northern Rock: a*

remuneration, as well as the possible adoption of more aggressive rules regarding capital requirements.

While it is recognised that there is a need for fundamental change in the regulatory supervision, it is equally important to consider the incentives and behaviours of the internal controllers on the one hand, and owners of large institutions on the other. The analysis of the internal participants in corporate governance is carried out on two levels. First, the paper examines the directors' failure to understand the strategies and products adopted by their institutions. This is a particularly worrying matter, especially in considering the supervisory role attached to boards of directors. If board members do not have the knowledge or skills to challenge other key company participants (such as the chief executive officers) significant difficulties arise. The paper proceeds to examine two interconnected issues linked to this particular inadequacy. First, it considers the question of directors' training and qualifications, as well as the question of their accountability. It is suggested that there should be a requirement for directors to possess a minimum level of training and qualifications akin to that required of other professionals. This is followed by the question of their disqualification, a strong measure should they fail to display the required degree of understanding and skill. The field of disqualification needs to be reviewed and a number of cases should be targeted that would involve the possibility of disqualifying directors of institutions that would have failed had it not been for the last-minute financial support by the government.

The last part of the paper considers whether shareholders could ever act as effective guardians. The idea that shareholders should play an important role in the governance of

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*Lessons Learnt Review*, 2008, available at [http://www.fsa.gov.uk/pubs/other/nr\\_report.pdf](http://www.fsa.gov.uk/pubs/other/nr_report.pdf) [accessed 10 June 2016].

public institutions is not novel;<sup>5</sup> yet still, possibly due to the failure of alternative solutions to solve the “agency problem” this notion has received considerable attention in recent years. This renewed interest is also due to the introduction of the UK Stewardship Code, which requires institutional investors to engage with and challenge management more than before. The Code promotes a strong investment ideology; however, the paper suggests that due to a plethora of reasons its ambition cannot realistically materialise; by and large, it introduces a quasi-regulatory framework whilst making few substantive changes. Although the question of investor engagement is not new, the circumstances are new, and possibly not as advantageous as previously. Therefore, given the significant issues with shareholder stewardship, one ought to be careful before casually increasing the powers of shareholders to interfere.

## **II. THE ROLE OF THE EXTERNAL SUPERVISORS IN CORPORATE GOVERNANCE**

### **A. The Discipline of the Market**

The problems with the 2008 financial crisis began following the heavy losses by major financial institutions as a result of their involvement in asset-backed securitization. In reviewing the main reasons for the failure in the US, two under-recognized causes were identified. First, the excessive reliance on credit rating agencies which became increasingly subject to client pressure as competition increased in this market. Second a shift toward more self-regulatory rules which allowed investment banks to increase leverage and reduce

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<sup>5</sup> DJ Baum and NB Stiles, *The Silent Partners: Institutional Investors and Corporate Control* (Syracuse University Press, 1965).

diversification under the pressure of competition.<sup>6</sup>

During the 1990's the UK Government was committed to the idea of self-regulation and minimal government interference. Although in the same decade there was a succession of reports initiated by industry (such as Cadbury Report, 1992; Greenbury Committee Report, 1995; Hampel Committee, 1998) aimed at improving corporate governance practices,<sup>7</sup> to a large extent these were initiated because of fear that government may interfere and impose higher requirements.<sup>8</sup> But industry had no reason to worry. The Government was determined not to interfere and was committed to maintaining a neo-liberal agenda. Rigorous regulation was opposed by market theorists on the grounds that the market already imposes a certain discipline which is sufficient to safeguard an acceptable level of competence and efficiency. The potential consequences of legal regulation in addition to those already provided by the markets were not viewed as desirable or necessary; instead, they were seen as a distortion of managerial behaviour.<sup>9</sup> All in all, there was a powerful faith in the merits of the market economy.

For a generation or more, the public was told, not least by the City, that the disciplines of the

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<sup>6</sup> JC Coffee, 'What Went Wrong? An Initial Inquiry into the Causes of the 2008 Financial Crisis' [2009] *Journal of Corporate Law Studies* 1.

<sup>7</sup> Cadbury Report, *Report of the Committee on the Financial Aspects of Corporate Governance: The Code of Best Practice*, London, Gee Professional Publishing, 1992; Greenbury Committee Report, *Report on Directors' Remuneration*, London, Gee Professional Publishing, 1995; Hampel Committee, *Committee on Corporate Governance Final Report*, London, The Committee on Corporate Governance and Gee Publishing Ltd, 1998;

<sup>8</sup> R Tomasic, 'Raising Corporate Governance Standards in Response to Corporate Rescue and Insolvency' [2009] 2 *Corporate Rescue and Insolvency* 5, 7.

<sup>9</sup> JE Parkinson, *Corporate Power and Responsibility* (Clarendon Press, 1993); DM Phillips, 'Principles of Corporate Governance: A Critique of Part IV' [1984] 52 *George Washington Law Review* 653.

market economy were essential for greater prosperity in the longer term, even if harsh and painful in the short run.<sup>10</sup> Numerous market mechanisms were identified by economists as providing institutions such as banks with the incentive to perform well. Firstly, managers need to perform well in order to keep their jobs. Although normally the board decides whether an internal reorganisation of management is called upon, it is not uncommon for shareholders or creditors to apply pressure if it is believed that the apparent failings are the fault of certain individual managers. Secondly, the underperforming company could become the target of a takeover. In such cases the predator benefits by securing control of the poorly performed company at a price that is above the market price the shares held prior to the bid but below the price at which they would trade if the target company was properly managed. Thirdly, managers are motivated to perform well in order to reduce the costs incurred by the company in its attempt to raise capital from the markets. Fourthly, compensation packages, such as shares, share options, stock options and cash bonuses linked to company performance, can be employed for the purpose of reducing the divergence between the interests of the shareholders and managers. Through the policy of compensation, managers have a personal interest in the company performing well. This, in turn, can help align the interests of shareholders and managers.<sup>11</sup>

There is a lot to be said in favour of market discipline. Legal rules come with substantial costs such as wasteful research and excessive documentation of decision-making that may actually prove unnecessary and costly. Those who oppose mandatory legal rules argue that legal

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<sup>10</sup> M King, 'Speech at the Lord Mayor's Banquet for Bankers and Merchants of the City of London' Mansion House, 17 June 2009 1-9, available at <http://www.bankofengland.co.uk/publications/Documents/speeches/2009/speech394.pdf> [accessed 16 June 2014], 8.

<sup>11</sup> E Ferran, *Company Law and Corporate Finance* (Oxford University Press, 1999), 118-120.



constraints merely supplement the parties' private bargain and the operation of market forces, and that parties should be free to decide whether or not to dispense with certain general laws deemed unnecessary to their bargain.<sup>12</sup> However, as noted by Ferran this assessment and the downplaying of the importance of general legal rules assumes that market forces operate effectively and with acceptable results. Both assumptions can be questioned. For example, studies indicate that there are many criteria that may influence a predator in a takeover situation; under-performance is not the sole criteria. Equally, the effectiveness of incentive schemes based on a firm's remuneration policies is impossible to assess. For instance, compensation packages were a major contributing factor to the excessive risk-taking by financial institutions. Executives were rewarded for risky behaviour, and by protecting them from the adverse consequences of that behaviour, pay arrangements for financial-sector bosses produced perverse incentives, encouraging them to gamble and take unnecessary risks on their firm's behalf. As noted, one important factor that actually provoked excessive risk-taking were the standard pay packages that rewarded directors for short-term gains, even when those gains are subsequently reversed. Even with more than half of the share-market value of the financial sector being wasted during the past five - seven years, "[...] executives were still able to cash out, prior to the stock market implosion, large amounts of equity compensation and bonus compensation."<sup>13</sup> Through these pay structures, directors were given the incentive to pursue short-term gains, and that is even when this meant enhancing the possibility of a subsequent implosion.<sup>14</sup> Similarly, stock options were identified as potentially having a negative effect on firms, particularly in those instances where managers would

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<sup>12</sup> E Ferran, *Company Law and Corporate Finance* (Oxford University Press, 1999), 120.

<sup>13</sup> L Bebchuck, 'Let the good times roll again', 15 July 2009, available at <http://www.project-syndicate.org/commentary/let-the-good-times-roll-again-> [accessed 15 May 2016].

<sup>14</sup> L Bebchuck, 'Let the good times roll again', 15 July 2009, available at <http://www.project-syndicate.org/commentary/let-the-good-times-roll-again-> [accessed 15 May 2016].

refrain from raising concerns about strategy because of possible adverse consequences on the share price and value of the options.<sup>15</sup>

## **B. The Evolution and Failings of the UK Regulatory Regime**

The idea that government should not interfere in the operation of the market has all too often been pushed to extremes. In fact, in thinking about the latest financial crisis, it could be said that it is not the discipline of the market that failed. Rather, the regulatory system has failed to react adequately and appropriately to the obvious signs that serious financial problems were steadily heading towards the UK and global economies. Had there been proper and effective supervision of the major institutions the crisis would not have reached such massive and catastrophic dimensions, that saw the UK government rescuing a number of banking institutions, such as Royal Bank of Scotland, Lloyds, Bradford and Bingley and Northern Rock.<sup>16</sup> This, at a substantial cost to the UK taxpayer. This scenario is not a novel. Despite the commitment to the idea of non-interference in the markets, the UK regulatory system has traditionally failed to act proactively; this lack of interference is seen in a series of financial failures in the 1990's, including the Bank of England's supervision of the Bank of Credit and Commerce International (BCCI) that collapsed in 1991. In fact, the closure of BCCI provoked widespread public concern, with some, especially in the financial community, heavily criticizing the UK authorities for not taking action earlier.<sup>17</sup> The Bingham inquiry, set up to examine the poor supervision of BCCI, criticised the Bank of England for its supervisory

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<sup>15</sup> E Ferran, *Company Law and Corporate Finance* (Oxford University Press, 1999), 122.

<sup>16</sup> R Tomasic, 'Raising Corporate Governance Standards in Response to Corporate Rescue and Insolvency' [2009] 2 *Corporate Rescue and Insolvency* 5.

