ARTICLES

International Financial Instability and the Financial Stability Board. ............................ G.A. Walker

Foreign Corrupt Practices Act Compliance Issues for Import/Export Operations ..................... John F. McKenzie

The Role of External Auditors in Bank Supervision: A Supervisory Gatekeeper? .................... Dr. Dalvinder Singh

Harmonizing the Shield to Corporate Liability: A Comparative Approach to the Legal Foundations of Corporate Compliance Programs from Criminal Law, Employment Law, and Competition Law Perspectives .......................................................... Gönenç Gürkaynak and Derya Durlu

Implications of the Interim Accord Ruling of the International Court of Justice .................... Halil Rahman Basaran

The Rules of the Game for Eurozone Debtors: Will the 21st Century See Effective Reform or Financial Calamity? ................................................... Cody T. Perlmeter
The International Lawyer
A Quarterly Publication of the ABA/Section of International Law

Section of International Law
2013-2014

Officers:
Chair, Gabrielle M. Buckley
Chair-Elect, Marcelo E. Bombau
Vice Chair, Lisa J. Savitt
Finance Officer, Sara P. Sandford
Liaison Officer, Adam B. Farlow
Membership Officer, Robert L. Brown
Secretary/Operations Officer, William B.T. Mock, Jr.
Programs Officer, Steven M. Richman
Rule of Law Officer, Isabella Danuta Bunn
Policy/Government Affairs Officer, Yee Wah Chin
Publications Officer, Catherine M. Doll
Diversity Officer, Lelia Mooney
Technology Officer, Dixon F. Miller
Communications Officer, Christine M. Castellano
Immediate Past Chair, Barton Legum
Delegate/Member-At-Large, Glen P. Hendrix
Delegate/Member-At-Large, Jeffrey B. Golden
Senior Advisor, Michael H. Byowitz
ABA Board of Governors Liaison, Sandra R. McCandless

Members of the Council:
Section Delegate, Glen P. Hendrix
Section Delegate, Jeffrey B. Golden
Co-Editor-in-Chief of The International Lawyer, John B. Attanasio
Co-Editor-in-Chief of The International Lawyer, Marc I. Steinberg
Editor-in-Chief of the International Law News, Richard L. Field
Former Section Chair, Salli A. Swartz
Former Section Chair, Aaron Schildhaus
Former Section Chair, Michael E. Burke
Young Lawyer Division Representative, Hong Tang
Law Student Division Liaison, Joseph David Prestia
Congressional Liaison, Maximilian Trujillo
Non-Governmental Organization Liaison, Theresa Lynn Harris
Public International Law Liaison, Katherine D. McManus
Private International Law Liaison, Harold S. Burman
Alt. Private International Law Liaison, Keith Loken
International Trade Law Liaison, John T. Masterson, Jr.
Non-U.S. Lawyer Representative, Patricia O'Brien

Published in cooperation with
SMU Dedman School of Law
Council Members-At-Large:  
Alex B. Blumrosen 2014  
Ronald J. Bettauer 2014  
David D. Caron 2014  
Ronald A. Cass 2014  
Linda A. Klein 2014  
Hans Corell 2015  
David M. Crane 2015  
Eli Whitney Debevoise, II 2015  
Lord Peter Goldsmith 2015  
A. Joshua Markus 2015  
Delissa Anne Ridgway 2015  
David P. Stewart 2015  
Lorraine C. Arkfeld 2016  
Curtis A. Bradley 2016  
Deborah Enix-Ross 2016  
Peter W. Galbraith 2016  
David Scheffer 2016  
Robert A. Stein 2016  
Louise Ellen Teitz 2016

Division Chairs:  
Africa/Eurasia Division, Nancy Kaymar Stafford  
Americas/Middle East Division, Carlos Velaquez-de-León  
Business Law I Division, William R. Black  
Business Law II Division, Patrick L. Del Duca  
Business Regulation Division, David A. Schwartz  
Constituent Division, Gretchen Chantelle Bellamy  
Disputes Division, M. Cristina Cardenas  
Finance Division, Marcos Ríos  
Legal Practice Division, Saul R. Feilbogen  
Public International Law I Division, Christopher R. Kelly  
Public International Law II Division, John W. Boscariol  
Tax, Estate & Individuals Division, Lisa Ryan

The Year in Review Co-General Editors:  
Cindy Galway Buys, Kim D. Chanbonpin, and Mark E. Wojcik
CONTENTS

ARTICLES

International Financial Instability and the Financial Stability Board ......................... G.A. Walker 1

Foreign Corrupt Practices Act Compliance Issues for Import/Export Operations .............. John F. McKenzie 43

The Role of External Auditors in Bank Supervision: A Supervisory Gatekeeper? .... Dr. Dalvinder Singh 65

Harmonizing the Shield to Corporate Liability: A Comparative Approach to the Legal Foundations of Corporate Compliance Programs from Criminal Law, Employment Law, and Competition Law Perspectives ...................... Gönenç Gürkaynak and Derya Durlu 99

Implications of the Interim Accord Ruling of the International Court of Justice ........ Halil Rahman Basaran 123

International Financial Instability and the Financial Stability Board

G.A. WALKER

Abstract

The reconstituted Financial Stability Board has made some of the most substantial and significant sets of contributions to the new regulatory reform agenda under construction at the international level following the global financial crisis beginning in Autumn 2007. The various packages of measures adopted cover all of the principal areas of policy revision not dealt with by specific sector technical committees such as the Basel Committee on Banking Supervision and its Basel III capital, liquidity, and leverage program. The number and quality of the papers produced by the Board is a remarkable achievement and testimony to the expertise and commitment of all of the individual participants involved. Further initiatives could nevertheless be undertaken to ensure that this work is as complete, coherent, effective, and accessible as possible.

One of the most significant reform initiatives adopted following the global financial crisis, beginning in autumn 2007, was the establishment of the Financial Stability Board (FSB) in April 2009. The FSB was created through an extension of the mandate and membership of the earlier Financial Stability Forum (FSF), which had originally been set up in 1999 following the earlier Asian Crisis beginning in July 1997. The Asian and global financial crises were ten years and one month apart with the FSB being set up ten years and two months after the original FSF.

The unique nature of the FSF and FSB is principally attributable to the mixed membership and the extended international, regional, and national expertise and experience,
which the mixed membership has made available.\(^6\) The FSF consisted of the Heads of the Finance Ministries, central banks, and regulatory authorities of each of the G7 countries;\(^7\) This group was later extended to include the full G20 with the replacement of the FSF by the FSB.\(^8\) All of the principal International Financial Institutions (IFIs) and technical standard setting bodies and committees (SSBs) are also represented with the European Commission and European Central Bank (ECB).\(^9\) This brings together all of the key expertise in the financial area at the domestic, European, and international levels.

The initial work program of the FSF appears to have been relatively wide in scope although limited in terms of substantive regulatory content, with the focus on key areas of concern following the Asian financial crisis, including global capital flows, off-shore financial centers (OFCs), and highly leveraged institutions (HLIs).\(^10\) The FSF’s most significant single contribution was the establishment of a “Compendium of Standards” governing all of the principal aspects of international financial regulation.\(^11\) As well as increase the membership to include the full G20, the work of the FSF has been extended substantially following the establishment of the FSB and the addition of a number of new areas of vulnerability and response work following the global financial crisis.\(^12\)

The purpose of this paper is to consider the origins of the FSF and its original work program. The need for replacing the FSF with the FSB is examined and its substantially expanded areas of activity reviewed. Each of the key sets of principal reform activity is examined in further detail as well as the revised content of the Compendium of Standards and the separate work undertaken by the FSB in terms of implementation and adherence assessed. A series of provisional comments and conclusions are drawn with regard to the contribution of the FSB to the construction of a new, meaningful, and effective regulatory reform agenda following the recent crises.

I. Asian Financial Crisis and FSF

The FSF had been set up following the Asian financial crisis, which began with the devaluation of the Thai Baht on July 2, 1997, and with the Bank of Thailand having been forced to abandon its peg with the US dollar.\(^13\) The crisis in Thailand quickly spread to other Asian economies including Malaysia, Indonesia, and the Philippines, as well as Taiwan, Hong Kong, and South Korea and then Japan.\(^14\) These Asian “Tiger” economies had

---

\(^{6}\) Walker, supra note 4 at 308.

\(^{7}\) Id.

\(^{8}\) Draghi, supra note 2.


\(^{10}\) See Walker, supra note 4, at 311-13.

\(^{11}\) Id. at 317.

\(^{12}\) See Draghi, supra note 2.

\(^{13}\) The devaluation led to an initial recovery in stock market prices although concerns increased with the effect of the revaluation on financial exposures, continued volatility, and high interest rates. The Thai crisis was triggered by “unsound macroeconomic policy and fundamentally weak banking practices and supervision” accompanied by economic slowdown, a speculative attack on the currency, and political instability. Walker, supra note 4, at 279 n.40.

\(^{14}\) The value of the Malaysian, Indonesian, and Philippine currencies fell by 25-33 percent, with the Taiwan dollar having to be devalued; this led to speculative attacks on the Hong Kong dollar. Id. at 279.
enjoyed substantial growth during the earlier 1990s, although international markets had been shocked by the instability in Mexico in 1994; this vulnerability subsequently spread to Japan, Russian, and then Latin America.

The size and severity of the Asian financial crisis attracted significant political attention, with the G7 Heads of Government and Financial Ministers assuming a lead in the response efforts undertaken. The G7 Finance Ministers issued an important report on Financial Stability in May 1998, although the G7 had taken an interest in financial markets since the Halifax Summit in 1995 following the collapse of Barings Bank in the UK. Separate papers were issued by the G10, G22, and International Monetary Fund (IMF), with other government and private reform initiatives being announced. UK

15. Average growth was 9 percent between 1992 and 1995, with an average of 5 percent GNP between 1965 and 1990. Id. at 278-79.
16. Mexico had to devalue the Peso on December 20, 1994, and then allow it to float following the assassination of the presidential candidate Colosio. Then, $28 billion in short-term government tesobones had to be closed out with the assistance of the United States and International Monetary Fund. Id. at 277.
17. Japan issued poor economic figures in the middle of 1998, with Russia defaulting on its debt in August 1998. Id. at 279.
18. Id. at 282. The G7 was originally set up as the Group of Six in 1975 with France, West Germany, Italy, Japan, the UK, and the US, with the G7 being created the following year with Canada. Stephanie Lee & Alexandra Silver, The Group of Eight (G8) Industrialized Nations (March 27, 2009), http://www.cfr.org/global-governance/group-eight-g8-industrialized-nations/p10647#p6. This would be referred to as the G8 with Russian from 1997. Id. This would be expanded to form the G20 in September 1999, following the global financial crisis, with South Africa, Mexico, Brazil, Argentina, China, South Korea, India, Indonesia, Turkey, Saudi Arabia, and Australia joining with the European Union. G20, What is the G20?, http://www.g20.org/docs/about/about_G20.html (last visited June 7, 2013).
22. Walker, supra note 4, at 273. Three working groups have been set up by the G22 on Enhancing Transparency and Accountability, Strengthening Financial Systems, and Managing International Financial Crises. Walker, supra note 4, at 289. The G22 was set up in 1997 to consider reform of the global financial system following the Asian crisis and consisted of the G8 and 14 additional countries. IMF Factsheet, supra note 21; Walker, supra note 4, at 273 n.14. It was originally referred to as the Willard Group and was expanded to consist of the Group of 33 in 1999. It was then superseded by the G20. IMF Factsheet, supra note 21.
23. The IMF produced a framework paper that identified a number of categories of issues considered to be of importance in connection with financial sector reform. David Folkerts-Landau & Carl-Johan Lin-
Chancellor of the Exchequer, Gordon Brown, recommended the establishment of a new permanent Standing Committee for Global Financial Regulation in autumn 1998.\textsuperscript{24} The G7 Finance Ministers and Central Bank Governors agreed to commission a report by Hans Tietmeyer, former President of the German Bundesbank,\textsuperscript{25} to consult and consider new structures necessary to enhance cooperation between national and international supervisory bodies and international financial institutions.\textsuperscript{26} A formal mandate was issued the same month,\textsuperscript{27} with a final report being produced in February 1999.\textsuperscript{28} This explained the earlier international financial architecture and split responsibilities with the need for a more integrated approach being highlighted.\textsuperscript{29} The report stressed the need to monitor domestic vulnerabilities, which could generate larger systemic threats through evolving global conditions.\textsuperscript{30} The report concluded that fundamental institutional change was not required although it was necessary to establish a new “Financial Stability Forum” to meet regularly to identify and assess relevant issues and vulnerabilities concerning the global financial system.\textsuperscript{31} This led to the establishment of the FSF by the G7 Ministers and Governors at the Bonn meeting in February 1999, with the FSF holding its first meeting in Washington on February 14, 1999.\textsuperscript{32}

The FSF was originally set up with thirty-five representatives from the G7 countries, the IFIs, and the SSBs.\textsuperscript{33} Its original Chairman was Andrew Crockett, former General Manager of the BIS.\textsuperscript{34} The principal objective “was to create a new contact vehicle through which all of the separate bodies. . . could meet and exchange views on systematically important issues.”\textsuperscript{35} The initial general activities of the FSF were concerned with “disclosure, training, and standards.”\textsuperscript{36} Three initial working groups were set up on highly leveraged institutions (HLIs), capital flows, and off-shore financial centers (OFCs),\textsuperscript{37} with a separate task force on implementation and a Study Group on Deposit Insurance.\textsuperscript{38} The FSF also constructed the first global Compendium of Standards through the collection of the most important papers issued by each of the principal IFIs.