<sup>17</sup> The Bank owed more than 5 billion dollars, causing severe losses for 80,000 depositors including local authorities mainly in the UK.

failures, particularly for its inability to spot crucial and numerous warning signs early on.<sup>18</sup> Remarkably, the bank's collapse led to something unprecedented in British legal history: the liquidators of the bank instituted a substantial lawsuit of one billion dollars against the Bank of England as a regulatory body, thereby breaking new grounds by challenging the Bank's statutory immunity.<sup>19</sup> The charge the Bank of England faced was the charge of negligence amounting to misfeasance in public office. The liquidators made extensive allegations of wrongful conduct against the Bank of England and the Bank had to defend itself in the way it regulated and supervised the banking industry.<sup>20</sup>

The genesis of the Financial Services Authority (now Financial Conduct Authority) previously the single regulator for the financial services industry in the UK, derived from the

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<sup>18</sup> For example, in 1988 the Bank of England ignored warning about BCCI from City fraud squad. When the Bank of England became aware of BCCI's involvement in drug money laundering and the financing of terrorism, it increased its supervision of the bank. However it later transpired that this was insufficient. In 1990 the Bank of England was advised by the bank's accountants that there were numerous poor banking practices, substantial loan losses and evidence that fraudulent transactions were taking place.

<sup>19</sup> Due to the Bank's statutory immunity there was a nine-year battle before creditors were finally able to take the case to trial in 2004: Editorial, *The Observer*, 19 January 2000.

<sup>20</sup> Initially it considered bringing the action on the grounds of mere incompetence for failing to act despite years of warnings about the bank's affairs. However, that was not possible due to the Bank of England's immunity against this charge. The allegations concerned the decision to license BCCI in the UK as a deposit taker on the assurance of regulators based in Luxembourg where BCCI SA was incorporated, the failure to revoke this license on the realisation that the decision was wrong, and the failure to act appropriately in order to protect the interests of depositors in BCCI in the period until it closed down, despite the problems and irregularities becoming obvious: see J Gray, 'Lessons for BCCI Saga for the Current Accountability Debate surrounding Northern Rock' [2008] 23 *Journal of International Banking Law and Regulation* 37, 38. The case went to trial in the High Court in 2004 but was eventually dropped a year later as it was thought to be contrary to the interests of the creditors.

collapse of the BCCI. It was set up in 1997, taking over the Bank of England's supervisory role for banks.<sup>21</sup> It was established in order to bring together various distinct regulatory bodies in the light of certain regulatory failures that occurred in the 1990's, such as the collapse of BCCI and Barings Bank. Its past supervisory approach was viewed as "light touch"<sup>22</sup> and prior to the emergence of the 2008 economic crisis, it was based on three solid (and rather convincing) beliefs: that the markets are self correcting and that the discipline of the market is much more effective as a tool, than regulation or supervisory oversight; second, that the management of risk is the responsibility of senior management and boards of directors; this is because they are in a better position to assess business model risk than bank regulators; finally, that customer protection is best achieved by ensuring that wholesale markets are as

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<sup>21</sup> The FSA was set up under the Financial Services Act 1986 and the Banking Act 1987. Prior to it, supervision of UK banks was carried out by the Bank of England. Friendly societies, building societies and insurance companies were subject to prudential regulation created by specific legislation, and the investment industry was regulated by the Financial Services Act 1985. The Financial Services Authority took on its full powers in December 2001. In June 2010, George Osborne, the then Chancellor of the Exchequer, announced plans to break up the authority of the FSA, dividing its powers between the Bank of England and new agencies, including a consumer regulator. The changes took place in 2013. Now the responsibilities of the former FSA are transferred to two new bodies, the 'Prudential Regulation Authority' (PRA) and the 'Financial Conduct Authority' (FCA). The FCA regulates banks, building societies, insurers, independent financial advisers, mutual societies and investment managers as well as stockbrokers, and it is charged with the responsibility of ensuring conduct and markets regulation is firmer and more involved with consumers. It regulates conduct in retail and wholesale markets and its key strategic objective is the protection and enhancement of confidence in the UK financial system.

<sup>22</sup> The FSA, however, has never explicitly endorsed the "light touch" descriptor: A Turner, 'The Turner Review – A Regulatory Response to the Global Banking Crisis', *Financial Services Authority*, March 2009:

The Turner review referred to it as "[...] somewhat a caricature, and a term which the FSA never itself used".

creative and transparent as possible.<sup>23</sup>

This approach had many supporters. In contrast to the system of supervision adopted by the Bank of England, an informal regulatory approach based on confidence and trust, the FSA<sup>24</sup> was arguably better equipped to perform a supervisory function; its improved accountability mechanisms placed it in a stronger position to supervise and monitor large institutions. Still, the FSA was criticised for its ‘over’ focus on the supervision of individual institutions, a function undertaken quite sporadically and randomly. Its focus on wider sectoral and system-wide risks was insufficient and as a consequence the “[...] vital activity of macro-prudential analysis, and the definition and use of macro-prudential tools fell between two stools”.<sup>25</sup> The FSA ideological approach meant that the supervision of individual firms would be given priority at the great expense of the whole system’s regulation and supervision.<sup>26</sup> Moreover, rather than focusing on the issues presented by various complex business models and strategies, the FSA concentrated too much in ensuring that processes were precisely defined. These issues combined, supported by the then governing philosophy of utter confidence in self-correcting markets, meant that even where the FSA did meet high standards in the execution of its regulatory and supervisory approach, “[...] it was not with hindsight

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<sup>23</sup> A Turner, ‘The Turner Review – A Regulatory Response to the Global Banking Crisis’, *Financial Services Authority*, March 2009, 86.

<sup>24</sup> In other words the former FCA, i.e. the Financial Conduct Authority.

<sup>25</sup> A Turner, ‘The Turner Review – A Regulatory Response to the Global Banking Crisis’, *Financial Services Authority*, March 2009, 84.

<sup>26</sup> It should be noted that this focus was a common feature and in retrospect, a common failing of bank regulation and supervisory systems across the world. See A Turner, ‘The Turner Review – A Regulatory Response to the Global Banking Crisis’, *Financial Services Authority*, March 2009, 86.

aggressive enough in demanding adjustments to business models.”<sup>27</sup> This is so, even when an institution’s models were excessively risky.<sup>28</sup>

Although corporate failures are not a new phenomenon, regulators and supervisors appear to have learnt few lessons from previous experiences with regards to the safeguarding of the long-term prosperity of firms that are under their management and supervision. Nonetheless, the inadequacies of the regulatory system became too apparent to ignore with the occurrence of the first bank run in over 100 years, that of Northern Rock.<sup>29</sup> While its events might appear extreme, the case constitutes a common example of the continuous and various challenges faced by the banking regulators. The subsequent report examining the bank’s failure is therefore unique in its type. It is also of great importance to the consideration of failures within large institutions more generally: it identifies the key regulatory challenges for the first time ever since the events of 2008, and its evaluation can be applied more widely to a variety of institutions including those that have nearly failed, such as Royal Bank of Scotland, Bradford and Bingley, Lloyds.<sup>30</sup> In more detail, the Parliamentary Enquiry into the Northern Rock crisis was unsparring in its censure of the FSA and the Bank of England, reserving its firmest criticism towards the FSA in particular. The enquiry found that while the crisis of

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<sup>27</sup> A Turner, ‘The Turner Review – A Regulatory Response to the Global Banking Crisis’, *Financial Services Authority*, March 2009, 86.

<sup>28</sup> A Turner, ‘The Turner Review – A Regulatory Response to the Global Banking Crisis’, *Financial Services Authority*, March 2009, 86.

<sup>29</sup> The bank encountered significant funding difficulties in rolling over its short-term debt.

<sup>30</sup> It should be emphasised that there were other events pointing to the fundamental problems that existed within institutions. In fact, some of these other events were more catastrophic than those surrounding Northern Rock. There is some focus on Northern Rock (particularly on the subsequent report examining its near-failure) because of the stark reminder of the dangers of not supervising institutions properly or managing risk effectively.

Northern Rock was indeed a failure of its own board, it was also a failure of the regulators and the regulatory system more widely. The FSA did not assign sufficient resources or time to monitor a bank whose business model was so clearly an outlier, and the procedures it followed were simply insufficient to supervise a bank with such a rapid business growth. This malfunction contributed significantly to the subsequent catastrophic difficulties faced by the bank. The FSA should have been continuously concerned with the bank's liquidity, as the liquidity of such a 'high-impact' financial institution had the potential to adversely affect the wider financial sector; therefore, the FSA should not have allowed Northern Rock to weaken its balance sheet. It neglected its utmost duties, such as that of ensuring that the work of the board of Northern Rock was capable of performing its tasks, and in addition, it should not have allowed two individuals to be appointed to the position of chairman and chief executive because they both lacked any relevant financial qualifications.<sup>31</sup> By and large, the prevailing view of the enquiry was that the FSA fell short of high professional standards in the execution of its supervisory approach, and that it showed serious failures in the performance of its management discipline duties and procedures.<sup>32</sup> Its procedures as the main supervisory authority were inadequate to supervise large institutions, such as those banks whose business grew so rapidly. There was lack of proper direction and a general failure to allocate sufficient resources or time to monitoring institutions whose business models were clearly problematic. These failures played a major role in the financial catastrophe of 2008, and linked with the fact that its resources were insufficient, it systematically failed in its duty as a regulator to ensure institutions do not pose a systemic risk to the country's economy.<sup>33</sup>

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<sup>31</sup> House of Commons Treasury Committee, "The run on the Rock", *Fifth report of session 2007-08*, January 2008, Vol. I.

<sup>32</sup> A Turner, "The Turner Review – A Regulatory Response to the Global Banking Crisis", *Financial Services Authority*, March 2009, 86.

<sup>33</sup> House of Commons Treasury Committee, "The run on the Rock", *Fifth report of session 2007-08*, January

Indeed, the near-collapse of Northern Rock and other institutions such as Royal Bank of Scotland, Lloyds and Bradford and Bingley raised serious questions about the levels of banking supervision, especially the ability of the FSA and the Bank of England to adequately meet their principal duty of bank monitoring. In fact these weaknesses were acknowledged by the FSA itself: the regulator did accept that there were obvious warning signals about the risks associated with Northern Rock's business model, both with regards to its speedy growth and also in relation to the rapid drop in its share price. And yet, despite the signs, it did nothing to prevent the problems that came to the fore.<sup>34</sup> It is also crucial to note the conclusions reached by another post-crisis report conducted by Lord Turner; the report noted the 'pervasive influence of assumptions' about the City of London on the political dynamic of the UK. As a result of this widespread influence there was clear pressure on the FSA to go easy on the City of London. Interestingly, the FSA never used the phrase "light-touch"; rather, politicians did so in speeches directed at the FSA. Additionally, there was an expectation that the regulator would be an advocate for the City; the FSA was not expected to do anything that would harm the corporate sector. In the end its dual role as 'part regulator' – 'part sponsor spokesman for the industry' was risky and confusing, resulting in catastrophic outcomes for the whole of the UK economy.<sup>35</sup>

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2008, Vol. I, 34.