\textsuperscript{28} TIETMEYER, supra note 25, § 1.
\textsuperscript{29} See id. § 3.1.
\textsuperscript{30} Id.
\textsuperscript{31} Id. § 4.
\textsuperscript{32} Walker, supra note 4, at 307.
\textsuperscript{33} Id. at 308.
\textsuperscript{34} Id. at 307.
\textsuperscript{35} Id. at 309.
\textsuperscript{36} Id. at 316.
\textsuperscript{38} Walker, supra note 4, at 315.
and SSBs, including on public sector transparency, banking, securities, insurance, corporate governance, and payment and settlement.\textsuperscript{39} This was set up as a form of virtual global financial rulebook using html links to all of the original documents on each of the member institution’s websites.\textsuperscript{40} A sub-set of twelve key standards for sound financial systems was subsequently added to the Compendium.\textsuperscript{41}

The creation of the FSF in 1999 was an important development in the construction of a “new international financial architecture.”\textsuperscript{42} This was the first initiative to attempt to deal with the fundamental global market and local control conflict that arises.\textsuperscript{43} A fundamental institutional, organizational, and operational gap exists in terms of international financial market supervision and control, which has to be managed and discharged at the national level.\textsuperscript{44} The FSF brought representatives from the national finance ministries, central banks, and supervisory authorities together for the first time with all of the principal IFIs and SSBs.\textsuperscript{45} While its initial original research work was fundamentally limited, it was able to draw all of the main international financial standards together for the first time with its Compendium.\textsuperscript{46} The earlier inherent advantages of the original FSF model were retained but extended with its replacement by the FSB and with its work load being substantially extended to include all major areas of potential concern following the global financial crisis.\textsuperscript{47}

II. Global Financial Crisis

The background causes to the global financial crisis were referred to by the G20 in the first Summit Declaration in Washington in November 2008.\textsuperscript{48} The crisis was generally stated to have occurred as a result of a search for yield, vulnerability and policy, regulatory, and supervisory failure.\textsuperscript{49} The principal factors behind the crisis had been reviewed

\textsuperscript{39} Id. at 317-18.
\textsuperscript{40} Fin. Stability Bd., \textit{About the Compendium of Standards}, http://www.financialstabilityboard.org/cos/index.htm (last visited June 9, 2013).
\textsuperscript{42} Walker, supra note 4, at 273, 307.
\textsuperscript{43} Id. at 273. A single global market in financial services has been created, although this has to be controlled on a local domestic basis using national regulatory and supervisory systems. Id. at 306.
\textsuperscript{44} Id. at 305-06.
\textsuperscript{46} Id. at 4.
\textsuperscript{47} Id. at 3, 5.
\textsuperscript{49} “Market participants [had sought] higher yields with an inadequate appreciation of risk[s]” and failure “to exercise proper due diligence” following a period of strong global growth, capital flow, and stability. Vulnerabilities were created through “weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products” and excessive leverage. “Policy-makers, regulators[,] and supervisors in some advanced countries[,] did not adequately appreciate and [manage] the risks building up [within] financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.” Excesses and severe market disruption followed from major underlying factors, including “inconsistent and insufficiently coordinated macroeconomic policies [and] inadequate struc-
in further detail by the FSF in its report on *Enhancing Market and Institutional Resilience* in April 2008.\(^{50}\)

The FSF explained the crisis in terms of market turmoil, underlying weaknesses in risk management and underwriting, and mismanagement by some firms of the originate-to-distribute (OTD) model.\(^{51}\) Low interest rates and abundant liquidity had increased borrower, investor, and intermediary risk and leverage with the financial system not being able to manage the new risks created through expansion and financial innovation, especially with collateralized debt obligations (CDOs) and mortgage-backed securities (MBSs).\(^{52}\) A weakening in credit standards within the U.S. subprime mortgage market and household and corporate lending more generally led to a mispricing of risk by banks, investors, and Credit Rating Agencies (CRAs).\(^{53}\)

The value of subprime-related indices began to fall sharply with rising delinquencies from early 2007, which triggered a wider downturn in market risk-taking and withdrawal of support for off-balance conduits and structured investment vehicles (SIVs).\(^{54}\) This resulted in a sharp contraction in liquidity and subsequent increased risk aversion, market uncertainty, and deleveraging.\(^{55}\) The report refers to continuing difficulties being suffered in markets in April 2008, which was eight months after the crisis began,\(^{56}\) although these problems subsequently continued for five years afterwards.\(^{57}\)

The report accepts that some market adjustment was inevitable, especially with a turn in the credit cycle and weakening of the U.S. housing market, although this was much more severe due to the scale of the adjustment required, especially through accumulated weak-tural reforms" that had “led to unsustainable global macroeconomic outcome.” Id. The G20 April annex, the *Declaration on Strengthening the Financial System*, contains specific provisions with regard to expanding the FSF, international cooperation, prudential regulation, regulatory scope, compensation, tax havens and non-cooperative jurisdictions, accounting standards, CRAs and follow-up work. G20 London Summit 2009, London, Eng., Apr. 1-2, 2009, *Declaration on Strengthening the Financial System*, 1-2, 4 (Apr. 2, 2009), available at http://www.treasury.gov/resource-center/international/g20/Documents/London%20April%202009%20Fin_Depgs_Fin_Reg_Annex_020409_-_1615_final.pdf.


51. Id. at 1.

52. Global low risk premia and “low expectations of future volatility” increased from 2003, especially with the growth in the use of CDOs and perceived higher liquidity through the “pooling and tranching of credit assets,” credit enhancement, and increased credit protection through the credit default swap market. This was accompanied by the use of off-balance sheet funding and investment vehicles issuing mortgage-backed securities (MBSs) with low capital and liquidity support. Id. at 5.

53. Id.

54. Delinquencies produced a fall in index prices, which resulted in losses and margin calls on highly rated subprime products. Multiple downgrades were imposed by CRAs on subprime related structured products with money-market investors refusing to purchase asset-backed commercial paper (ABCP) to roll over conduit and structured investment vehicles (SIV) debt from August 2007. Id. at 6.

55. Sponsoring banks had to support conduits and SIVs, which resulted in a sharp contraction in liquidity on interbank markets and rise in term premia or LIBOR rates. Valuation losses were suffered in broad asset classes with fears of fire sales and banks’ contingency plans not being able to sustain their continued market losses. Capital levels shrank as banks realabsorbed assets and recorded large valuation losses. Id.

56. Id. at 6.

nesses in risk management and underwriting standards. Underlying weaknesses arose specifically through poor underwriting standards, failures in firm risk management practices, poor investor due diligence, defective performance by CRAs (especially with regard to structured products), incentive distortions, disclosure weaknesses, and “feedback effects” between valuation and risk-taking.

The report also specifically refers to weaknesses in regulatory frameworks with authorities failing to take effective “countervailing action” having “overestimated the strength and resilience of the financial system.” The report accepts that securitization markets and the OTD intermediation model were not defective in themselves, although difficulties arose through increased leverage and complexity with weak credit standards. Some firms were better than others in managing the consequent write-down and restructuring required; a number of specific concerns arose with regard to misaligned incentives, lack of transparency, poor risk management, and the usefulness and transparency of credit ratings.

The FSF proposed that specific action be taken in the five key areas of (1) strengthened oversight of capital, liquidity, and risk management; (2) enhanced transparency and valuation; (3) credit rating adjustment; (4) strengthened official responsiveness to risk; and (5) increased arrangements to deal with financial system stress. A number of provisional recommendations were made to improve regulatory practices in each of these areas.

The FSF Chairman issued an Update on the Implementation of the FSF’s Recommendations to the G8 Finance Ministers in June 2008, along with other papers being issued on procyclicality and provisioning. The FSB issued a report on Improving Financial Regulation in September 2009, which contained a review of progress achieved and continuing work underway.

---

59. This can be understood in terms of cyclic effects with rating downgrades, forced sales, mark to market accounting, margin calls, and further downgrades. See id. at 6-9.
60. Id. at 9.
61. The OTD model allowed originators “greater capital efficiency, enhanced funding . . . and lower earnings volatility,” with investors having increased choice, diversification, and risk matching. Borrowers also benefited from increased credit availability, product choice, and lower borrowing cost. Difficulties nevertheless arose through increased leverage, maturity, and liquidity risk through conduit and SIV asset holdings (including “through contingent credit lines, reputational links, revenue risks, and counterparty credit exposures”), continuing liquidity exposure, and large retained pipeline exposures. Id. at 9-10.
62. Id. at 10.
63. Id. at 2.
64. See id. at 12-62.
67. The report covered strengthening the global capital framework, making global liquidity more robust, reducing the moral hazard of systemically important institutions, strengthening accounting standards, improving compensation practices, expanding financial system oversight, strengthening the robustness of the
III. Financial Stability Board

The decision to establish the FSB was made at the London G20 Summit in April 2009 hosted by the then-British Prime Minister, Gordon Brown. This set out the core objectives for the FSB with a separate Declaration on Strengthening the Financial System and Declaration on Delivering Resources through the International Financial Institutions attached to the Leaders’ Statement. The Leaders’ Statement declared that the FSB would consist of all G20 countries, FSF members, Spain, and the European Commission, with the FSB collaborating with the IMF to provide an early warning of macroeconomic and financial risks and to take necessary action. It would “reshape” regulatory systems to allow authorities to identify and take account of macro-prudential risks and “to extend regulation and oversight to all systemically important financial institutions, instruments and markets.”

The 2009 London Summit followed the initial G20 Summit in November 2008, hosted by then-President George Bush, which examined the initial causes of the crisis and outlined possible areas for reform.


69. Leaders’ Statement, supra note 68, at ¶ 4.


71. Leaders’ Statement, supra note 68, ¶ 15.

72. The leaders agreed to implement the FSF’s principles on pay and compensation, to improve the quality, quantity, and international consistency of banking in the financial system “once recovery is assured,” “to take action against non-cooperative jurisdictions,” including tax havens, to improve global accounting valuation and provisioning standards and to “extend regulatory oversight and registration to Credit Rating Agencies” (CRAs). Id.


75. The FSB considered risks, vulnerabilities, and responses to the international financial system, and progress towards implementing reforms. It also addressed further work that is required to improve financial regulation with specific reference to strengthening the global capital framework, making global liquidity more robust, reducing moral hazard and strengthening cross-border resolution capacity, strengthening accounting standards, improving compensation practices, expanding oversight of the financial system, strengthening the OTC derivatives markets, re-launching securitization on a sound basis, and adhering to...
on January 9, 2010. The FSB set up a plenary of full members with a steering committee and three standing committees, including the Committee on the Assessment of Vulnerabilities (SCAV), the Committee for Supervisory and Regulatory Co-operation (SCSRC), and the Committee for Standards Implementation (SCSI). The Secretariat is located at the Bank for International Settlements (BIS).