<sup>34</sup> House of Commons Treasury Committee, "The run on the Rock", *Fifth report of session 2007-08*, January 2008, Vol. I, 24.

<sup>35</sup> Additionally, as Turner explains, "[...] there is a major issue here about clarity of who is responsible. If you set up in London, as a branch of a European legal entity, then the single market rules are very clear that the local regulator has only limited control over what you do." A Turner, "The Turner Review – A Regulatory Response to the Global Banking Crisis", *Financial Services Authority*, March 2009.



### C. Improving the Effectiveness of the Regulatory Authority

Supervisory, regulatory and enforcement authorities are key in promoting and safeguarding sound corporate governance practices. As the OECD explains, such authorities must possess the ability, integrity and resources to fulfil their duties in a professional and objective manner.<sup>36</sup> It is therefore disappointing that serious omissions within the UK's banking supervision were identified since the emergence of the banking and financial crisis. The actions of bankers may have triggered the catastrophe but this is also misadventure on behalf of the supervisory system supposedly designed to protect the public from systemic risk. The FSA, an institution that should have comprised of experienced professionals, should not have failed so dramatically in its duties. No amount of supervision can absolutely protect the public against systematic risk but a failure of this magnitude can never be justified. What has become clear is that, as the relevant market becomes more competitive, the case for prudential regulatory supervision of financial institutions becomes more urgent too.<sup>37</sup>

Nonetheless, there are some ways to improve the effectiveness of the regulatory authority. To start with, the recent changes to the regulatory regime appear rather promising. The Financial Services Act of 2012 introduced a new, improved structure for regulating financial services in

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<sup>36</sup> Organisation for Economic Cooperation and Development (OECD), *Corporate Governance and the Financial Crisis – Conclusions and Emerging Good Practices to Enhance Implementation of the Principles*, 2010, available at <http://www.oecd.org/daf/corporateaffairs/corporategovernanceprinciples/44679170.pdf> [accessed 13 May 2016], 27. Principle I.D also states that “[...] rulings should be timely, transparent and fully explained.”

<sup>37</sup> There are also issues that are beyond the scope of this article, concerning the architecture and the co-ordination of supervision itself, at national level, at the EU level, and at the global level. See JC Coffee, ‘What Went Wrong? An Initial Inquiry into the Causes of the 2008 Financial Crisis’ [2009] *Journal of Corporate Law Studies* 1.

the UK: not long after the emergence of the 2008 crisis, the responsibilities of the former FSA have been transferred to two new bodies, the ‘Prudential Regulation Authority’ (PRA)<sup>38</sup> and the ‘Financial Conduct Authority’ (FCA), with the FCA regulating banks, building societies, insurers, independent financial advisers, mutual societies and investment managers and stockbrokers. The FCA is responsible for ensuring that conduct and markets regulation is firmer and more involved with consumers, and its main strategic objective is the protection and enhancement of confidence in the UK financial system. Additionally, it is given significant powers under the Financial Services Market Act 2000, an interesting development, particularly in light of the ~~fact that~~ these powers have never been properly utilised. The principles of the FSMA 2000 reinforce the FCA’s regulatory objectives and impose heavy obligations that must be observed by a regulated firm.<sup>39</sup> The Act grants the FCA extensive powers to undertake authorization and supervision of the banking sector with significant enforcement sanctions and powers. It has a direct impact on corporate governance standards within the banking and financial services sector in that it imposes high standards of conduct and integrity on senior managers and key persons, including controller shareholders. If an institution fails to comply with the FSMA principles, the FSMA allows the FCA to take direct action, such as withdrawing a firm’s authorization, disciplining authorised firms and people (approved by the FCA to work in those firms), and imposing penalties for market abuse. Significantly, the FSMA rules require bank directors to comply with the ‘fit and proper’ person requirements both at the outset and on a permanent basis.<sup>40</sup> The intention is to promote

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<sup>38</sup> The PRA, a subsidiary of the Bank of England, is responsible to supervise deposit takers, insurers and a small number of significant investment firms.

<sup>39</sup> I MacNeil, ‘Activism and Collaboration among Shareholders in UK Listed Companies’ [2010] *Capital Markets Law Journal* 419, 428; A Arora, ‘The Corporate Governance Failings in Financial Institutions and Directors’ Legal Liability’ [2011] *Company Lawyer* 32, 3.

<sup>40</sup> The FCA’s handbook states that under the ‘Fit and Proper test for Approved Persons’ the FSA will have

management responsibility and to ensure there is competency and ability in all key roles. In assessing applicants, the FCA focuses on the “fit and proper” person criteria of honesty, integrity, reputation, competence, capability and financial soundness. It can look at people’s financial industry experience as well as their relevant qualifications. As noted, although the “fit and proper person” test has been used to judge the context of fraud and bankruptcy, in light of the excessive risk taking witnessed in recent years, there would be strong grounds for extending the criteria to professional skills and risk management.<sup>41</sup>

Still, the regulatory enforcement measures have not been properly deployed ever since the crisis occurred. Certainly, the proper use of the FMSA rules is a pressing matter. For example, since the emergence of the financial crisis not many have been banned from financial services despite the extensive powers granted by the Financial Services and Markets Act. The FCA should use its powers more effectively and must not permit people to be appointed to high-impact financial institutions if they lack the relevant qualifications, including training. As Turner puts it, the regulator relies on the presumption that management and boards of directors are better placed to assess the appropriateness of specific individuals for specific

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regard to a number of factors when assessing the fitness and propriety of a person to perform a particular controlled function. The most important considerations will be the person's:

- (1) honesty, integrity and reputation;
- (2) competence and capability; and
- (3) financial soundness (FCA Handbook, FIT 1.3.1): Financial Services Authority Handbook, available at <http://fsahandbook.info/FSA/html/handbook> [accessed 18 May 2016].

<sup>41</sup> A Arora, ‘The Corporate Governance Failings in Financial Institutions and Directors’ Legal Liability’ [2011] Company Lawyer 32, 3

roles.<sup>42</sup> But this is not a logical assumption. Undoubtedly the absence of proper qualifications must be a cause of concern. For instance, the former CEO of Royal Bank of Scotland, Fred Goodwin, who presided over a breakneck acquisition spree that ultimately led to the collapse of RBS in 2008, had no formal qualifications. Similarly, the chief executive of Northern Rock was not a qualified banker and the FSA (the former 'FCA') was highly criticised for allowing this appointment. A good regulatory body should periodically carry out a review of the qualifications of senior directors in financial institutions, particularly of those institutions deemed to be "high-impact" and must ensure that the existing approved person regime requirements are adequate.<sup>43</sup> As suggested during the Treasury Committee Enquiry into the collapse of Northern Rock, the regulatory authority must exercise its power to approve the appointment of bank directors and must ensure that these individuals have the required skills, knowledge and training to understand the business of their bank, its risk models and its financial implications. This will benefit not only the bank's shareholders but also the firm as a whole, as well as the broader economy.

The quality of board members is a particular concern of bank supervisors; after all, they are the ones who set the fit and proper person tests. However, such tests do not fully address the matter of competence, particularly board members' ability to oversee large businesses with

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<sup>42</sup> A Turner, "The Turner Review – A Regulatory Response to the Global Banking Crisis", *Financial Services Authority*, March 2009, 86.

<sup>43</sup> A conclusion supported by the House of Commons Treasury Committee: House of Commons Treasury Committee, "Banking Crisis", *Oral Evidence*, April 2009, Vol. 1, House of Commons, London, The Stationery Office Limited, 34. Also see International Monetary Fund (IMF), *Global financial stability report: responding to the financial crisis and measuring systematic risks*, 2009, available at <http://www.imf.org/external/pubs/ft/gfsr/2009/01/pdf/text.pdf> [accessed 06 June 2016].

potentially gigantic consequences on shareholders and other stakeholders.<sup>44</sup> Although the FSMA 2000 grants the FCA the power to impose a financial penalty where it establishes that there has been a contravention by an authorised person of any requirement imposed by the Act,<sup>45</sup> there is an obvious weakness here: the provisions do not encompass the type of behaviour witnessed in institutions such as Royal Bank of Scotland, Northern Rock, Lloyds and many others; in other words conduct which shows a lack of skill and diligence. The FCA can, at present, assess the type of conduct that results in market abuse, in authorised persons acting without permission, in the contravention of the general prohibition to be an authorised person and in misleading statements and practices. Nevertheless, negligent conduct and general unfitness in the management of firms (such as of the type that resulted in the near collapse of several banking institutions in the 2008 economic catastrophe) can have catastrophic consequences within the UK context and more widely, and therefore cannot be pushed aside as irrelevant. Such conduct must be included within the powers of the FCA to impose financial penalties. The issue of directors' competence must be fully addressed in the exercise of these powers and more thorough tests must be developed to help this goal materialise.

Two further issues need to be raised. The first matter concerns the question of scale. The current staff resources within the FCA are simply inadequate. This is an institution that employs about 4,000 employees. In contrast with the bank HSBC that employs 330,000 staff

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<sup>44</sup> Organisation for Economic Cooperation and Development (OECD), *Corporate Governance and the Financial Crisis – Conclusions and Emerging Good Practices to Enhance Implementation of the Principles*, 2010, available at <http://www.oecd.org/daf/corporateaffairs/corporategovernanceprinciples/44679170.pdf> [accessed 13 May 2016], 21.

<sup>45</sup> Section 206, FSMA 2000.

worldwide this is a modest amount.<sup>46</sup> Indeed, two critical deficiencies were confirmed during the 2008 crisis: that there were inadequate staff resources and inadequate staff training. These shortfalls resulted in the ineffectiveness of the risk-based system of supervision.<sup>47</sup> All in all, there was under-resourcing, and shortage of expertise in many fundamental areas, notably prudential banking experience and financial data analysis. Interestingly the FSA itself in its review of the supervision at Northern Rock, agreed with this conclusion;<sup>48</sup> in fact, that there were only three members of the FSA's staff assigned to the direct supervision of Northern Rock was described as unacceptable by the chief executive Officer of the FSA.<sup>49</sup> Under-resourcing is a major problem and deficiencies in terms of adequate supervisory staff resources must be addressed sooner rather than later. The consequences of such deficiencies are not trivial, particularly in view of the demands placed on supervisors. Further, in light of the difficulties in attracting competent and accomplished staff, regulators' salaries could increase to help entice individuals capable of carrying out the more interventionist regulatory approach advocated here.