The FSB is a forum of national supervisors and regulatory authorities for the world’s largest financial systems and key international financial institutions. The FSB was established in May 2009 to address weaknesses in the international financial system identified by the 2007–08 financial crisis. It is headquartered in Basel, Switzerland.

The FSB set up a plenary of full members and three standing committees, including the Committee on the Assessment of Vulnerabilities (SCAV), the Committee for Supervisory and Regulatory Co-operation (SCSRC), and the Committee for Standards Implementation (SCSI). The Secretariat is located at the Bank for International Settlements (BIS).
Sixty-four agencies are represented on the FSB, with the Plenary having seventy members and the Steering Committee forty members. The FSB also operates through six Regional Consultative Groups (RCGs) for (1) the Americas, (2) Asia, (3) the Commonwealth of Independent States, (4) Europe, (5) the Middle East and North Africa, and (6) Sub-Saharan Africa.

An original Charter came into effect on September 25, 2009, although it was subsequently replaced by an extended Charter in June 2012, following agreement at the G20 Cannes Summit in November 2011 to strengthen the FSB’s capacity, resources, and governance through the creation of an enduring organizational basis. The FSB is required under its Charter to coordinate the alignment of activities between the SSBs and to develop standards to address any regulatory gaps not “fall[ing] within the functional domain of another” SSB. The FSB is to consult widely among members and other stakeholders and to maintain “a structured process for public consultation on policy proposals.” Accountability and transparency are to be maintained through the publication of reports and periodical progress updates to the G20. Membership eligibility is specified in Article 5 of the Charter, and members must commit to maintain financial stability, to maintain financial sector openness and transparency, to implement international financial standards, to undergo periodic peer reviews, and to participate in implementation monitoring of agreed commitments, standards, and policy recommendations. The Charter specifies the organizational structure of the FSB, as well as the responsibilities of each of its operations. While the FSB is to have legal personality, the Charter is specified as not being

88. Cannes Summit, Nov. 3–4, 2011, Final Declaration: Building Our Common Future: Renewed Collective Action for the Benefit of All, ¶ 38 (Nov. 4, 2011), available at http://www.g20civil.com/documents/Cannes_Declaration_4_November_2011.pdf. The FSB would be strengthened following Chairman Mark Carney’s recommendations by conferring on the FSB legal personality and greater financial autonomy and by reconstituting the Steering Committee to include the executive branch of governments of the G20 Chair, of the larger financial systems and geographic regions, and of centers not currently represented. Id. ¶ 38; Appointment of Chairman, supra note 78. Its coordination role would also be strengthened with other standard setting bodies (SSBs) “on policy development and implementation monitoring” without functional overlap and while preserving the independence of the SSBs. Cannes Summit Final Declaration, supra.
89. Fin. Stability Bd. Charter (June 2012), supra note 9, art. 2(2)-(3).
90. Id. art. 3.
91. Id. art. 4.
92. The FSB is to report periodically on member adherence, and standard setting bodies (SSBs) will report to the FSB on implementation. The international financial institutions (IFIs) will work with the FSB in accordance with their specific legal frameworks and policies. Id. art. 6.
93. Id. arts. 7, 9-22.
intended to create any legal rights or obligations.\textsuperscript{94} The revised Charter came into effect on June 19, 2012.\textsuperscript{95} Formal Articles of Association were also adopted at a plenary meeting in January 2013.\textsuperscript{96}

### IV. Financial Stability Board Reform Program

The FSB has supported a large number of initiatives since its formation in 2009.\textsuperscript{97} Its principal areas of work include Market Resilience and Financial Regulation, Compensation, Global Systemically Important Institutions (G-SIFIs), Crisis Management, and Macro-Prudential Oversight.\textsuperscript{98} It has also been working in the areas of shadow banking, disclosure, supervision, financial derivatives, and legal identifiers, as well as credit risk transfer and service regulation.\textsuperscript{99} It has subsequently been involved with continuing work on standards implementation in each of these other functional areas.\textsuperscript{100}

#### A. Improving Financial Regulation

The FSF issued a follow-up report on Enhancing Market and Institutional Resilience in October 2008 and then again in April 2009\textsuperscript{101} in advance of the G20 London Summit, which reviewed wider international initiatives following the crisis.\textsuperscript{102} The FSB issued its first principal report to the G20 Leaders on Improving Financial Regulation in September 2009, which outlined the achievements made to date and critical work underway.\textsuperscript{103}

The G20 Leaders had confirmed their determination to implement fully and consistently the reforms agreed to at the national level to secure a level playing field and to avoid protectionist pressures.\textsuperscript{104} They were anxious to dispel any expectation that the private financial sector would be allowed to return to its pre-crisis position.\textsuperscript{105} The “objective [was] to create a more disciplined and less procyclical financial system that better supported balanced sustainable economic growth.”\textsuperscript{106} Leverage had to be limited and individuals not allowed to extract profit with “ultimate losses [being] borne by governments.

---

\textsuperscript{94} Id. art. 23.
\textsuperscript{95} Id. art. 24.
\textsuperscript{97} See generally Fin. Stability Bd. Charter (Sept. 2009), supra note 77.
\textsuperscript{98} About the FSB, FIN. STABILITY BOARD, http://www.financialstabilityboard.org/about/overview.htm (last visited Aug. 5, 2013).
\textsuperscript{99} Id.
\textsuperscript{100} Key Standards for Sound Financial Systems, supra note 41.
\textsuperscript{102} See, Leaders’ Statement, supra note 68, ¶ 20.
\textsuperscript{103} Improving Financial Regulation, supra note 67 at 1, 2-12.
\textsuperscript{104} Id. ¶¶ 3, 53.
\textsuperscript{105} Id. ¶ 4.
\textsuperscript{106} Id. ¶ 5.
The Leaders were committed to resolving the problems of moral hazard stemming from large institutions that were too complex to resolve and too big to fail (TBTF). Profits arising from the extraordinary official measures had to be retained to strengthen institutions, and restrictions were imposed on dividend payments, share buy-backs, and compensation rates.

The substantial progress achieved to give effect to the measures recommended in the FSF’s April 2008 and 2009 Reports, the G20 Washington Action Plan, and the London Summit Statement were reviewed and the critical work underway was outlined. The G20 Leaders also confirmed the need for perseverance and consistent national implementation over time, in particular, to maintain a level playing field.

The FSB issued a parallel Report to the G20 Leaders in September 2009 titled Overview of Progress in Implementing the London Summit Recommendations for Strengthening Financial Stability. The establishment of the FSB was referred to and its general structure and operation. The paper outlined the action taken in connection with securing international co-operation (including through supervisory colleges, cross-border crisis management and deposit insurance, and carrying out an Early Warning Exercise), prudential regulation (including capital, risk management, and liquidity), macro-prudential frameworks and tools, regulatory scope (including hedge funds, OTC derivatives and other unregulated markets and products), compensation, adherence, accounting standards, and credit rating agencies.

Criteria will be developed to identify jurisdictions of concern, evaluation process procedures will be developed to complement FSAP assessments, and a toolbox of measures will be developed to promote adherence and co-operation among jurisdictions. This included strengthening the global capital framework, making global liquidity more robust, reducing the moral hazard created by systemically important institutions, strengthening accounting standards, sound compensation practices, expanding oversight of the financial system, strengthening the robustness of the OTC derivatives markets, re-launching securitization on a sound basis, and securing adherence to international standards.

Regarding “too big to fail” (referred to as “too big and too complex to fail”) issues, measures considered included additional capital, liquidity, prudential requirements, the use of stand-alone subsidiaries, and contingency planning (including promoting the resiliency of key functions and allowing rapid resolution and wind-down where necessary).

During implementation, the FSB will develop a global compliance “snapshot” of standards, building on the IMF Financial Sector Assessment Program (FSAP).

The London Summit had called on accounting standards setters to work urgently to improve standards, valuation, and provisioning and to produce a single set of high-quality, global accounting standards. The Financial Services Authority (FSA) recommendations were also supported on limiting procyclicality in accounting issues. Almost all FSB member jurisdictions were committed to implement IASB standards by 2012. The IASB had published an exposure draft in May on fair value measurement to identify inactive markets and determine whether transactions were orderly. This followed U.S. Financial Accounting Standards Board (FASB) staff guidance. A further consultation document was issued on the effects of fair value gains arising from deterioration in a company’s own credit risk. The IASB was working on separate proposals to enhance the accounting and disclosure treatment of off-balance sheet entities in December 2008 and March 2009. This included proposals on both accounting consolidation and de-recognition following financial asset transfers. The FASB published its final standards on the accounting treatment of financial assets in...
On macro-prudential risks, quantitative tools were being developed to monitor and assess relevant exposures, including on aggregate risk and tools to measure systemic liquidity risk, margins, haircuts, and other system wide indicators, including leverage. The work of other bodies on macro-prudential oversight was reviewed. The IMF, BIS, and FSB were developing guidelines to identify systemically important institutions, markets, and instruments. The Basel Committee had set up a working group on macro-prudential supervision, which was considering how to deal with the externalities created by systemically important banks, macro and micro stress tests, systemic impact, information exchange, and possible capital surcharges. The IMF and FSB were separately working on their treatment of data gaps. Two ‘Early Warning Exercises’ (EWEs) had been carried out on financial market conditions and expected future developments. Priority vulnerabilities had been identified by the FSB’s Standard Committee on Assessment of Vulnerabilities (SCAV). EWE methodologies would be further refined over time. The paper reviewed work in other areas such as the scope of regulation, including hedge funds and OTC derivatives, compensation, adherence, accounting standards, and credit rating agencies.

B. Sound Compensation Practices

The FSB has taken forward a number of initiatives in the area of compensation practices within large financial institutions following the criticism during the recent financial turbulence and perceived distorting effects of excessive bonus entitlement. A separate report had been prepared by a Senior Supervisors Group on the Risk Management Lessons from the Global Banking Crisis in October 2009. The FSB issued nine Principles for June 2009 (FAS 166 and FAS 167) on the treatment of securitization and special purpose entities. Further work was being carried out to converge IASB and FASB standards. Three new exposure drafts had been issued in 2009 on reducing complexity. The FASB would attempt to develop a single comprehensive model for accounting for financial instruments to replace IAS 39. The Basel Committee had proposed a set of high level principles to the IASB in April 2009 dealing with complexity, provisioning, fair value, and disclosure. The IASB was separately working with the Basel Committee on provisions to replace IAS 39. The IASB had consulted on an impairment standard based on expected loss (expected cash flow). Guidance was also issued by the IASB and FASB on valuation to improve fair value measurement. Neither the IASB nor the FASB had yet included any valuation adjustments where significant valuation uncertainties arose. The IASB and FASB were working with other prudential supervisors, regulators, and stakeholders on various issues. A Financial Crisis Advisory Group had specifically been set up with a report being issued in July 2009. This work continues. See id. at 14-20.

114. This would cover the measurement of systemic liquidity risk, margins, and haircuts and other system-wide indicators, such as leverage. Id. at 8.

115. The IAIS had prepared a progress report on the development of macro-prudential tools in connection with insurance companies. The Basel Committee and CGFS were working systemic liquidity risk with identification of early warning signals and policy options. The BIS and IMF were looking at data collection on systemic liquidity risk. The CGFS was reviewing margining practices in securities financing and OTC derivatives transactions to develop options to reduce procyclicality in margining. The BIS and CGFS were working on a data framework and common vocabulary to facilitate co-operation and discussion on market conditions and relevant exposures. Id. at 7-8.

116. Id. at 9.

117. Id. at 5.

118. Overview of Progress in Implementing the London Summit, supra note 112, at 8-20.

Sound Compensation Practices in April 2009\textsuperscript{120} structured in terms of effective governance of compensation, effective alignment of compensation with prudent risk-taking, and effective supervisory oversight and engagement by stakeholders.\textsuperscript{121}

The FSB produced a series of follow-up implementation standards in September 2009 dealing with governance, compensation and capital, pay structure and risk alignment, disclosure, and supervisory oversight.\textsuperscript{122} A review template for member jurisdictions reporting on principles implementation was issued in December 2009\textsuperscript{123} with two thematic reviews on compensation in 2010 and 2011.\textsuperscript{124} The FSB had commissioned a separate report on Banking Compensation Reform from Oliver Wyman, which reported in March 2010.\textsuperscript{125}

C. Systemically Important Institutions

The FSF had set up an initial Working Group on Highly Leveraged Institutions (HLIs) at its inaugural meeting in April 1999; the Working Group produced its first report in

\begin{itemize}


\item \textsuperscript{121} \textit{Id.} at 2-3. The FSF principles for effective governance of compensation are: (1) “the firm’s board of directors must actively oversee the compensation system’s design and operation”; (2) “the firm’s board of directors must monitor and review the compensation system to ensure the system operates as intended”; and (3) “staff engaged in financial and risk control must be independent, have appropriate authority and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.” The FSF principles on effective alignment of compensation with risk taking are: (4) “compensation must be adjusted for all types of risks”; (5) “compensation outcomes must be symmetric with risk outcomes”; (6) “compensation payout schedules must be sensitive to the time horizon on risk”; and (7) “the mix of cash, equity and other forms of compensation must be consistent with risk alignment.” The FSF principles for effective supervisory oversight and engagement by stakeholders are: (8) “supervisory review of compensation practices must be rigorous and sustained and deficiencies must be addressed promptly with supervisory action”; and (9) “firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.” \textit{Id.}


\item \textsuperscript{125} The report provides an independent assessment of the implementation issues that arise following a review of twenty systemically-relevant global firms with material business operations in the Americas, Europe, and Asia. Considerable progress had been achieved, although further work was required. Residual challenges were summarized in terms of regulatory, competitive, financial, operation and technical, and organizational challenges. Some further recommendations were made in terms of revising the principles and considering some further extensions. Oliver Wyman, \textit{Banking Compensation Reform: Summary Report of Progress and Challenges Commissioned by the Financial Stability Board}, Fin. Stability Bd. (Mar. 2010), www.financialstabilityboard.org/publications/r_100330b.pdf.
\end{itemize}
April 2000. This followed the specific concerns raised with regard to HLIs following the Asian financial crisis, including hedge funds and with regard to the forced support of Long Term Capital Management (LTCM). A Progress Report was issued in March 2001 with an Update Assessment in March 2002 that identified specific further concerns with regard to leverage levels, possible disorderly collapse of an unregulated HLI, and market integrity effects in small and medium sized economies. A further Update was issued in May 2007 and Progress Report in October 2007.

The FSB switched its attention following the global financial crisis to Systemically Important Financial Institutions (SIFIs) at the direction of the G20 rather than HLIs specifically. Six interim principles were issued on the moral hazard risks created by SIFIs in June 2010 with a full report on reducing moral hazard being issued in November 2010. Fifty-one recommendations were produced, structured in terms of higher loss absorbency, SIFI resolution, strengthening SIFI supervision, strengthening core financial infrastructures, and ensuring effective and consistent implementation of national policies for global SIFIs (G-SIFIs or GSIFIs). A separate report was issued on Intensity and Effectiveness of SIFI supervision that outlined ten findings on SIFI supervision and contained thirty-two recommendations for supervisory improvement.

Eight further sets of recommendations were made with regard to SIFI resolution in July 2011, which covered resolution powers and tools, cross-border arrangements, planning, and resolution cultures. 

126. This included a definition of HLIs and identification of potential problems for financial stability and available policy options. The Group concluded that market discipline was the most effective means for dealing with systemic risks and market dynamic concerns supported by additional measures to improve supervision and regulation of HLI credit providers, a stronger market infrastructure, increased HLI disclosure, enhanced national market surveillance, and good practice guidelines for foreign exchange trading. The Group rejected creating a credit register and direct regulation of HLIs at that stage. Financial Stability Forum, Report of the Working Group on Highly Leveraged Institutions, 138-141 (Apr. 5, 2000), available at www.financialstabilityboard.org/publications/r_0004a.pdf.

127. Id. at 5.

128. Developments in the market were reviewed, including with regard to counter-party risk management and regulatory oversight, hedge fund risk management practices, hedge fund disclosures, public sector initiatives to enhance hedge fund disclosures, infrastructure improvements, and documentation and national surveillance of financial market activity and functioning. New concerns arose with regard to the marketing of hedge funds to retail investors, capital guaranteed hedge fund products, in-house hedge funds, and terrorism financing and money laundering. Nine further recommendations were made in response to the issues identified. Fin. Stability Forum, The FSF Recommendations and Concerns Raised by Highly Leveraged Institutions (HLIs): An Assessment, 3 (Mar. 11, 2002), www.financialstabilityboard.org/publications/r_0203b.pdf.


obstacles to resolvability with some further discussion points. G-SIFI Recovery and Resolution Plans (RRPs) would specifically consist of a separate pre-resolution Recovery Plans (RCPs) and follow-up Resolution Plans (RSPs). Twelve sets of Key Attributes for effective resolution regimes would later be produced in November 2011 with specific provisions on RRPs, resolvability, bail-in and cross-border cooperation. A Progress Report on SIFI resolution would be issued in November 2012 with additional “Guidance for Recovery and Resolution Planning.”

A common data template for Global Systemically Important Banks (GSIBs) was produced in October 2011 to correct key information gaps identified during the crisis and to assist authorities in constructing more effective frameworks for assessing potential systemic risks. The Basel Committee on Banking Supervision issued an assessment methodology with additional loss absorbency conditions for GSIBs in July 2011, which proposed an additional range of 1 to 2.5 percent, with an additional 3.5 percent Common Equity Tier 1 (CET1) for GSIBs. The Macroeconomic Assessment Group (MAG) set up by the FSB and Basel Committee produced an assessment of the macroeconomic impact of the higher absorbency conditions in October 2011.


133. Id. at 53-60. Specific recommendations were made with regard to underlying assumptions and responsibility for the RCP and RSP, review, and national and cross-border co-ordination. On assumption, RRPs should reflect the specific characteristics of the individual firm and tools available under national resolution regimes with no assumptions being made with regard to taxpayer funding of losses. RRPs should contain an executive summary, strategic analysis, intervention conditions (prerequisites for triggering the implementation of recovery or resolution actions), practical recovery and resolution options, implementation actions, and responsibilities. Additional essential elements for RCPs and RSPs and on information requirements and planning. Id.


D. Crisis Management and Resolution

The initial work of the FSF on crisis management had focused on deposit protection. A Study Group on Deposit Insurance had been set up in November 1999, which was subsequently converted into a more formal Working Group. A Background Paper was issued in June 2000 with a full report on developing effective deposit insurance systems in September 2001.

While the Basel Committee had issued Supervisory Guidance on Dealing with Weak Banks in March 2002, the FSF would not issue its formal paper on Cross-Border Co-operation on Crisis Management until April 2009. This consisted of fifteen short principles on preparing for and managing a financial crisis and was partly based on a Joint Task Force Report on Winding Down a Large Complex Financial Institution (LCFI) and relevant EU Principles for Financial Crisis Management. The FSB issued a later specific paper on the effective resolution of SIFIs in July 2011. Its initial attention had focused on reducing or withdrawing the various financial sector support measures that had been adopted to contain markets immediately following the crisis, with specific guidance having been issued on temporary deposit insurance arrangements. It would issue its key attributes for the effective resolution of financial institutions in November 2011. The FSB has also been monitoring the G20 recommendations on carrying out OTC derivatives contracts on exchanges or electronic trading platforms as part of its crisis resolution function.

E. Macro-Prudential Policy

Neither the FSF nor FSB considered the development of macro-prudential policy or oversight mechanisms specifically immediately following the crisis, although work in this area was taken forward subsequently. The FSF April 2008 report on “Enhancing Market

123. See generally id.
124. Effective Resolution, supra note 80.
126. Key Attributes, supra note 134.
and Institutional Resilience” only referred to strengthening the authority’s responsiveness to risk with robust arrangements being put in place to deal with stress in the financial system. The FSF highlighted the importance of procyclicality in the financial system in April 2009, although this was more concerned with capital, provisioning and valuation, and leverage. The FSF September 2009 paper on improving financial regulation only referred to expanding oversight of the financial system, especially with regard to hedge funds, credit rating agencies, the regulatory perimeter, and regulatory arbitrage.

The FSB Secretariat had been directed by the G20 to work with IMF in April 2009 to explore information gaps and provide appropriate proposals for strengthening data collection. An initial joint report titled The Financial Crisis and Information Gaps was produced by the IMF and FSB in October 2009, with the IMF and FSB holding a conference in Basel in April 2010 and a Progress Report being published in May 2010. A further Implementation Progress Report was published in June 2011. Twenty recommendations were made in the initial 2009 Report on better capturing the build-up of risk in the financial sector, improving data on international financial network connections, monitoring the vulnerability of domestic economies to shocks, and on the communication of official statistics. The June 2011 Report outlined progress to date with the implementation schedule and residual challenges in terms of resources, priorities and inter-linkages, data access, and international co-ordination.

The issue of developing a coordinated macro-prudential policy framework was referred to in the G20 Seoul Communiqué following the Summit in November 2010, which called on further work to be carried out by the FSB, IMF, and BIS in this area. An Update paper was produced by the FSB, IMF, and BIS in February 2011 with a further Progress Report being produced in October 2011. The February 2011 Report reviews the work undertaken at the national and international levels to develop effective macro-prudential policies and frameworks, including the survey initiatives taken forward by the Committee on the Global Financial System (CGFS) and IMF. Specific difficulties are identified in

148. Enhancing Market and Institutional Resilience, supra note 50, §§ V, VI.
153. Id.

VOL. 47, NO. 1

PUBLISHED IN COOPERATION WITH
SMU DEDMAN SCHOOL OF LAW
terms of design and collection of necessary information and data, techniques to identify and measure systemic risk, effective tools, and governance arrangements.\footnote{158}

In the October 2011 Report, the core characteristics of macro-prudential policy are defined in terms of its objective of being to limit systemic risk, its scope focusing on the financial system as a whole, and its primary use of prudential tools re-calibrated to deal with sources of systemic risk and subject to effective governance arrangements.\footnote{159} A number of key measurement approaches are identified in terms of monitoring aggregate indicators of imbalances, market condition indicators, metrics of concentration risk, macro stress testing, and integrated monitoring systems.\footnote{160} These have to be used to capture both the time and cross-sectional elements of systemic risk.\footnote{161} The need to assess the build-up of systemic risk across the financial system, including within the shadow banking area, was highlighted.\footnote{162} Initiatives in the area of enhancing data infrastructure and material gaps in data collection were referred to. The most commonly used macro-prudential tools or instruments were summarized in terms of dealing with excessive credit expansion,\footnote{163} amplification mechanisms,\footnote{164} and limiting structural vulnerabilities and stress spill-over.\footnote{165}

Empirical studies have confirmed that pro-cyclicality tools, including loan to value (LTV) and debt to income (DTI) caps, can limit property booms with credit or credit growth caps, reserve requirements, and dynamic provisioning.\footnote{166} International policy tools included the procyclical elements within the new Basel III framework with its maximum leverage ratio, capital conservation buffer, and counter-cyclical capital buffer and proposed additional SIFI and GSIB measures. The CGFS had also recommended the possible imposition of additional haircuts and margining practices to limit the build-up of leverage and system-wide effects of rapid de-leveraging.\footnote{167} Other work was being taken forward on improving market operations and market infrastructure and on OTC derivatives.\footnote{168}

\footnote{An Organizing Framework-Background Paper (Mar. 2011). The FSB, IMF, and BIS also held two workshops on “High-Level Conference in Macro-Prudential Policy Frameworks” (Washington, April 17, 2011) and “Roundtable on Macro-Prudential Frameworks and Policies” (Basel, June 21-22, 2011).}

\footnote{158. Id.}

\footnote{159. See generally Macroprudential Policy Tools Progress Report, supra note 156.}

\footnote{160. Id. § 2.1.}

\footnote{161. Id.}


\footnote{163. Tools to deal with excessive credit expansion include: (1) time varying capital requirements; (2) dynamic provision; (3) credit or credit growth ceilings; (4) loan-to-value (LTV) ration limits on a static or time varying basis; (6) minimum margin requirements on a fixed or time varying basis; and (7) reserve requirements. See generally Macropu

\footnote{164. Tools to limit the amplification of systemic risk include: (1) maturity mismatch limits; (2) limit of foreign currency lending; (3) limits on net open currency positions or mismatches; (4) non-core funding levies. \textit{Shadow Banking}, supra note 162.}

\footnote{165. Tools to limit structural vulnerabilities and spill-over effects include: (1) additional loss absorbency tied to systemic importance; (2) market and institution disclosure policies targeting systemic risk; and (3) SIFI resolution requirements. Id.}

\footnote{166. Id. at 12.}

\footnote{167. \textit{Shadow Banking}, supra note 162, at 13.}

The October 2011 Report considered governance arrangements in terms of mandate, powers and instruments, accountability, composition and domestic policy consistency, and coordination. It was essential that macro-prudential policy was appropriately coordinated at the international level with a number of separate initiatives being referenced. Policy arbitrage in the macro-prudential area would be partly limited through “embedded reciprocity” provisions within new standards, including the Basel Committee counter-cyclical capital buffers and FSB G-SIFIs recommendations. Countries had still to retain sufficient flexibility in assessing local needs and to be able to act quickly to avoid damaging spill-over effects.