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<sup>46</sup> B Maddox and J Elwes, "Shrinking the City", *Prospect*, 14 December 2013.

<sup>47</sup> Organisation for Economic Cooperation and Development (OECD), *Corporate Governance and the Financial Crisis – Conclusions and Emerging Good Practices to Enhance Implementation of the Principles*, 2010, available at <http://www.oecd.org/daf/corporateaffairs/corporategovernanceprinciples/44679170.pdf> [accessed 13 May 2016], 27.

<sup>48</sup> According to the FSA's review of Northern Rock, "we cannot provide assurance that the prevailing framework for assessing risk was appropriately applied in relation to Northern Rock, so that the supervisory strategy was in line with the firms risk profile." (FSA Internal Audit Division Report, *The Supervision of Northern Rock: a Lessons Learnt Review*, 2008, available at [http://www.fsa.gov.uk/pubs/other/nr\\_report.pdf](http://www.fsa.gov.uk/pubs/other/nr_report.pdf) [accessed 10 June 2016].

<sup>49</sup> House of Commons Treasury Committee, "The run on the Rock", *Fifth report of session 2007-08*, January 2008, Vol. I, 22.

A further issue relates to the capital requirements which banks are required to hold to protect themselves against financial troubles. Lax rules in relation to capital requirements place a heavy burden on supervisors. Turner, in his report on the 2008 crisis, explained this well; he suggested that if there were higher capital and liquidity requirements, the need for ‘tight’ supervision would be seriously diminished. This is because when the capital and liquidity requirements are set “too close to the point of danger”, supervision is, by necessity, intensified to ensure that banks have not gone beyond the prescribed rules.<sup>50</sup> In this regard, more aggressive rules would help diminish this difficulty and therefore, the international drive for higher capital requirements is a welcome step forward.<sup>51</sup>

### III. THE INTERNAL ORGANS OF CORPORATE GOVERNANCE

Two aspects of corporate governance have been linked with the emergence of the financial crisis approximately a decade ago. One is the widespread failure on the part of the boards of directors to understand and control the risks assumed on behalf of their companies.<sup>52</sup> The other is the role of the shareholders as guardians of corporate governance. This part considers the question of directors’ qualification as an *ex-ante* measure and the question of their disqualification for unfitness as an *ex-post* measure to good corporate governance. This is

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<sup>50</sup> A Turner, ‘The Turner Review – A Regulatory Response to the Global Banking Crisis’, *Financial Services Authority*, March 2009.

<sup>51</sup> However, as Turner explains, although the UK has very significantly increased capital requirements, one obstacle is that: “*you have to get a global agreement and there are different points of view around the world about how radical to be.*”: A Turner, ‘The Turner Review – A Regulatory Response to the Global Banking Crisis’, *Financial Services Authority*, March 2009.

<sup>52</sup> I MacNeil, ‘Activism and Collaboration among Shareholders in UK Listed Companies’ [2010] *Capital Markets Law Journal* 419, 518.

followed by a discussion of the role and significance of shareholder engagement in the governance of companies, a matter that has re-emerged into the scene following the renewed interest in their participation as owners as a result of the UK Stewardship Code introduced in 2010.

#### **A. Directors' Quality and Accountability**

Corporate governance concentrates primarily on boardroom behaviour. It requires management to consist of fit and proper persons in the sense of strong business ethics and high levels of competence in the performance of managerial functions. Still, it is not uncommon to find bank executives not even possessing the minimum degree of skill needed to do the job right. But why is this so? And more importantly, why is this a common characteristic of the numerous bank crises throughout history? For instance, the risky and flawed business models chosen by many executives significantly contributed to the 2008 economic disaster, resulting in the UK's eighth largest bank, Northern Rock to be nationalised and its largest mortgage lender, Halifax, Bank of Scotland (HBOS) to be rescued by a rival. On top of this, the UK also became the majority owner of two of the country's top four banks, the Lloyds Banking Group and Royal Bank of Scotland (RBS). According to a consultation green paper on corporate governance, several deficiencies contributed to the failure of boards to exercise effective control over senior management.<sup>53</sup> The deficiencies identified provoked serious questions about the quality of the board of directors, its composition, training and qualifications. The report found that boards of directors were incapable of seeing that the risk

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<sup>53</sup> European Commission, "Green Paper: The EU Corporate Governance Framework", COM(2011) 164 final, 5 April 2011, available at [http://ec.europa.eu/internal\\_market/company/docs/modern/com2011-164\\_fr.pdf#page=2](http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_fr.pdf#page=2) [accessed 18 June 2016], 6.



management frameworks were *actually* appropriate for their institutions; they were not in a position to recognise the systemic nature of certain risks and were therefore unable to provide sufficient information upstream to their supervisory authorities. In fact, banks such as Royal Bank of Scotland and Lehman Brothers have suffered gigantic losses partly due to their executive's inability to appreciate the lethal nature of risks they were taking with regards to the sub-prime mortgage market.<sup>54</sup> Significantly, there was insufficient training for those employees responsible for distributing risk products.<sup>55</sup>

This lack of understanding of strategies and products, such as collateralised debt obligations, is particularly worrying, especially when considering the supervisory role attached to the board of directors. If board members do not possess the knowledge or skills to challenge other key internal company participants (such as the chief executive officer) then critical questions are raised regarding the quality of their qualifications and credentials. On this note, the shortcomings identified by the numerous post-crisis reports appear to point to the absence of healthy sets of skills and qualifications. Any deficiencies in this regard will eventually disturb the way board members manage, supervise and organise their firms' internal affairs. But what can be done to tackle this issue? Increasing the duties and responsibilities of directors is not the logical conclusion; directors already have significant duties to comply with. Rather, the

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<sup>54</sup> D Arsalidou, 'The Banking Crisis: Rethinking and Refining the Accountability of Bank Directors' [2010] *Journal of Business Law* 4, 284; D Arsalidou, *Rethinking Corporate Governance in Financial Institutions* (Routledge, 2015), chapter 1.

<sup>55</sup> European Commission, "Green Paper: The EU Corporate Governance Framework", COM(2011) 164 final, 5 April 2011, available at [http://ec.europa.eu/internal\\_market/company/docs/modern/com2011-164\\_fr.pdf#page=2](http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_fr.pdf#page=2) [accessed 18 June 2016], 6. Also see As stated by the Chairman of the ICSA Steering Committee, Sir John Egan: see R Sullivan, "Good Chair is Key to an Effective Board", *The Financial Times*, 1<sup>st</sup> August 2010.

identified shortcomings require concrete, long-lasting and durable solutions that can actually help improve the practices of large financial institutions in the long-term. Thus, this part will discuss two interconnected issues linked to this particular inadequacy: the question of qualifications and training is considered as an *ex-ante* measure to good corporate governance standards, followed by an examination of directors' disqualification as an *ex-post* measure should they nevertheless fail to display the required degree of knowledge and skill expected of them.

### *1. Directors' qualifications and training as an 'ex-ante' tool*

In order to secure a healthy risk management culture at all levels, it is essential that directors of financial institutions are themselves exemplary.<sup>56</sup> It is, in fact, the quality of a firm's management rather than its business models that explains the difference in performance between banks.<sup>57</sup> With this crucial point in mind, it is essential that directors of large companies be required to have a minimum level of training and qualifications, akin to that required of other professionals. At present, anyone can become a company director; there is no requirement for any prior training or prior qualifications. The UK Companies Act 2006 does not expect 'future' executives to possess any qualifications before securing a job with a large firm, although upon assuming the post pressure is placed on them in two ways. To begin with, the Company Directors Disqualification Act 1986 can disqualify anyone who does not appear to do the job right. The next pressure stems from the FCA itself: in considering the question of competence and capability the FCA considers a number of factors, such as

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<sup>56</sup> European Commission, "Green Paper: The EU Corporate Governance Framework", COM(2011) 164 final, 5 April 2011, available at [http://ec.europa.eu/internal\\_market/company/docs/modern/com2011-164\\_fr.pdf#page=2](http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_fr.pdf#page=2) [accessed 18 June 2016], 7.

<sup>57</sup> Editorial, "The Contract between Society and Banks Will Get Stricter", *The Economist*, 14 May 2009.

whether a person fulfils the relevant FCA training and competence requirements in relation to the controlled function performed or intended to be performed, whether the person has shown by experience and training that they are suitable, or will be suitable if approved, to perform the controlled function, and whether the person has sufficient time to perform the controlled function and satisfy the responsibilities associated with that function.<sup>58</sup>

It can be difficult for outsiders to assess board competence; even so, it is frequently asserted that those managing large institutions blatantly lack any banking and financial experience, expertise and business qualifications.<sup>59</sup> Perhaps the absence of a requirement for qualifications or training makes some sense in relation to those leading small companies; there is inevitably a minimum cost to training that directors of closely-held companies may not be able to meet well, or meet at all for that matter.<sup>60</sup> However, this is less so in relation to directors of large financial institutions. The larger the institution, the greater should the demand be for the appropriate set of skills and qualifications, particularly in relation to the specific functions performed. Worryingly, a post-crisis study estimates that at eight US major financial institutions, two thirds of directors had no banking experience.<sup>61</sup> In addition, the

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<sup>58</sup> Financial Services Authority Handbook, available at <http://fsahandbook.info/FSA/html/handbook> [accessed 18 May 2016].

<sup>59</sup> Organisation for Economic Cooperation and Development (OECD), *Corporate Governance and the Financial Crisis – Conclusions and Emerging Good Practices to Enhance Implementation of the Principles*, 2010, available at <http://www.oecd.org/daf/corporateaffairs/corporategovernanceprinciples/44679170.pdf> [accessed 13 May 2016], 27.

<sup>60</sup> For instance, the cost of the training course, travel and accommodation costs.