F. Shadow Banking

The G20 Seoul Summit Communiqué in November 2010 had referred to the need to strengthen regulation and supervision of the shadow banking sector. Shadow banking had increased from $27 trillion in 2002 to $60 trillion by 2007 and remained generally the same until 2010. Important background papers had been issued by the Federal Reserve, with the European Commission issuing separate reports subsequently. The FSB held a workshop in London with relevant experts on December 6, 2010, to consider relevant definitions, monitoring approaches, and regulatory measures. A Task Force was set up and issued the Background Note on Shadow Banking: Scoping the Issues in April 2011. Shadow banking was generally defined as credit intermediation involving entities and activities outside the regular banking system that either raised systemic risk concerns (through maturity/liquidity transformation, leverage, and imperfect (flawed) credit risk transfer) or regulatory arbitrage.

http://www.bis.org/publ/cps94.pdf. The FSB had issued recommendations to promote international consistency on standardization, central clearing, organized platform trading, and use of trade repositories in connection with OTC derivatives contracts. Other initiatives were being considered regarding central bank liquidity access for CCPs, the macro-financial effects of different CCP access options, and margining requirements for non-centrally cleared OTC derivatives. Securitization practices were also being reviewed with possible recommendations on sound securitization markets. See id. at 14-15.

169. Id. at 15-19.
170. These included the FSB Standing Committee on Assessment of Vulnerabilities work, the IMF bilateral and multilateral surveillance work, the IMF/FSB “Early Warning Exercise,” the G20 “Mutual Assessment Process,” and BIS and CGFS survey work. Id. at 19.
171. Id. at 19-20.
172. See Seoul Summit, supra note 154, ¶ 41.
177. Supra § 1; id. § 1.2.
The Task Force on Shadow Banking produced initial recommendations that were approved by the FSB at its Plenary Meeting in July 2011.\(^{178}\) Five separate work streams would be set up on indirect regulation and bank interaction, money market funds (MMFs), other shadow banking entity regulation, securitization and securities lending, and repos.\(^{179}\) Information would be collected through Flow of Funds and Sector Balance Sheet data to assess the scale and development of non-bank credit intermediation, with further preparation being carried out on future data collection and assessment. A series of monitoring exercises were conducted over summer 2011 with more substantial recommendations being formulated. The Task Force was chaired by the United Kingdom Financial Services Authority (FSA) Chairman Lord Adair Turner and BIS General Manager, Jaime Caruana.\(^{180}\)

A formal report on shadow banking was produced in October 2011.\(^{181}\) This generally deals with overall approach (Section 1), monitoring (Section 2), and enhancing regulation (Section 3). Seven high-level principles are identified for monitoring the shadow banking system based on scope, process, data/information, innovation/mutation, regulatory arbitrage, justification, and information exchange.\(^{182}\) A stylized three-step approach is constructed to strengthen monitoring based on scanning and mapping, systemic risk identification, and assessment.\(^{183}\) A further series of five general principles are adopted in designing and implementing regulatory measures for shadow banking based on focus, proportionality, forward-looking and adaptability, effectiveness and assessment, and review.\(^{184}\) Eleven more specific recommendations are then produced in applying these principles to the areas of concern identified in the Background Note and July Plenary Meeting.\(^{185}\) The FSB issued a Progress Report in April 2012 with a separate Report on Securities Lending and Repos.\(^{186}\)

179. Id.
180. Id.
181. Id.
182. The High-level principles are: (a) authorities should maintain an appropriate system-wide oversight framework of shadow banking and its risks; (b) the monitoring framework should identify and assess risks on a regular and continuing basis; (c) authorities should have power to collect all necessary data and information and define the regulatory perimeter for reporting; (d) monitoring should be flexible and adaptable to cover innovations and mutations producing emerging risks; (e) authorities should recognize incentives to expand shadow banking in response to regulation; (f) the structure of financial markets and regulatory framework should be considered at the domestic level and international connections; and (g) there should be appropriate exchange of information within and across jurisdictions on a regular basis. See id. at 6.
183. The three steps consist of: (a) scanning and mapping the overall shadow banking system; (b) identification of specific aspects creating systemic risk or regulatory arbitrage concern; and (c) detailed assessment of relevant concerns. See id. at 7.
184. Id. at 15.
185. These were generally based on consolidation, quantitative limits, risk-based assessment, implicit support, MMF reform, other activity review, securitization incentives, securities lending and repo assessment, transparency and reporting, improved underwriting, and reduced CRAs’ role. Id. at 16-26.
The FSB issued a more general consultative document titled *Strengthening Oversight and Regulation of Shadow Banking* in November 2012, which contained an integrated overview of policy recommendations, with two specific papers on other shadow banking activity oversight and on securities lending and repos.\(^{187}\) The FSB published the results of its second annual monitoring exercise of global shadow banking activity on the same day, which contained data on total financial intermediary assets, share of total financial assets, and non-bank intermediary assets.\(^{188}\) The *Integrated Overview* document explains the FSB’s concerns, approach, and outline recommendations on monitoring and regulation. Authorities had to adopt a targeted approach to shadow banking with the objective of ensuring that it was subject to appropriate oversight and regulation to cover “bank-like” risks to financial stability arising outside the regular banking system without inhibiting sustainable non-bank financing models without equivalent risk. The FSB supported the development of a resilient system of non-bank credit intermediation with a proportionate approach adopted toward financial stability risks.\(^{189}\) A two-stage approach was generally adopted with all forms of non-bank credit intermediation being monitored to ensure that data gathering and surveillance was sufficiently wide, with authorities then focusing on specific sub-sets of activity creating systemic or arbitrage concerns.

A number of proposals have been developed in each of the five work streams identified to limit shadow banking runs, procyclicality, and systemic risk. A comprehensive approach had also been adopted in response to the interconnectedness of markets and adaptive capacity of the shadow banking system.\(^{190}\) The second monitoring exercise, conducted in summer 2012, confirmed the interconnectedness between banks and non-bank financial entities, specifically including finance companies, with further improvements being required in data collection and granularity (sub-divisions).\(^{191}\) The rest of the report focuses on the progress achieved by the FSB or its member organizations in each of the five work streams identified (WS1-5).\(^{192}\)

---


\(^{189}\) See *Global Shadow Banking Monitoring Report*, supra note 188, at 1.

\(^{190}\) Id. at 2.

\(^{191}\) Macro-mapping confirmed that non-bank financial intermediation grew substantially before the crisis and continued subsequently at a much slower pace. There was considerable diversity in the relative size and composition of non-bank financial intermediaries across jurisdictions. Data granularity improved, with the share of unidentified non-bank financial intermediation reduced from 36 percent to 18 percent. More detailed breakdowns of activity categories were nevertheless required across countries to increase granularity. See id.

\(^{192}\) Id. at 5-14.
G. Enhanced Disclosure

The FSF issued an initial report, Improved Disclosure Practices for Financial Intermediaries, in April 2001 at the same time as a Multidisciplinary Working Group report on enhanced disclosure. A Senior Supervisor’s group published a separate report entitled Leading-Practice Disclosures for Selected Exposures in April 2008. The FSF produced a request for comments on “Risk Disclosure Practices” in July 2010 as part of a peer review of the implementation of the recommendations contained in the FSF April 2008 Report, with a thematic review being conducted on risk disclosure in March 2011. The FSF established an Enhanced Disclosure Task Force (EDTF) in May 2012 after a roundtable meeting of senior officials and experts in December 2011, which considered means of improving the quality, compatibility, and transparency of risk disclosures, while at the same time reducing the use of redundant information so as to streamline the bringing of disclosures to the market in a timely manner.

The EDTF produced a report, Enhancing the Risk Disclosures of Banks, in October 2012. This established seven fundamental principles to enhanced disclosure practices to produce high quality, transparent disclosures that could clearly communicate business models and key risks. The EDTF had established six work streams on governance, capital, liquidity, funding, market, and credit, amongst other risks. A number of private sector press statements were subsequently produced from major banking institutions, banking associations, investors, end users, SSBs, and audit firms confirming support.

H. Supervision

The FSF issued a specific report on the intensity and effectiveness of SIFI supervision in November 2010, with second and third progress reports issued in November 2011 and


198. The seven fundamental principles on enhanced disclosure consisted of: (a) disclosures being clear, balanced, and understandable; (b) disclosures being comprehensive and including all key activities and risks; (c) present relevant information; (d) disclosures reflecting the manner in which the bank manages the risks; (e) disclosures being consistent over time; (f) disclosures being compatible with other banks; and (g) disclosures being provided on a timely basis. Id. at 6.

199. Id. at 2.

2012.\textsuperscript{201} The November 2010 paper contains a number of recommendations, under ten headings, intended to make the supervision of financial institutions more intense, effective, and reliable, while also following a coordinated assessment of the principal lessons from the global financial crisis.\textsuperscript{202} The report contains thirty-two specific recommendations intended to improve the supervision of SIFIs, as well as supervisory practices more generally.

A Supervisory Intensity and Effectiveness (SIE) group was set up within the FSB, which produced the 2011 and 2012 progress reports. A number of difficulties and supervisory challenges were referred to in the November 2011 report.\textsuperscript{203} Work was also reviewed in other areas, including acquisitions, Supervisory Colleges, stress testing, corporate governance, and macro-prudential surveillance or oversight, with FSB members submitting self-assessments against the Basel \textit{Core Principles for Effective Banking Supervision}.\textsuperscript{204} Five follow-up recommendations were made on supervisory expectations, resource adequacy, progress assessment, thematic review, and audit quality.\textsuperscript{205} The report contains detailed examples of recommended disclosures on capital, liquidity, funding, and credit risk, as well as examples of leading or best-practice disclosures in current bank reporting.\textsuperscript{206}

I. \textbf{FINANCIAL DERIVATIVES}

The G20 Leaders agreed at their Pittsburgh meeting that all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where possible, and cleared through central counterparties by the end of 2012, with all OTC derivative contracts being reported through trade repositories. A Working Group was set up in April 2010 at the initiative of the FSB, with the Committee on Payment and Settlement Systems (CPSS), the International Organization of Securities Commissions (IOSCO), and the European Commission to bring forward recommendations to implement the G20 commitments.

The FSB set up a separate internal OTC Derivatives Working Group (ODWG), with an initial report being produced on “Implementing OTC Derivatives Market Reforms” in October 2010 and implementation reports published in April 2011, October 2011, and


\textsuperscript{202} The recommendations are based on mandates, independence, resources, supervisory powers, improved techniques, group-wide and consolidated supervision, continuous and comprehensive supervision, supervisory colleges and home/host information sharing, macro-prudential surveillance (including multi-disciplinary approach), and the use of third parties. \textit{See Intensity and Effectiveness of SIFI Supervision (2010), supra} note 131, \textsection II, Appendix A. The senior line supervisors that contributed to the report are listed in Appendix B.

\textsuperscript{203} These included data aggregation, resources, business models and financial analysis, risk appetite frameworks (RAF), model risk, and external auditor. \textit{See Intensity and Effectiveness of SIFI Supervision (2011), supra} note 201. \textsection II.

\textsuperscript{204} Id. at 1.

\textsuperscript{205} Id. at 20-23.

\textsuperscript{206} Id. at 24-26.
June 2012, along with a final report in October 2012.207 The ODWG had conducted a survey of Central Counterparty (CCP) and Trade Repository (TR) practices in July 2012, with FSB members also being asked to set out their approaches to central clearing in August 2012.208

The Group’s recommendations have principally been concerned with increasing standardization, promoting central clearing and trading on exchanges or electronic trading platforms, trade repository reporting, assessing progress, and cooperating on market reforms. Market infrastructure was in place and could be scaled up by the time of the final report in October 2012 and cover all of the five major asset classes identified, including commodity, credit, equity, foreign exchange, and interest rate products. Policy work on safeguards for global clearing had been substantially completed, while national implementation work is continuing. Regulatory uncertainty remained the most significant obstacle, with authorities having been encouraged to identify and resolve any residual conflicts, inconsistencies, and gaps.209

J. Legal Identifiers

The FSB has been the key coordinating body in the development of a Global Legal Entity Identifier (LEI) system that would provide unique numeric and alphabetic identifications for parties to financial transactions. This was agreed at the Cannes G20 Summit with the FSB producing an initial report before the Los Cabos Summit.210 This outlined the proposed Global LEI System with development and implementation recommendations, high-level principles, and outline provisions for inclusion within the Charter of the new Global LEI Regulatory Oversight Committee (ROC).211 The objective was to establish an independent, open, fair, and transparent system. The FSB had earlier set up an internal LEI Expert Group with an outside LEI Industry Advisory Panel and separate LEI Implementation Group. A substantial amount of work has subsequently been carried out in bringing the legal identifier initiative forward.212


209. Nineteen CCPs had been set up in nine jurisdictions and Fourteen TRs. Summary information was provided in Appendices A and B. A summary of national implementation progresses, cataloged by country, was provided. FSB, Fourth Progress Report, supra note 207, at 13 n.42.


211. Id. at 8.

THE INTERNATIONAL LAWYER
A QUARTERLY PUBLICATION OF THE ABA/SECTION OF INTERNATIONAL LAW

26 THE INTERNATIONAL LAWYER

K. Credit Risk Transfer and Service Regulation

The FSF and FSB have been involved in other areas of reform activity. In addition to its work on capital flows, OTCs, HLIs, and Deposit Protection, the FSF had cooperated with the Joint Forum on Financial Conglomerates on Credit Risk Transfer (CRT), with three reports being produced in October 2004, March 2005, and April 2008.213 The FSB has also subsequently issued separate papers on such other issues as emerging markets and developing economies, residential mortgage underwriting, consumer finance protection, and the availability of long-term finance.214

L. Standards Implementation

The issue of standards implementation was initially considered by the FSF. The FSF produced a working group report on Offshore Financial Centres (OFC) in April 2000 with two reports by a Follow-Up Group on Incentives to Foster Implementation of Standards in September 2000 and 2001.215 The FSB issued a statement on a framework for strengthening adherence to international standards in January 2010,216 with a separate initiative to promote global adherence to cooperation and information exchange standards in March 2010, and with follow-up papers being produced in April and October 2011 and November 2012.217 The FSB confirmed its commitment to strengthening adherence to


international financial standards in January 2010 through “leading by example,” with FSB member jurisdictions being committed to implement relevant standards and disclose their adherence, participate in periodic peer reviews, and comply with the measures set out in the toolbox to encourage adherence to standards on international cooperation and information exchange.218 This toolbox was developed in the subsequent documents in 2011 and 2012.

The FSF had issued a number of papers on implementation. Work in this area dates from the establishment of a Study Group on Implementation of Standards by the FSF in November 1999 with an Issue Paper being produced in March 2000, as well as other follow-up group reports.219 The FSF had identified 12 policy areas for priority implementation selected in accordance with specified criteria, including: relevant and critical, universal, flexible, broadly endorsed, and assessable. These would form the key measures within the FSF and the FSB Compendium of Standards, which still effectively constitutes the international rulebook for financial regulatory provisions.

This work would subsequently be taken forward by the FSB following the global financial crisis. A general framework was issued in January 2010, with two specific initiatives on co-operation and information exchange, as well as regulatory and supervisory standards.220 These aimed to achieve a “race to the top” by encouraging all countries and jurisdictions to adhere properly to all relevant international financial standards. Three specific mechanisms were developed based on leading by example,221 periodic thematic and single country peer reviews,222 and the introduction of adherence procedures, including those by non-co-operative jurisdictions.223

221. FSB members had committed to implementing relevant international standards, assessed under the IMF World Bank FSAP program every five years, as well as disclosure of adherence levels. See FSB Framework for Strengthening Adherence to International Standards, supra note 216, Annex A. FSB members also committed to undergoing periodic peer reviews.
222. The peer reviews would complement, but not duplicate, the existing IMF (WB FSAPs) and ROSCs. Thematic reviews would compare policy and standards implementation across countries with country peer reviews focusing on individual country adherence. Reports would be produced by experts from FSB member countries and international institutions under the Standard Committee on Standards Implementation. The FSB prepared a Handbook for FSB Peer Reviews.
223. The FSB was developing procedures to secure adherence by all countries, including non-cooperative jurisdictions. This work would specifically focus on securing international cooperation and information exchange in the regulatory and supervisory areas. A pool of countries would be examined to attempt to assess and improve adherence. Countries would be ranked according to domestic financial assets, external financial assets and liabilities, gross capital flows, and market share of selected global market segments (including cross-border inter-bank assets, pension fund assets, hedge fund assets, OTC derivatives, and insurance premiums). See Global Adherence to Regulatory and Supervisory Standards on International Cooperation and Information Exchange: Status Update, supra note 217.
A number of specific papers and press releases have been produced subsequently on implementation of the FSB recommendations on Enhancing Market and Institutional Resilience and related G20 measures.\(^\text{224}\) The G20 and FSB agreed a Co-ordination Framework for Implementation Monitoring (CFIM) in October 2011.\(^\text{225}\) This would build on existing mechanisms but create a coordinated new mechanism for monitoring G20/FSB recommendations specifically. Other facilities included the IMF/World Bank Financial Sector Assessment Programmes (FSAPs) and Reports on the Observance of Standards and Codes (ROSCs) with the FSB having a simpler Implementation Monitoring Network (IMN) and with other standard setting bodies (SSBs) operating their own processes.\(^\text{226}\) Monitoring was also carried out by the FSB through its Standing Committee on Standards Implementation (SCSI), which would be incorporated within the new CFIM under the FSB, IMN, and SSB mechanisms. The FSB also published separate substantial Ongoing and Recent Work reports every six months on work being carried out in strengthening financial systems by the FSB and other financial institutions, groups, and committees.\(^\text{227}\)

V. Financial Stability Comment and Conclusions

A substantial work program has been brought forward and a large number of informed papers have been issued by the FSB since its establishment in 2009. While this has extended some of the earlier work of the FSF following the Asian financial crisis, much of this is original and in response to the new challenges generated by the global financial crisis. The FSB has emerged as the most senior institution in the hierarchy of international technical agencies and new international financial architecture constructed. While substantial progress has been made, a significant amount of further reform work remains to be carried out.

The following provisional comments and conclusions may be drawn with regard to the significance and contribution of the FSB to date.

A. FSB AND FSB TRANSITION

The FSB has enjoyed a successful transition from its earlier FSF origins with a number of important actions being taken to strengthen its capacity, resources, and governance, especially following the Cannes, November 2011 Summit. While Steering Committee meetings are of a similar size to the earlier full FSF meetings, Plenary Representation has almost doubled. It is interesting that the revised June 2012 Charter does not place any limits on the nature or size of its composition and only refers to member authorities from jurisdictions responsible for financial stability, IFIs and international SSBs, including central bank bodies on an unlimited basis (Article 5).

The internal organizational structure and governance arrangements are clearly set out in Article 7 of the Charter, while the specific responsibilities of each of the internal parts of the FSB are detailed in Articles 9-22, and the express consultation, accountability, and transparency requirements in Articles 3 and 4. Key membership provisions and further organizational directions are set out in Articles 3-6 of its new Articles of Association, which were adopted in January 2013.228 Funding is also expressly provided for under the BIS, by way of a Multi-Year Funding Agreement and through voluntary member contribution under Article 7 of its Articles. Its accounts and annual financial statements are to be audited by external auditors under Article 8. All of this substantially improves the funding stability and accountability of the FSB.

The functions of the Secretariat are expanded in Article 22 of the Charter. The Secretariat is to be directed by a Secretary General appointed by the Plenary for a five-year term and then responsible to the Chair. Secretariat staff are to be appointed on a balanced-composition basis, having regard for geographic and institutional function and retention of 'institutional memory' through the use of open-ended contracts. The Secretary General and Secretariat are stated to owe their duties entirely to the FSB and to no other authorities' institutions, although they are to be located in Basel at the BIS. The principal responsibilities of the Secretariat are also specified in the Charter. All of this strengthens its operational integrity and independence.

The liability of the Association is limited under Article 9 of the Articles with members not being responsible for its liabilities. Despite these strengthened arrangements and the conferment of legal status under the Articles on the FSB as an Association under Article 60 of the Swiss Civil Code, the activities and any decisions of the FSB are expressly stated not to be binding or to give rise to any legal rights or obligations under Article 10 of the Articles, with the Charter not intended to create any legal rights or obligations under its Article 23. Membership does not constitute any waiver of sovereign immunity or IFI privilege or immunity unless otherwise provided for.

The effect of this is to confirm the status of the FSB as a leading international institution despite its still relatively limited size. It has clear organizational, governance, and funding arrangements with a dedicated Secretariat independent from the BIS and member institutions. This will apply even where Secretariat staff are appointed on recommendation from other organizations. Limited liability is confirmed with legal effect excluded. While the legal effectiveness of any of the FSB’s work is expressly excluded, this can be considered necessary in light of the highly sensitive nature of its activities and the need for

228. See FSB Articles of Association, supra note 96.
these to be conducted on an informal and extralegal basis, with implementation being
dealt with through member commitment, adherence, and national adoption. Much of this
continues the earlier consensus based nature of the Basel Committee model. The only
significant anomaly is that no other non-formal, IFI technical committee has been given
similar status. This was presumably considered necessary in light of the immediate and
potentially longer term importance of the FSB as the central standard setting body at the
international level and its position at the apex of the new international financial archite-
cture at the political G20.

B. FSB Function and Financial Stability

The FSB objectives are defined in terms of agency coordination and policy develop-
ment with SSBs, as well as to address vulnerabilities with IFIs under Article 1 of its Char-
ter with specific tasks being set out in Article 2. Article 2 of its Articles further specifies
that its purpose is to promote international financial stability, including the furthering of
the objectives as set out in the Charter. While financial stability has been expressly incor-
porated into the FSB’s purposes from 2013, financial stability is not separately defined.
While stability was referenced in the original G7, October 1998 Declaration, which set
the mandate for the February 1999 Tietmeyer Report that was principally concerned with
organizational arrangements and vulnerabilities. The main FSF post-crisis report ex-
amined Enhancing Market and Institutional Resilience, although this does not consider the
nature of financial stability directly with the first FSB report in September 2009, focusing
on Improving Financial Regulation without further express comment. The issue of promoting financial stability has been raised in a number of more recent
research papers following the global financial crisis, as well as in speeches and presenta-
tions by senior officials. A number of different approaches have been adopted, with some
attempting to define financial stability positively and others negatively in terms of its
obverse or opposite of financial instability. Some papers have attempted to develop
quantitative measures. The most appropriate definition is arguably in terms of financial
function with the need to ensure that financial markets can carry out their normal func-
tions on a continuing basis.

It is possible that the FSF and FSB have avoided attempting to define financial stability
expressly in light of these difficulties. Attempting to do so would nevertheless substi-
tially clarify the FSB’s purpose and objectives, especially as financial stability is now ex-
pressly referred to in its Articles of Association. The FSB has a range of express separate
purposes, objectives, and mandates and tasks to secure. Its role and vision could be sub-
stantially improved if this was clarified and made consistent.