<sup>61</sup> Study by Guerra and Thal-Larsen 2008 cited in OECD: Organisation for Economic Cooperation and Development (OECD), *Corporate Governance and the Financial Crisis – Conclusions and Emerging Good Practices to Enhance Implementation of the Principles*, 2010, available at

study found that those without a financial background are often members of highly technical board committees, for instance risk and audit committees. For example, at the collapsed Lehman Brothers four of the ten board members were over 75 years of age and only one had some knowledge of the financial sector the firm was operating in. This led the OECD report to state (in no uncertain terms) that boards must not be viewed as retirement homes “for the great and the good”. Still, history also tells us that having experience in banking is not everything; for instance, there were two board members on the board of Northern Rock who had extensive banking experience under their belt.<sup>62</sup> Also, at the failed Bear Stearns seven out of thirteen directors had solid banking backgrounds and a good degree of financial experience.<sup>63</sup>

What the above highlight is the need for training, particularly of those managing the large financial institutions. Interestingly this is also emphasised in the draft guidance issued by the Institute of Chartered Secretaries and Administrators (ICSA). The Chairman of the ICSA Steering Committee recognised the importance of offering board members and chairmen a lot more guidance on how to do their job properly, and its renewed guidelines talk of the huge role training can play in improving directors’ skills and knowledge of strategies, products and

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<http://www.oecd.org/daf/corporateaffairs/corporategovernanceprinciples/44679170.pdf> [accessed 13 May 2016], 27.

<sup>62</sup> The report states: “we are concerned that the Chief Executive of Northern Rock was not a qualified banker, although of course he has significant experience.”: House of Commons Treasury Committee, “The run on the Rock”, *Fifth report of session 2007-08*, January 2008, Vol. I, 34.

<sup>63</sup> : Organisation for Economic Cooperation and Development (OECD), *Corporate Governance and the Financial Crisis – Conclusions and Emerging Good Practices to Enhance Implementation of the Principles*, 2010, available at <http://www.oecd.org/daf/corporateaffairs/corporategovernanceprinciples/44679170.pdf> [accessed 13 May 2016], 27.

risk.<sup>64</sup> Similarly, Alexander (who gave evidence during the Treasury Committee Enquiry) highlighted the importance of training bank management to manage the technical aspects of stress-testing, stating that this is as important as the importance of the FSA (currently the FCA) properly exercising its power to approve the appointment of bank directors.<sup>65</sup>

Many institutions were subject to severe criticism in the aftermath of the 2008 crisis, for lacking the strong corporate governance procedures that would have ensured incentivised management to appreciate the risks they were pursuing on their institutions' behalf.<sup>66</sup> Even though responsible institutions are able to take their own steps to ensure that their controllers somehow understand complex business activities, there is a lot more that can be done. One step would be a legal requirement for the annual training of directors of large financial institutions. The purpose of this would be to ensure that those managing such institutions have the required skills, knowledge and training to comprehend the complex nature of their organisation, as well as the complicated financial implications of their individual decisions. Additionally, the FCA should ensure that the existing approved person regime requirements are fitting and appropriate; for instance, it should undertake an annual review of the actual qualifications of senior directors in financial firms, specifically of those directors leading the

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<sup>64</sup> The Institute of Chartered Secretaries and Administrators (ICSA), *The Governance Institute*, 2016, available at <https://www.icsa.org.uk> [accessed 19 April 2016]

<sup>65</sup> House of Commons Treasury Committee, "Banking Crisis: Regulation and Supervision", *Fourteenth Report of Session 2008-09*, July 2009, evidence 57, submitted by Kern Alexander.

<sup>66</sup> Organisation for Economic Cooperation and Development (OECD), *Corporate Governance and the Financial Crisis – Conclusions and Emerging Good Practices to Enhance Implementation of the Principles*, 2010, available at <http://www.oecd.org/daf/corporateaffairs/corporategovernanceprinciples/44679170.pdf> [accessed 13 May 2016]; European Commission, "Green Paper: The EU Corporate Governance Framework", COM(2011) 164 final, 5 April 2011, available at [http://ec.europa.eu/internal\\_market/company/docs/modern/com2011-164\\_fr.pdf#page=2](http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_fr.pdf#page=2) [accessed 18 June 2016].

“high impact” firms. The combination of soft law, legal rules and the FCA rules can ensure that the training requirements are effective, and remain effective for that matter. This will certainly be a positive step forward in assuring the public that boards are able to comprehend and manage the risks pursued by their firms. Crucially also, although training can be a significant expense to a large company, the social benefits and benefits to the broader economy should far outweigh the cost of training itself.<sup>67</sup>

## *2. Directors’ disqualification as an ‘ex-post’ tool*

The proposition that directors must possess a minimum level of training and qualifications akin to those required of other professionals is noteworthy. Nevertheless, should directors fail to display the required degree of understanding and skill, the question of their disqualification as an ex-post measure becomes even more significant. This is so, as major weaknesses in UK bank corporate governance exposed a key flaw in the past few years; too many directors simply failed to appreciate the risks they were undertaking on their firms’ behalf; there is general agreement that mismanagement, incompetence and reckless risk-taking helped to ~~pushed~~ many of the UK banks to the brink of collapse. In many ways, this comes ~~to~~ as ~~no~~ surprise: historically failures akin to those of the 2008 crisis’ magnitude frequently occur because the nature of the transactions or the level of risk is not properly comprehended by those in high-level positions. On a positive note, past bank failures must provide an opportunity for wider policy learning and improvement. And certainly within the current

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<sup>67</sup> House of Commons Treasury Committee, “Banking Crisis: Regulation and Supervision”, *Fourteenth Report of Session 2008-09*, July 2009, evidence 57, submitted by Kern Alexander.

corporate governance environment, accountability is one critical issue.<sup>68</sup>

Three decades ago the Cork Committee Report viewed the revival of disqualification for unfitness as an efficient way to protect the public from the negligent actions and abuse of limited liability by company directors.<sup>69</sup> A disqualification order is an order made against a person under the Company Directors Disqualification Act 1986 (CDDA);<sup>70</sup> such a person shall not be a director of a company or in any way be directly or indirectly concerned with the promotion, formation or management of a company.<sup>71</sup> Although the CDDA includes an extensive range of grounds, in practice the majority of the disqualification orders are made under section 6. The section imposes a duty on the court to disqualify unfit directors of insolvent companies; it is the most litigated provision in the statute and provides for the mandatory disqualification of directors whose company has become insolvent, for the minimum period of two years and the maximum period of fifteen. Companies however, do not have to become insolvent for disqualification to occur: under section 8 the court can disqualify a person if satisfied that their conduct makes them unfit to be concerned in the management of a company.<sup>72</sup> Additionally, it is possible to disqualify a director under section

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<sup>68</sup> J Gray, 'Lessons for BCCI Saga for the Current Accountability Debate surrounding Northern Rock' [2008] 23 *Journal of International Banking Law and Regulation* 37.

<sup>69</sup> *Insolvency Law and Practice*, (1982) Cmnd 8558.

<sup>70</sup> Referred to as the 'CDDA 1986'.

<sup>71</sup> The relevant provisions are in the *Company Directors Disqualification Act 1986* and the main disqualification provisions are organised into four general areas. Disqualification may arise out of bankruptcy and personal insolvency; criminal offences connected with management of companies or involving dishonesty and offences associated with winding up; non-compliance by a company with requirements of the Companies Act (especially reporting obligations) and of other related legislation; and insolvent winding up of a company or other corporate insolvency procedures.

<sup>72</sup> This is on an application from the Secretary of State following an investigation. There is a wide range of

121 of the Banking Act 2009: according to the section, the provisions of the Company Directors Disqualification Act 1986 can be applied to the bank insolvency procedure to ensure that an action can be taken against a director of a failed bank.<sup>73</sup> Nevertheless, despite the enactment of the Banking Act 2009, there are real question marks over the effectiveness of the pre-existing laws to render bank directors accountable. Although there is general agreement that mismanagement, incompetence and reckless risk-taking significantly contributed to pushing many of the UK banks to the brink of collapse, there is a serious gap in the legislation: at present, a director whose company fails can be disqualified for incompetence and made personally liable for wrongful trading. At the same time, a banker who makes gross errors in the management of the bank can escape liability if the bank is eventually saved from collapse by the government. This normally happens because the government may fear that if the bank collapses or is allowed to go into administration, the consequences on the whole financial system would be catastrophic; to put simply, the bank might be viewed as being too big to fail. Still, this can result in some bankers comfortably slipping through the net; they avoid the possibility of disqualification because their ‘large’ institutions are saved at the last minute by the taxpayer.

The statistics on disqualification generate both good and bad news. Although the number of disqualification orders against directors rose by 5% in the year 2012-13,<sup>74</sup> most

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investigation powers such as CA 1985, ss. 437, 447 and 448; FSMA 2000, ss. 165, 167-169, 171-173.

<sup>73</sup> The Banking Act explanatory notes explain that a wide range of matters may be considered in determining whether a director’s conduct has been such that action should be taken to bar him or her from acting as a director (and holding certain other offices) for a period of between 2 and 15 years, as prescribed in the Company Directors Disqualification Act 1986.

<sup>74</sup> These are the most recent and detailed statistical results. There were 1,615 director disqualifications recorded by Companies House in the 12 months to April 2013 and these are the highest figures since the aftermath of the



disqualifications continue to fall under section 6 of the CDDA 1986. This largely agrees with the general historical pattern: the Companies House statistical analysis shows that approximately nine years ago (2007-08) there have been 138 disqualifications under s. 6 and only 22 under s. 8. The pattern was similar in previous years: in 2008-09 there were 143 disqualifications under s. 6 and 23 under s. 8 and in 2005-06, 90% of disqualifications were under CDDA 1986, s. 6.<sup>75</sup> On a positive note, the statistics also point to the tough line adopted by the government on the question of unfitness: that directors who break the rules can face a ban.<sup>76</sup> However, the failure to make accountable those responsible for near-collapses remains. It is certainly the case that banks are special institutions, and therefore any potential loss of access to banking services, even for a short period of time must be treated with sensitivity due to the resultant detrimental effect this can have on overall economic stability. Such institutions are too big to fail, or more accurately, too interrelated to fail. Banks have several counterparties in the financial system and may be integral to the global payments system, increasing the risk of contagion should they collapse. They have hundreds of thousands of depositors, meaning that a corporate distress on their side could lead to widespread personal hardship for many people. In fact, the integral part played by banks in the national economy is demonstrated by the nearly universal system adopted by states in regulating the banking world.<sup>77</sup> And yet, if bank directors know that there exists an implicit guarantee, moral hazard

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dotcom share price bubble bursting in March 2000: Companies House, *Companies House Statistics*, available at <https://www.gov.uk/government/statistics> accessed 18 May 2016.

<sup>75</sup> Additionally, in 2005-06, the pattern was that 90% of disqualifications were under CDDA 1986, s. 6, available at [http://www.companieshouse.gov.uk/about/pdf/companiesRegActivities2008\\_2009.pdf](http://www.companieshouse.gov.uk/about/pdf/companiesRegActivities2008_2009.pdf) [accessed 5 February 2012].