---

230. See Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, supra note 224; see also Improving Financial Regulation, supra note 67; see also Tietmeyer, supra note 25.
C. Regulator y Access and Clarity

While the FSB has issued a substantial number of papers since the global financial crisis, one of the difficulties that has arisen is that its continuing work streams and publication archive are not always clear from its website. The FSB has retained a number of “Publications by category” listings rather than clearly demarcated work areas, with a number of these categories retaining earlier FSF work areas, such as on Highly Leveraged Institutions (HLIs) and Credit Risk Transfer (CRT). Some of these separate areas may then overlap or conflict over time. The issue of financial stability, referred to above, can be considered to be dealt with separately under “Market and Institutional Resilience” and “Ongoing Work on Sound Financial Systems,” as well as under the new category of “Macro-prudential Policy tools and Frameworks.” Adoption is also still separately included under “Adherence to Standards” and “Implementation of financial reforms.”

In terms of Standing Committees, the FSB also retains three principal committees on Assessment of Vulnerabilities, Standards Implementation, and Supervisory and Regulatory Cooperation, with a separate, new committee on Budget and Resources. The FSB could substantially clarify its ongoing operations and publications output if it established a new Standing Committee on Financial Stability with a new publications category being included at the top of its current “publications by category” list on Financial Stability. While it is arguable that all of the activities of the FSB are concerned with financial stability, a more general sub-set of publications focusing on wider financial stability issues would be of value. This would incorporate all of the existing Market and Institutional Resilience publications, although some of these could be moved elsewhere, with the highly valuable biannual update reports on Sound Financial Systems being incorporated as a sub-set within Financial Stability. The FSB could also consider producing, for example, a separate Background Note on its understanding of Financial Stability and explaining the organizational structure of its work and publications.

D. Compensation and Incentives

The FSB has made a substantial contribution in the development of effective Principles for Sound Compensation Practices, which date from its original April 2009 report and September 2009 Implementation Standards. Nine basic Principles were issued and organized in terms of effective governance, alignment to risk taking, and oversight and engagement. This has been followed up by thematic reviews and an implementation report and separate workshop.

This is highly valuable with the FSB having taken a significant lead in this area in the early post-crisis period. A number of more substantial programs have subsequently been constructed, such as by the Basel Committee in the banking area, and at the domestic

233. See Senior Supervisors Group, supra note 119; see also FSF Principles for Sound Compensation Practices, supra note 120.

level with the provisions incorporated within Section 19A of the UK FSA Senior Management Arrangements, Systems and Controls (SYSC) within its Handbook of Rules and Guidance. The FSB should consider these separate remuneration Codes and incorporate possible revisions to its basic Principles as necessary.

The issue of compensation is also intimately connected with the wider issue of management incentives and governance. Executive and non-executive board members as well as senior management and all other personnel within financial institutions must be properly incentivized and rewarded. Using variable reward entitlements within a payment package is legitimate, provided it does not distort risk management or conflict with customer interests. This should also be tied into other larger incentive structures within firms, including retraining and promotion entitlements. The FSB could reconsider the wider issue of incentives within financial firms and produce appropriate formal principles as necessary. The FSB could also consider issuing further governance requirements outside the remuneration area, following its more recent review work on risk governance.

A number of difficult issues also arise with regard to financial ethics, which are generally left to be dealt with at the national level. The FSB could consider issuing some guidance in this area, so that a common, minimum best practice can be identified.

E. Systemically Important Financial Institutions

The FSB has highlighted the importance of SIFIs, GSIFIs, and DSIFIs. A number of papers have been issued on SIFI supervision, moral hazard, and resolution. Thirty two specific recommendations were included within the November 2010 report on Intensity and Effectiveness of SIFI Supervision, with 12 sets of Key Attributes of Effective Resolution Regimes, as well as additional provisions on RRPs, resolvability, bail-in, and cross-border cooperation.

The November 2010 recommendations on Intensity and Effectiveness were principally concerned with adjusting the application of the Basel Committee Core Principles for Effective Banking Supervision and are consequently bank centric. The initial FSB list of 29 GSIFIs, published in November 2011, only contained banking groups. Many SIFIs derive their systemic status as complex groups involved in more than one core financial area with this work having to be extended to include Global Systemically Important Financial Groups (GSIGs) in addition to single institution SIFIs. The development of a more complete set of SIFI recommendations should also be considered, while incorporating equivalent provisions within the IAIS Insurance Core Principles and IOSCO Securities Standards and Objectives. These provisions should also be more clearly integrated into the

217. See supra § IV(D); see also Reducing the Moral Hazard (June), supra note 130; see also Reducing the Moral Hazard (Oct.), supra note 130; see also Intensity and Effectiveness of SIFI Supervision (2010), supra note 131; see also Key Attributes, supra note 82.
earlier papers issued by the FSF on HLIs and the Joint Forum on Financial Conglomerates and Complex Groups.\footnote{240}{See \textsc{Walker}, supra note 4, ch. 3. Joint Forum publications are \url{available at http://www.bis.org/list/jforum/index.htm}.}

It must also be stressed that the stability of financial markets may not only be threatened by the systemically important status of specific institutions. A series of “Systemically Important Principles” (SIPs) should be developed for all “Systemically Important Risks” (SIRs) including specifically, as noted, Systemically Important Financial Groups (SIFGs), as well as “Systemically Important Financial Markets” (SIFMs), “Systemically Important Financial Systems” (SIFSs), and “Systemically Important Financial Activities” (SIFAs). All of this should then be integrated into a larger more coherent program on SIFs and SIRs. This should be considered by the FSB in due course.

F. Resolution

The FSB has constructed an impressive program on resolution, especially with its extended consultation package in July 2011, then \textit{Key Attributes} in November 2011, and \textit{Guidance for Recovery and Resolution Planning for SIFIs} in November 2012.\footnote{241}{See \textsc{Fin. Stability Bd. Charter}, supra note XX, Annex B; \textsc{Standing Committee on Supervisory and Regulatory Cooperation}, supra note 80; \textsc{Members of Standing Committee on Supervisory and Regulatory Cooperation}, supra note 80; \textsc{Standing Committee on Supervisory and Regulatory Cooperation (FSB Watch)}, supra note 80; \textsc{Members of the Financial Stability Board}, supra note 83; \textsc{Links to FSB Members}, supra note 83; \textsc{FSB Steering Committee}, supra note 83.} The FSB originally consulted on its \textit{Key Attributes} with additional provisions on bail-in powers, cross-border cooperation, resolvability, RRPs and creditor hierarchy, and temporary suspension of proceedings. The October 2011 \textit{Key Attributes} were extended to apply to financial institutions more generally (including holding companies, non-regulated operational entities, and foreign firm branches), with 12 essential features being specified, including the establishment of Crisis Management Groups (CMGs) and additional guidance on specific issues in the Annexes, including institution-specific Cross-Border Cooperation Agreements (COAGs), resolvability assessments, RRPs, and temporary suspensions. The FSB subsequently consulted in November 2012 on the issuance of guidance on recovery triggers and stress scenarios, resolution strategies and operational resolution plans, and critical functions and critical shared services.

While the initial consultation in July 2011 was directed at SIFIs, this was slightly extended in the \textit{Key Attributes} in November 2011 to all financial institutions, with the November 2012 guidance again focused on SIFIs. The FSB accepts that these were also principally concerned with banking groups, although the parallel work being undertaken by IOSCO, IAIS, and the CPSS was referred to in the November 2012 document. As noted, the most significant dangers will arise with regard to larger complex groups, with each of these separate sets of resolution provisions having to be incorporated into a larger integrated set of “Key Attributes for DSIFGs and GSIFGs,” which incorporate effective “Group Resolution Plans or Procedures” (or GRPs).\footnote{242}{The FSB does refer to “group resolution plans” in \textit{Key Attributes of Effective Resolution Regimes for Financial Institutions}, supra note 82, ¶¶ 1.3, 11.8, Annex III ¶ 1.24.} CMGs will also have to work with group Supervisory Colleges in practice.
While the emphasis in many of the FSB papers is on post-crisis Resolution Planning (RP), the stability of DSIFIs and GSIFIs will be principally dependent on the effectiveness of their initial pre-crisis recovery planning and reconstruction strategies. Firms and supervisory agencies have a common interest in ensuring that the designs of these recovery or reconstruction programs are effective. Some difficulty may arise with regard to the use of the term “recovery” in a pre-crisis situation, as this may suggest an element of asset recovery or liquidation. A more appropriate term may have been “restructuring” or “reconstruction,” although it is presumably too late to change this in light of the number of official documents issued in this area.

Further work will also have to be undertaken to integrate the post-crisis Resolution Plans effectively into domestic post-crisis resolution procedures, such as with the Special Resolution Regime (SSR) set up in the United Kingdom under the Banking Act 2009, with possible work on the design of integrated effective “Global Resolution Regimes” (GRRs) being considered over time.

G. Shadow and Wholesale Markets

The FSB examined the nature of the general problems that arise with regard to shadow banking with its Scoping the Issues paper in April 2011. This was followed by the Strengthening Oversight and Regulation paper in October 2011, which focused on definition, monitoring, and outline regulatory measures. This included seven high level principles and a three-stage approach to monitoring with five general principles on regulatory tools and eleven specific recommendations. The FSB had already decided at the Paris meeting in July 2011 to focus on indirect regulation, MMFs and other entities, securitization and securities lending, and repos, with five work streams being set up. Much of this was confirmed in the Integrated Overview document in November 2012, following the further macro-mapping work and with two separate papers (Securities Lending and Repos and Shadow Banking Entities) based on a five-part functional approach, focusing on cash pools, short-term funded lending, and investment, credit creation, and securitization. The FSB has also continued its data collection work through its Global Shadow Banking Monitoring Reports.

A substantial amount of work has been carried out in this area with important recommendations issued, especially on monitoring and regulatory tools. This is nevertheless a complex area and covers a large number of different activities, which will necessarily change and evolve over time. The early IMF work was of particular value in identifying the nature of extended credit intermediation chains running between separate markets. All of these activities are not necessarily part of larger credit chains, with the credit intermediation definition possibly causing more difficulties than it solves. The principal vulnerabilities before the crisis arose in such new wholesale investment markets, as the ABCP, ABS, CDO, and CDS markets, which are not strictly credit, but also investment or capital markets, and in the use of off-balance sheet investment holding conduits and structured investment vehicles (SIVs). Separate concerns then arose with regard to such other specific markets as MMFs, which have a retail connection, as well as securities and repo markets and re-hypothecation.

It would be simpler and more inclusive to refer to these markets as more generic “wholesale markets” or “wholesale credit and investment markets,” which would include
the corporate ends of the MMF and securities and repo market. All of this only strictly constitutes “credit intermediation” if this is extended to include the provision of funding both through lending and investment through the purchase of bonds, notes, commercial paper, financial derivatives, and other corporate stock or other capital market instruments. If the term “shadow banking” is to be retained, it could be limited for use with regard to the use of off-balance sheet conduits or holding vehicles by regulated institutes, which could either be included within FSB WS1 (on Banks’ interactions with shadow banking entities) or a separate work stream.

In terms of regulatory control, each of the existing work streams should be continued to identify the extent to which existing direct or indirect regulation is sufficient or whether specific new sets of measures are required. The principal difficulties will arise within WS3, which covers other non-specific functions or activities (including cash pools, short-term funding, and credit creation), although there is overlap with WS4 on securitization. As the FSB has already acknowledged, many of these activities are highly useful and assist liquidity, risk management, collateral cover, investment choice, and overall stability. Five basic regulatory principles were identified in developing control tools in the October 2012 Strengthening Oversight and Regulation paper (based on focus, proportionality, adaptability, effectiveness, and review). These could be extended to include market efficiency and advantage, or be made subject to an overall presumption in favor of the preservation of market function. The authorities should generally avoid the temptation of imposing new regulatory controls on shadow banking more generally when it covers such a wide, unspecified, incoherent, separate, and often valuable set of financial activities. Controls should only be imposed where specific areas of risk or regulatory concern arise.

H. Crisis Management and Support

The establishment of effective cross-border crisis management arrangements remains a sensitive and difficult issue. This is closely connected with national interest and sovereign identity, sovereign autonomy, and the territorial exclusivity of the nation state and national jurisdiction. Many crisis management tools will also be discharged at the national level and be dependent on domestic powers and competences. The global financial crisis nevertheless confirmed the dangers of market integration and interdependence with consequent new global contagion. It is essential that effective cross-border crisis management arrangements be put in place to facilitate market support and firm restructuring, or winding down.