<sup>76</sup> J Moules, "Rise in Director Disqualifications", *The Financial Times*, 2 March 2012.

<sup>77</sup> In many cases this includes a state sponsored safety net that protects and compensates depositors when banks collapse and lender of last resort facilities for banks facing problems obtaining credit and liquidity: House of

is likely to arise, increasing the need for regulation and supervision.<sup>78</sup> Exacerbating and heightening the possibility of moral hazard arguably gives bank directors the licence to view this as an insurance policy, resulting in an increase in the cost of a rescue if there is an eventual failure.

Eight years on from the economic disaster of 2008 and the irony is clear: had banks been allowed to fail there would have been a number of successful disqualifications orders by now, especially on the grounds of unfitness. The evidence suggests that banks such as Northern Rock, Royal Bank of Scotland and Lloyds have suffered huge losses because directors failed to understand the nature of the derivatives that securitised “toxic debt” consisting of sub-prime mortgages.<sup>79</sup> Even when warned of the emerging difficult market conditions, boards failed to sufficiently safeguard their banks or to take steps to reinforce their position; not even as a precaution.<sup>80</sup> They failed to see that a tightening in the credit markets would extend to good quality credit; rather, they opted for the more “reckless” approach to risk management.<sup>81</sup> Indeed, their behaviour fits the type of ~~type~~ behaviour described in the CDDA: case law

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Commons Treasury Committee, 2009.

<sup>78</sup> TF Hellmann, K Murcock and J Stiglitz, ‘Liberalization, Moral Hazard in Banking, and Prudential Regulation: Are Capital Requirements Enough?’ [2009] 90 American Economic Review 147.

<sup>79</sup> D Arsalidou, ‘The Banking Crisis: Rethinking and Refining the Accountability of Bank Directors’ [2010] Journal of Business Law 4, 284; D Arsalidou, *Rethinking Corporate Governance in Financial Institutions* (Routledge, 2015), chapter 1.

<sup>80</sup> A Arora, ‘The Corporate Governance Failings in Financial Institutions and Directors’ Legal Liability’ [2011] Company Lawyer 32, 3; House of Commons Treasury Committee, “The run on the Rock”, *Fifth report of session 2007-08*, January 2008, Vol. I.

<sup>81</sup> R Tomasic, ‘Raising Corporate Governance Standards in Response to Corporate Rescue and Insolvency’ [2009] 2 Corporate Rescue and Insolvency 5, 330; House of Commons Treasury Committee, “The run on the Rock”, *Fifth report of session 2007-08*, January 2008, Vol. I, 77.

indicates that unfitness equates to the level shown in the recent crisis. This includes the failure to understand the complexities of one's organisation and the failure to obtain at a minimum some financial knowledge to enable one to appreciate the company's financial position.<sup>82</sup> The courts are prepared to disqualify those who have been careless in attending to accounting matters and have engaged in conduct that generally demonstrates an element of recklessness.<sup>83</sup> Inactivity, lack of supervision, improper delegation, and so on, carry significant weight in the determination of unfitness and "incompetence".<sup>84</sup> Directors are under "[...] a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors".<sup>85</sup> Conduct that falls below the standards of probity and competence appropriate for persons fit to be directors will result in disqualification.<sup>86</sup> This does not mean that directors are expected to possess detailed knowledge of the company's day-to-day conduct; a director's role is strategic and organisational and therefore a good general knowledge of the business would normally suffice.<sup>87</sup> *Re Westmid Packing* sums up the position well; the judge held that directors owe duties to the company to inform themselves about its affairs and to join with its co-directors in supervising and controlling them.<sup>88</sup> Certainly, anyone who accepts the

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<sup>82</sup> A Walters and M Davies-White, *Disqualification: Law and Practice* (Sweet & Maxwell, 1999).

<sup>83</sup> BR Cheffins, *Company Law – Theory, Structure and Operation* (Clarendon Press, 1997), 320.

<sup>84</sup> *Re Continental Assurance Co of London plc* [1997] 1 BCLC 48, p. 56: Chadwick J. stated that a competent director in the defendant's position would have been aware as to what is going on, and for this, "his failure to know displays serious incompetence or neglect in relation to the affairs" of the company.

<sup>85</sup> *Re Barings Plc & Others (No 5)* [1999] 1 BCLC 433, p. 483. Also, see *Re Queens Moat Houses plc, Secretary of State for Trade and Industry v. Bairstow (No 2)* [2005] 1 BCLC 136.

<sup>86</sup> *Re Barings Plc & Others (No 5)* [1999] 1 BCLC 433, p. 483. Also see *Secretary of State for Trade and Industry v. Gray*, [1995] 1 BCLC 276.

<sup>87</sup> *Re Vintage Hallmark plc, Secretary of State for Trade and Industry v. Grove* [2007] 1 BCLC 788.

<sup>88</sup> *Re Westmid Packing* [1998] 2 All ER 124. The case is also referred to in *Re Barings Plc & Others (No 5)*,

statutory and fiduciary obligations of being a company director “should realise that these are inescapable personal responsibilities”.<sup>89</sup>

Bailing out banks and ensuring that depositors’ savings are safe has been the aim of the UK Government; in the meantime however, the “[...] cherished concept of moral hazard has been left to wither away”.<sup>90</sup> This is where we witness the reinstatement of moral hazard “[...] as a functioning market discipline in bringing about the reasonable financial discipline that we would all like to see”.<sup>91</sup> As the report into the failure of Northern Rock recognises, banks and building societies view government’s support to Northern Rock as an indication of the fact that no UK bank will be allowed to fail.<sup>92</sup> Although the existence of the FCA penalties makes disqualification a less significant path, we still need to deal with the problem of coherence in the law. The Government bailout is generally credited with having saved the UK economy, but by doing so it may have also saved irresponsible bankers from being held accountable for their actions. When the government stepped in to rescue institutions such as Royal Bank of Scotland and Lloyds through share purchases, Northern Rock through nationalisation, and Bradford and Bingley through loans, it won plaudits for prompt and decisive action that saved them from collapse. The price of this rescue however, may be more than financial. By

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[1999].

<sup>89</sup> *Re Westmid Packing* [1998] 2 All ER 124.

<sup>90</sup> The then Chancellor of the Exchequer, Alistair Darling, stated during the Enquiry into the failure of Northern Rock that “*if you are a bank, there has to be a situation where, if there is a reward, there has to be a penalty if you fail. That is what went pretty badly wrong in a lot of the banking system.*”; House of Commons Treasury Committee, “The run on the Rock”, *Fifth report of session 2007-08*, January 2008, Vol. I, 77, 386.

<sup>91</sup> House of Commons Treasury Committee, “The run on the Rock”, *Fifth report of session 2007-08*, January 2008, Vol. I, 77, 386.

<sup>92</sup> House of Commons Treasury Committee, “The run on the Rock”, *Fifth report of session 2007-08*, January 2008, Vol. I, 77.

preventing the directors involved from being held accountable, we may not learn the lessons of the credit crunch, nor be able to prevent it from being repeated in future. The measures under the disqualification provisions have not been properly deployed, as shown by the fact that there have been no disqualifications for the near failures of institutions since the emergence of the crisis eight years ago. With both the banks and bankers escaping from the consequences of their reckless risk-taking, there is clearly an urgent need to review the field of disqualification. The idea that banks or companies should fail in order for disqualification to follow reinforces the issue of moral hazard.<sup>93</sup> This is a serious matter that must be addressed sooner rather than later.

In light of the above, section 6 of the CDDA must be amended in such a way so as to reflect better the current realities of the financial world. Within its reach it must encompass failures as well as *near-failures* of firms.<sup>94</sup> The same applies to section 121 of the Banking Act; it should allow actions against directors of banks that nearly failed. In addition, the powers of the Secretary of State under Section 8 should be used more extensively – the latest statistical figures show that the Insolvency Service rarely pursues cases under this section.<sup>95</sup> These measures would help to diminish moral hazard, which most agree contributes significantly to the near-failures discussed here. Focusing on the cases that typically fall through the ‘disqualification gap’ is a positive step forward in ensuring that the government’s framework

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<sup>93</sup> The report ‘The run on the Rock’, that examines the failure of Northern Rock, is the first post-crisis report that recognised this problem: it notes that that UK banks and building societies appear to view the Government’s support of Northern Rock as a promise that no bank would be allowed to fail in future: House of Commons Treasury Committee, ‘The run on the Rock’, *Fifth report of session 2007-08*, January 2008, Vol. I.

<sup>94</sup> D Arsalidou, ‘The Banking Crisis: Rethinking and Refining the Accountability of Bank Directors’ [2010] *Journal of Business Law* 4, 284.

<sup>95</sup> Companies House, *Companies House Statistics*, available at <https://www.gov.uk/government/statistics>

accessed 18 May 2016.

for maintaining financial stability “[...] does not provide free insurance to banks”<sup>96</sup>. In the absence of any such measures, the risk is that we will be less equipped to prevent the next catastrophe and make those responsible answerable for the chaos they may have caused.

## **B. Shareholders and their Monitoring Role**

Over the past few decades debate has been wide regarding the question of directors’ accountability. But recently the attention has somewhat moved to the ownership black hole represented by the wider corporate participants; following the global financial catastrophe eight years ago, the institutional shareholders’ role has become a subject that elicits strong emotional reactions. The corporate governance framework relies on the assumption that shareholders engage with companies and hold management to account for its performance.<sup>97</sup> However, this assumption rarely represents reality; shareholders tend to adopt a passive role because they are predominantly interested in the short-term. There is a clear lack of shareholder interest in holding institutions to account, and this in turn encourages the excessive risk taking frequently experienced by the financial world across the globe.<sup>98</sup>

The long-standing thesis is that shareholders can positively contribute to the governance of

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<sup>96</sup> House of Commons Treasury Committee, “The run on the Rock”, *Fifth report of session 2007-08*, January 2008, Vol. I, 77.

<sup>97</sup> European Commission, “Green Paper: The EU Corporate Governance Framework”, COM(2011) 164 final, 5 April 2011, available at [http://ec.europa.eu/internal\\_market/company/docs/modern/com2011-164\\_fr.pdf#page=2](http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_fr.pdf#page=2) [accessed 18 June 2016], 3.

<sup>98</sup> European Commission, “Green Paper: The EU Corporate Governance Framework”, COM(2011) 164 final, 5 April 2011, available at [http://ec.europa.eu/internal\\_market/company/docs/modern/com2011-164\\_fr.pdf#page=2](http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_fr.pdf#page=2) [accessed 18 June 2016].

public institutions.<sup>99</sup> By virtue of the increasing dominance of institutional investors in the equity markets and possibly due to the failure to find alternative solutions to the “agency problem”, there has been a renewed interest in their significance.<sup>100</sup> Consequently, the introduction of the UK Stewardship Code in 2010 (revised in 2012)<sup>101</sup> that applies generally to anyone investing in the corporate sector is of crucial importance. The Code makes it clear that the idea of stewardship is not restricted to company directors. Stewardship is as an investment ideology that ought to personify the investment responsibilities rather generally.<sup>102</sup> Institutional investors are expected to engage with management in collective terms especially during corporate or wider economic stress.<sup>103</sup> Therefore it is important to consider whether

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<sup>99</sup> DJ Baum and NB Stiles, *The Silent Partners: Institutional Investors and Corporate Control* (Syracuse University Press, 1965).

<sup>100</sup> AA Berle and GC Means, *The Modern Corporation and Private Property* (Harcourt, Brace and World, 1932).

<sup>101</sup> The changes to the Stewardship Code include the following:

Definition & Delineation — clarifying the actual definition and aim of stewardship and identifying which principles/guidance applies to asset managers and which are directed at asset owners.

Disclosure — substantive changes on disclosure including disclosure to clients (on request) of assurance reports on their record of stewardship activities and public disclosure of: conflicts of interest policies; the use of proxy or other advisory services; the approach to stock lending and recalling lent stock; and enhanced disclosure on collective engagement.

Direction — additional helpful direction and guidance on matters such as how to monitor investee companies performance and keep abreast of developments relevant to investee companies, considering if and when to become an insider.

Also, the UK Corporate Governance Code will also be amended slightly. The timing of the proposed revisions will be confirmed at a later stage.

<sup>102</sup> I H-Y Chiu, ‘The Interface between Financial Regulation and Corporate Governance’ (2012) 33 *Company Lawyer* 65, 66.

<sup>103</sup> I H-Y Chiu, ‘The Interface between Financial Regulation and Corporate Governance’ (2012) 33 *Company Lawyer* 65, 66.

shareholders can ever be encouraged to act more like owners with an interest in the longer-term performance of companies. Is a more systematic and continuous relationship between institutional shareholders and management about to evolve through the UK Stewardship Code? Should such a relationship even evolve at all? The Code, that has a lot of supporters, (some of who helped create it)<sup>104</sup> is the first of its kind in the world. Initially introduced in order to empower institutional shareholders to act as owners rather than “investors”, it is the most comprehensive attempt to date to bring to fruition the belief that shareholders are part of the solution rather than simply part of the main problem. Potentially, it could turn the UK into a model for stewardship guidelines worldwide.<sup>105</sup>

Shareholders are invited to challenge management far more than before. They are also invited to support the type of actions likely to result in a company’s long-term success. Instead of selling their shares at the first hurdle, they should communicate with the board and discuss the company’s strategy. Otherwise they should explain why they choose not to do so. More specifically, according to Principle 1 institutional investors are expected to publicly disclose their policy on how they will discharge their stewardship responsibilities. To ensure the monitoring is effective, they are required to hold a dialogue (where necessary) with the company’s board. Principle 2 tells investors to have a robust policy on managing conflicts of interest in relation to stewardship, and expects them to publicly disclose that policy. Its

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<sup>104</sup> For instance, the Institutional Shareholders’ Committee.

<sup>105</sup> R Sullivan, “UK Seen as Model for Stewardship Guidelines”, *The Financial Times*, 1<sup>st</sup> August 2010. However, as Nolan explains, unifying the structures for shareholder governance within companies incorporated under the national laws of a Member State is an immensely difficult task, given the diverse legal and commercial traditions with the European Union: RC Nolan, ‘Shareholder Rights in Britain’ [2006] *European Business Organisation Law Review* 549.



guidance stresses the duty upon institutional investors to act in the interests of beneficiaries when considering matters such as engagement and voting. It also requires them to put a policy in place to deal with conflicts of interest. This is followed by Principle 3: institutional investors are required to regularly monitor their companies, and as part of this monitoring they should ensure that their company's board and committee structures operate effectively and that independent directors do their jobs properly. Additionally, they should try to identify problems at an early stage to minimise any loss of shareholder value. If they have any concerns, they should raise these with the appropriate members of their board. Principle 4 requires investors to have clear guidelines in place on when and how they will actively intervene; it also expects them to regularly assess the outcomes of their interventions. If they are concerned about the company's strategy, performance or its governance, they must intervene. At first, any discussions should take place confidentially; should the board fail to respond, institutional investors should seek other ways of intervention, such as making a public statement in advance of the annual general meeting and submitting resolutions at shareholders' meetings. Principle 5 tells investors to act collectively with other investors, especially at times of serious economic stress or when the problems faced by the company jeopardise its ability to continue. According to Principle 6 investors should have a clear policy on voting, and that voting policy should be disclosed. They are also told to use all their votes and to refrain from automatically supporting the board.<sup>106</sup> Last but not least, under Principle 7 institutional investors are to report periodically on their stewardship and voting activities to their clients, and must include qualitative and quantitative information within their reports.

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<sup>106</sup> According to the guidance, they should publicly disclose their voting records and if they do not, they should explain why.

Some dismiss the UK Stewardship Code as mere exhortation or box-ticking.<sup>107</sup> There are doubts over key aspects of its application, with Lord Myners suggesting that there is “a degree of political correctness about signing up” to the Code.<sup>108</sup> Its main weakness lies in its lack of pragmatism and inability to propose realistic solutions to the primary question it identifies: investors’ incentive problems. Its idea of changing the incentive structures for the better in order to improve the monitoring mechanisms is sincere; yet, investors face significant incentive and structural problems which, provided they reveal the underlying reality about shareholding in large institutions, will prevent the Code’s anticipated aims. That is why there are considerable reservations about the influence the Code is likely and able to have. For a start, in relation to the standards against which compliance will be assessed, the ‘comply or explain’ model of the Code allows institutional investors to assess the reasons behind a firm’s non-compliance. The comply or explain policy means that companies are free to explain rather than comply, a useful option should firms regard their existing arrangements as sufficient in promoting proper accountability and board effectiveness. And yet, despite the benefits of this policy, post-crisis studies indicate that the informative quality of explanations published by those companies that choose to depart from corporate governance codes, is not satisfactory.<sup>109</sup> The Code expects shareholders to adopt their own policies on their

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<sup>107</sup> For an interesting discussion on its ‘box-ticking’ function, see: T Jackson, “A Coded Response in Game of Heading off Brussels”, *The Financial Times*, 24 October 2010.

<sup>108</sup> He further states that although it is to be welcome, there has been too much focus on getting as many signatories as possible. Lord Myners interview, available at [http://news.bbc.co.uk/1/hi/programmes/politics\\_show/7892136.stm](http://news.bbc.co.uk/1/hi/programmes/politics_show/7892136.stm) [accessed 10 February 2011].

<sup>109</sup> Study found in European Commission, “Green Paper: The EU Corporate Governance Framework”, COM(2011) 164 final, 5 April 2011, available at [http://ec.europa.eu/internal\\_market/company/docs/modern/com2011-164\\_fr.pdf#page=2](http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_fr.pdf#page=2) [accessed 18 June 2016], 3.

stewardship responsibilities (Principle 1), conflicts of interest (Principle 2), intervention (Principle 4), collective action (Principle 5) and voting (Principle 6); yet, crucially this is contrary to the UK Corporate Governance Code, introduced in 2010, which imposes objective standards on issues such as the structure and composition of the board. In fact, in so doing, the Code sets a common basis against which ‘comply or explain’ operates.<sup>110</sup> As noted, the credibility of a “comply or explain” obligation set against self-selected standards is consequently open to question.<sup>111</sup> The restricted nature of the legal obligation for disclosing whether an institution has “complied or explained” potentially undermines the scope of the Code’s application; it also undermines its status as an industry-wide standard.<sup>112</sup>

There are further complications to investors’ effective stewardship. Although there is nothing new about the matter of shareholder engagement, the question is now set during a different set of circumstances. These circumstances are possibly not as advantageous as previously.<sup>113</sup> The decline in insurance companies and pension fund holdings as well as the increase in sovereign wealth and hedge funds is one important detail here. In addition, foreign investors are now much more important in terms of size, holding more than 40% of listed companies;<sup>114</sup> yet, the

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<sup>110</sup> I MacNeil, ‘Activism and Collaboration among Shareholders in UK Listed Companies’ [2010] *Capital Markets Law Journal* 419, 436.

<sup>111</sup> I MacNeil, ‘Activism and Collaboration among Shareholders in UK Listed Companies’ [2010] *Capital Markets Law Journal* 419, 436.

<sup>112</sup> A Smith, “Crisis Highlights Need to Step up Governance”, *The Financial Times*, 27 March 2011, 4.

<sup>113</sup> BM Hannigan, ‘Board Failures in the Financial Crisis: Tinkering with Codes and the Need for Wider Corporate Governance Reforms: Part 2’ [2012] 33 *Company Lawyer* 35, 36.

<sup>114</sup> As shown by the ONS Share Ownership Survey 2008 (January 2010), for the year ending December 2008, 41.5% of shares listed on the UK Stock Exchange were owned by investors from outside the UK. Insurance companies and pension funds holding, respectively, 13.4% (down from 14.7% at end 2006 and 21% at end 2000) and 12.8% (12.7% at end 2006 and 17.7% at end 2000): see BM Hannigan, ‘Board Failures in the Financial

Code applies only to the domestic market. This points to its failure to recognise that times have changed and that the numbers of foreign investors have significantly increased. By and large, the shareholder base has been fragmenting; large parts of it have no rational reason to actively engage with company boards.<sup>115</sup> Expecting participation and engagement from foreign investors is really difficult, primarily because they are not subject to domestic political pressure to actually become involved. Also, as Hannigan says, as a result of stock lending practices it is difficult to isolate those shareholders with a real economic interest because of their distinct investment time scales and strategies. Therefore, it is unrealistic to expect increased participation and activism within such a diverse pool of investors, so reducing the scope for common action.<sup>116</sup>

In addition, the model of engagement envisaged by the Stewardship Code is one in which long-term institutional investors engage with portfolio companies for the purpose of improving their long-term returns.<sup>117</sup> However, institutions generally invest in order to receive a short-term financial return on their investment. Short-termism has been defined as “[...] foregoing economically worthwhile investments with longer-term benefits in order to

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Crisis: Tinkering with Codes and the Need for Wider Corporate Governance Reforms: Part 2’ [2012] 33 Company Lawyer 35.

<sup>115</sup> Such as the fast traders, the passive and exchange-traded funds and so forth. See T Jackson, “A Coded Response in Game of Heading off Brussels”, *The Financial Times*, 24 October 2010.

<sup>116</sup> BM Hannigan, ‘Board Failures in the Financial Crisis: Tinkering with Codes and the Need for Wider Corporate Governance Reforms: Part 2’ [2012] 33 Company Lawyer 35, 37.

<sup>117</sup> I MacNeil, ‘Activism and Collaboration among Shareholders in UK Listed Companies’ [2010] *Capital Markets Law Journal* 419, 424.

increase reported earnings for the current period”.<sup>118</sup> The focus on the short-term has occurred primarily for two reasons. First, due to the increased weight placed on the full reporting of company performance on a quarterly basis; second, as a result of the shareholder pressure for gains.<sup>119</sup> Interestingly, the OECD’s report has found that in some instances shareholders have been as concerned with short termism as managers and traders, neglecting the effect of excessive risk taking policies.<sup>120</sup> Conversely, investors’ dedication and focus on short-termism does not sit well with the section 172 of the UK Companies Act 2006, which tells directors to be inclusive in their approach and to consider the company’s sustainable growth. One of the most significant and controversial provisions, section 172 attracted the majority of the debate through the various stages that eventually produced the Companies Act. It specifies that the director’s duty is to promote the company’s success for the benefit of the members as a whole. In defining “success” directors must make decisions that are for the long-term benefit of the members as a whole.<sup>121</sup> Yet, it is not easy for investors themselves to measure

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<sup>118</sup> International Monetary Fund (IMF), *Global financial stability report: responding to the financial crisis and measuring systematic risks*, 2009, available at <http://www.imf.org/external/pubs/ft/gfsr/2009/01/pdf/text.pdf> [accessed 06 June 2016], xxiii.

<sup>119</sup> Keay notes that “*while hedge funds are the most aggressive, this is a system-wide phenomenon.*”: A Keay, ‘The Global Financial Crisis: Risk, Shareholder Pressure and short-termism in Financial Institutions’ [2010] 30 Working paper, Centre for Business Law and Practice, School of Law, University of Leeds 1, 14.

<sup>120</sup> Organisation for Economic Cooperation and Development (OECD), *Corporate Governance and the Financial Crisis – Conclusions and Emerging Good Practices to Enhance Implementation of the Principles*, 2010, available at <http://www.oecd.org/daf/corporateaffairs/corporategovernanceprinciples/44679170.pdf> [accessed 13 May 2016].

<sup>121</sup> *Mills v. Mills* (1938) 60 CLR 150 (High Court of Australia).

the performance of a company when a long-term approach is implemented.<sup>122</sup> This can result in investors focusing on short-term indicators, such as quarterly reports and share prices, despite the fact that such indicators may not reflect adequately the underlying value of the company.<sup>123</sup> Goodpaster summarises this well; he suggests that “[i]n business, there can be significant pressure for performance that potentially drives unproductive short-term behaviour. The goal of maximising shareholder value has become the justification for short-termism, and more specifically for fast personal enrichment. Institutions frequently get into financial difficulties by trying to grow without a well-understood mission and without clarity over purpose.”<sup>124</sup> Put simply, it is not in the genetic makeup of institutional investors to promote long-term goals of the firm in which they invest.

A more practical limitation of the Stewardship Code concerns the issue of cost. In a typical dispersed investment environment (such as that of the UK) activism typically equates to cost. This is borne by the ‘active’ investor and is relative to the size of shareholding. At the same time however, the passive ‘free-riders’ enjoy the engagement efforts of the more energetic shareholders;<sup>125</sup> this inharmonious scenario summarises the classic ‘free-rider’ problem that

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<sup>122</sup> A Keay, ‘The Global Financial Crisis: Risk, Shareholder Pressure and short-termism in Financial Institutions’ [2010] 30 Working paper, Centre for Business Law and Practice, School of Law, University of Leeds 1, 14.

<sup>123</sup> UK’S Department of Business Innovation and Skills, *A long-term Focus for Corporate Britain – A Call for Evidence*, Consultation paper, 2010, available at <http://www.bis.gov.uk/assets/biscore/business-law/docs/1/10-1225-long-term-focus-corporate-britain> [accessed 16 May 2016, para 4.23]; A Keay, ‘The Global Financial Crisis: Risk, Shareholder Pressure and short-termism in Financial Institutions’ [2010] 30 Working paper, Centre for Business Law and Practice, School of Law, University of Leeds 1.

<sup>124</sup> KE Goodpaster, *Conscience and Corporate Culture* (Blackwell Publishing, 2007), 118.

<sup>125</sup> I MacNeil, ‘Activism and Collaboration among Shareholders in UK Listed Companies’ [2010] *Capital Markets Law Journal* 419, 428.

typically occurs in corporate governance. In addition, since institutions routinely pursue the diversification of risk, they have fairly rigid limits on the size of any single holding in any one company; as Davies explains, this results in a limited benefit enjoyed by the institution that decides to act on its own to challenge any perceived managerial weaknesses.<sup>126</sup> The benefits gained by the closer monitoring of managerial performance are therefore outweighed by the costs of such a policy.<sup>127</sup>

The Stewardship Code introduces a quasi-regulatory framework but makes few substantive changes.<sup>128</sup> Comparatively it lacks the objective focus of the UK Corporate Governance Code, which facilitates more practical and effective approaches to the typical corporate governance problems, such as the annual re-election of directors;<sup>129</sup> indeed, challenging directors' under-performance can result in the formal external evaluation of boards with reports to shareholders.<sup>130</sup> Further, the annual re-election of directors would make a stronger safeguard for investors because of their power to vote against re-appointment. Therefore, the best way would be to view the Stewardship Code as underpinning the UK Corporate Governance Code

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<sup>126</sup> PL Davies, 'Institutional Investors: a UK View' [1991] 57 *Brooklyn Law Review* 129, 140.

<sup>127</sup> PL Davies, 'Institutional Investors: a UK View' [1991] 57 *Brooklyn Law Review* 130.

<sup>128</sup> I MacNeil, 'Activism and Collaboration among Shareholders in UK Listed Companies' [2010] *Capital Markets Law Journal* 419, 438.

<sup>129</sup> According to a post-crisis report, 70% of FTSE 350 companies have introduced annual re-election of directors in anticipation of the new UK Corporate Governance Code (available at [http://www.grant-thornton.co.uk/pdf/corporate\\_governance.pdf](http://www.grant-thornton.co.uk/pdf/corporate_governance.pdf)). The review covers the annual reports of 298 UK FTSE 350 companies, with years ending between May 2010 and April 2011.

<sup>130</sup> K Burgess, "Indignant Investors Flex Voting Muscles", *The Financial Times*, 6 May 2009; B Master and J Grant, "Boards Warned over Backlash on Executive Pay", *The Financial Times*, 6 January 2009; BM Hannigan, 'Board Failures in the Financial Crisis: Tinkering with Codes and the Need for Wider Corporate Governance Reforms: Part 2' [2012] 33 *Company Lawyer* 35.

rather than as a separate initiative in its own right.<sup>131</sup>

#### **IV. CONCLUSION**

Many of the intellectual beliefs held in the years leading up to the financial crisis – that markets are self-equilibrating, that directors' risky ventures are valuable to firms, that directors' training or shareholders' involvement with management are needless corporate governance tools, have been greatly challenged in the past decade. Certainly, the question of how far poor practices led to the eventual catastrophe has been one of the most controversial since the global crisis' emergence. In the aftermath, there are crucial questions about the way forward for the supervisory regime. There are vitally important issues about directors' training and accountability. Shareholders' level of engagement with their companies is also a matter that provokes a great deal of concern.

Almost a decade on, there are significant lessons to be learnt. Crucially, in the years leading up to the crisis the levels of supervision and the ability of the regulatory authorities to adequately meet their monitoring role have deeply disappointed. The regulator is not the advocate for the City, nor part-regulator, part-sponsor for the industry. The authorities must become more courageous in the fulfilment of their regulatory and supervisory duties and must not shy away from using their enforcement sanctions and powers. Importantly, the regulator must cease relying on the assumption that management and boards are better placed to assess the appropriateness of specific individuals to undertake particular roles. Rather, the regulator must review the qualifications of senior directors periodically. It must also keep a close eye

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<sup>131</sup> This was suggested by MacNeil in I MacNeil, 'Activism and Collaboration among Shareholders in UK Listed Companies' [2010] Capital Markets Law Journal 419, 438.



on the conduct of large firms. Negligent conduct and general unfitness must be included in the matters assessed and considered by the FCA in the imposition of financial penalties. Still, for these changes to materialise more thorough tests should be developed to assess questions of competence. Nevertheless, a regulatory body needs sufficient resources and time to monitor large institutions; under-resourcing and shortage of expertise, notably in the areas of prudential banking experience and financial data analysis is unjustifiable. It is therefore important to tackle deficiencies in terms of adequate supervisory staff resources if they are to expect the regulators to do their job right.

As far as the internal participants of corporate governance are concerned, there are crucial issues to consider. For a start, there is the matter of directors' accountability and training. The shortcomings identified by the numerous post-crisis reports point to the absence of a healthy set of skills and qualifications. A legal requirement for the annual training of directors, particularly of large institutions would be a positive step. Although training can be a rather pricey corporate governance device, the social benefits and benefits to the broader economy should far outweigh the cost of training itself. In addition, the current disqualification regime does not appear to strike the right balance. With both the banks and the bankers escaping from the consequences of their reckless risk-taking, there is a pressing need to tighten the law here; only then can the system ensure that the right people are made accountable for their actions. Last but not least, empowering investors can, in theory at least, be a worthy goal; after all, the typical investor appears to have interests that coincide with the interests of the large firm. Nonetheless, in practical terms it is doubted whether shareholder stewardship should be encouraged. There appear to be several reasons for investors' failure to do well in a stewardship role; perhaps that is why the UK Stewardship Code is yet to convince that it can make a noteworthy contribution to outcomes. Treating shareholders as the ideal management

monitors is simply the wrong approach; it is a romantic idea far removed from the reality that governance and shareholders in large companies exist separately. The promotion of a more systematic relationship between institutional investors and management is a costly use of company resources, and by preventing investors from evaluating most board decisions the separation between ownership and control has a valid efficiency justification.