The FSB’s work on crisis management has been relatively limited. The FSF was involved in the review and production of guidance on effective deposit insurance systems, and later work was being undertaken by the IMF and the International Association of Deposit Insurers (IADI) following the recent crisis.243 The FSB issued a separate note on planned exit from exceptional financial support measures in November 2009.244 All of the other

244. See Exit from Extraordinary Financial Sector Support Measures, supra note 145, at 1. This followed an agreement in June 2009 to exchange notes on planned exits from exceptional financial support measures introduced since 2007. A number of institutions had to rely on such support with continuing difficulties with
FSB documents on its website are listed under “Crisis Resolution” and cover financial institution resolutions, GSIBs, OTC derivatives, and higher loss absorbency for GSIBs. This effectively combines crisis management with institutional resolution. The only specific document that deals with crisis management separately is the FSB Principles for Cross-Border Cooperation on Crisis Management issued in April 2009 in advance of the London G20 Summit.

The April 2009, FSB Principles for Cross-Border Cooperation on Crisis Management was stated to be based on the earlier Joint Task Force Report on “Winding Down an LCFI” in 2001 and EU principles for financial crisis management. These consisted of fifteen outlined principles and were limited in scope, content, and detail with the express recognition that financial crisis management remained a domestic competence at that time. The FSB website does refer to the consultative document on effective resolution of SIFIs in July 2011 and Key Attributes in November 2011, which incorporate its work on Crisis Management Groups (CMGs) and RRPs. Firm-specific CMGs and RRPs will be of key importance in managing individual institutions in difficulty, although these may not directly deal with larger systemic threats and systems crisis management.

It is essential that a comprehensive set of global arrangements are at least outlined, if not formally adhered to, by the principal financial jurisdictions. The FSB April 2009 Principles for Cross-Border Cooperation on Crisis Management is too short and unspecified for this purpose. E.U. Finance Ministers and Central Bank Governors agreed to a formal Memorandum of Understanding (MoU) on cross-border financial stability in May 2005, which was updated in June 2008. This constitutes one of the most comprehensive and weak institutions. This required judgment and flexibility in terms of timing and sequencing in light of the possible spillover effects on other countries. Some measures had either expired or had not been used, with others being temporary but retained, and others permanent. Four general principles were identified for exit strategies in terms of pre-announcement, flexibility, transparency, and credibility.

246. FSB Principles for Cross-Border Cooperation on Crisis Management, supra note 142, at 1.
247. Id. at 4; Comm’n of the Eur. Cmty., An EU Framework for Cross-Border Crisis Management in the Banking Sector, 2, COM(2009) 561/4 (Oct. 20, 2009), available at http://ec.europa.eu/internal_market/bank/docs/crisis-management/091020_communication_en.pdf. This acknowledges that the crisis had exposed the E.U.’s lack of effective crisis management for cross-border financial institutions, with Member States having to recapitalize and guarantee banks on an ad hoc basis in Autumn 2008. The Commission proposed a fundamental reform of the regulatory and supervisory system with a new supervisory architecture and EU resolution framework. The 2009 Communication included separate sections on Early Intervention (Section 3), Resolution (Section 4), and Insolvency (Section 5). Id. at 5-17.
249. Publications - Crisis Resolution, supra note 245.
250. See Eur. Cent. Bank, Memorandum of Understanding on Cooperation Between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on Cross-Border Financial Stability, at 1, ECFIN/CEFCPE(2008)REP/53106 REV (June 1, 2008), available at http://www.ecb.int/pub/pdf/other/mou-financialstability2008en.pdf. This consists of eleven articles on (1) objective and scope of the memorandum; (2) common principles for cross-border financial crisis management; (3) cooperation arrangements; (4) activation of procedures and responsibility for coordination in a cross-border crisis; (5) information exchange; (6) public communication; (7) contingency planning; (8) confidentiality; (9) implementation and review; (10) nature; and (11) entry into effect. Id. at 4-10. This includes Common Practical Guidelines (Annex 1) and a Template for a Systemic Assessment Framework (Annex 2). Id. at 14, 32. This extends the 2005 Memorandum of Understanding based on the council conclusions of October 9, 2007 and ECF Report of September 5, 2007 (ECFIN/CEFCP(2007) REP/53990). Id. at 1.
complete MoUs on financial stability available and extends to thirty-six papers. It is possible that non-E.U. governments have entered into other bilateral MoUs or Financial Services MoUs (FSMoU)\textsuperscript{251} at the international level. The FSB could nevertheless assume a leading role in this area by producing a draft or outline FSMoU for global use following the revised 2008 E.U. model.

I. Global Rulebook

One of the most significant early successes of the FSF was the construction of the Compendium of Standards. This initially operated on a virtual basis using HTML links to each of the key documents produced by all the member institutions in the financial area. The standards are more generally classified in terms of sector and function and consist of a range of principles, practices, and other methodologies or guidelines. While the number of documents included was relatively limited to begin with, this has expanded substantially to consist of almost 100 documents.\textsuperscript{252} The FSB had identified twelve key standards from an early stage based on macroeconomic policy and data transparency, financial regulation and supervision, and institutional and market infrastructure.\textsuperscript{253} These were identified on the basis of relevance and critical nature, universality, flexibility, endorsement, and accessibility.

The establishment of the Compendium has been one of the more significant achievements of the FSF and FSB. This forms the basis for a single global financial rulebook. Despite the earlier advances secured, however, the Compendium has since become too large, complex, and opaque, as well as uncertain in scope and content. While the key standards should be retained, the larger Compendium has to be restructured to provide a clear and succinct statement of all relevant principles, practices, and methodologies or guides. The basic division used in the Key Standards of Macroeconomic Transparency, Regulation and Supervision, and Market Infrastructure may be retained, although this could be substantially expanded and include appropriate sub-divisions. Key standards should be listed with their methodologies and other supporting guidelines or link documents that could be archived through the use of columns or sub-links.

\textsuperscript{251} See Walker, supra note 4. Relevant Parties are encouraged under Annex 1 of the E.U. Memorandum of Understanding to enter into “Voluntary Specific Cooperation Agreements” (VSCA) with a common “Cross-Border Stability Group” (CBSG). Eur. Cent. Bank, supra note 187, at 15. Annex 1 also covers strengthening crisis preparedness in normal times; crisis alert; crisis assessment; establishing a crisis management network (with “Domestic Standing Groups” (DSGs) and the CBSG); crisis management (including supervisory functions, central bank functions, public sector functions, monitoring, and involvement of other bodies or authorities); and external communication. Id. at 15-22. A model VSCA is attached to Annex 1. Id. at 22-11. Annex 2 contains a template for a systemic assessment framework based on a “systemic assessment heat map” covering relevant financial institutions, financial markets, financial infrastructure, and the real economy with a best outcome, likely outcome, and worst outcome assessment against four systemic impact scores of zero (no impact), one (limited impact), two (serious impact), or three (very severe impact). Id. at 33-37.

\textsuperscript{252} Although this only covered the subject and issuing body listed documents for the last five years, ninety-three standards were listed on the FSB website in early 2013. While earlier standards were included, a number of these will have since been updated. It is nevertheless unclear whether there are other papers still included within the Compendium that either pre-date the initial FSF work in 1999 or were issued between 1999 and 2008. .

\textsuperscript{253} See Key Standards for Sound Financial Systems, supra note 41.
Accordingly, the FSB should consider preparing a “Consolidated Statement of Standards” (CSS). This could explain the structure and organization of the Compendium with more specific key standards that could restate the existing selection criteria of relevance and critical nature, universality, flexibility, endorsement, and accessibility. Separate sectoral and functional sub-divisions may then be included and a menu or code used to distinguish principles, practices, assessment methodologies, and supporting guidelines. A separate “Compendium Guide” could also be issued, such as the U.K. FSA User Guide. The CSS should list all of the relevant standard setting bodies as already provided for on the FSB website.

The CSS should be separately integrated with the FSB’s Ongoing and Recent Work on Sound Financial Systems (SFS), which provide comprehensive summaries of progress and implementation work. The continuing updated CFS and SFS should adopt the same structure and be provided on an integrated basis on the FSB website. The provision of a clear, coherent, complete, accessible, and updated set of standards would be a significant achievement for the FSB.

J. Effective Supervisory Oversight

Even with effective standards, national and international authorities must ensure that relevant standards are properly applied in practice and that all relevant firms are subject to effective supervision. The need to strengthen the prudential oversight of capital, liquidity, and risk management was referred to in the original FSF recommendations on Enhancing Market and Institutional Resilience in April 2008, although the discussion tended to mix the imposition of relevant standards and ensuring effective supervisory monitoring and compliance.

A number of further weaknesses in supervision were identified in the 2012 progress report on, Intensity and Effectiveness of Supervision, especially with regard to GSIFI supervision, corporate governance, risk appetite and culture, operational risk, revenue stream and business return supervision (“follow the money”), and stress testing. A number of further specific resource difficulties within national authorities were identified following a Supervisory Intensity Effectiveness (SIE) group member questionnaire and IMF review of recent FSAP assessments. Supervisory Colleges had been set up for all GSIFIs, with separate Crisis Management Groups (CMGs) also having been established for resolution purposes. Thirty-two global and ninety regional colleges had been appointed in the insurance area, with thirty-two countries using the IAIS Multilateral MoU (MMoU) and with a central repository for insurance college information being managed through a Re-

254. Such as with simple references to “Ps,” “Pr,” “M,” and “G,” which is similar to the designations used in the U.K. FSA Handbook of Rules and Guidance.
256. Enhancing Market and Institutional Resilience, supra note 50, at 2; see supra § II.
257. Increasing the Intensity and Effectiveness of SIFI Supervision, supra note 201 at 1; see supra § II.
258. Increasing the Intensity and Effectiveness of SIFI Supervision, supra note 201, at 24. Difficulties remained with regard to: (a) supervisory numbers and seniority and skill; (b) attracting and retaining quality staff; (c) high staff turnover; and (d) supervisory culture and “mind-set,” including “soft skills.” Id.; see supra § III.
pository of Supervisory Colleges (IROSC) set up in 2011. A separate review of compliance against the Insurance Core Principles by FSB member countries was carried out in 2012.\textsuperscript{259} Although not referred to in the 2012 FSB Report, IOSCO had also adopted a separate MMoU in the securities area, with all 115 ordinary and associate members expected to become signatories or committed to obtaining legal authority to become signatories.\textsuperscript{260}

It is essential that all financial institutions are subject to effective ongoing supervision to ensure compliance on a continuous basis. The FSB reports have revealed a number of significant continuing difficulties in terms of domestic supervisory resources, technical capabilities, experience, involvement, and commitment. Financial firms must ultimately remain responsible for the management of the risks that their activities generate, although supervisory authorities must also ensure that effective monitoring and compliance systems are in place in all cases. All of this will be supported by the enhanced transparency and disclosure standards issued by the FSB with the IMF, which will promote external market discipline in addition to strengthened external official oversight and internal risk management and governance.

K. Standards Implementation and Adherence

It is essential that all key jurisdictions fully adopt and implement relevant international standards in all core financial sector areas. The issue of implementation was initially examined by the FSF in November 1999 under one of its earlier working groups, with an issues paper being produced in March 2000.\textsuperscript{261}

The FSF produced a Working Group report on Offshore Financial Centres (OFC) in April 2000 with two reports by a follow-up group (Incentives to Foster Implementation of Standards) in August 2000 and 2001.\textsuperscript{262} The FSB issued a statement, its Framework for Strengthening Adherence to International Standards,\textsuperscript{263} in January 2010, with a separate initiative to promote global adherence to cooperation and information exchange standards in March 2010 and with follow-up papers in April and October 2011 and November 2012.\textsuperscript{264}

The FSB lists on its website separate initiatives on “Implementation of Financial Reforms.” While these initiatives include some of the Recommendations for Enhanced Supervision papers, they are generally concerned with the implementation of G20


\textsuperscript{260} Int’l Org. of Sec. Comm’ns, Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (May 2012).

\textsuperscript{261} See FSF Task Force on Implementation of Standards, Fin. Stability Forum, Terms of Reference, at 1, (Nov. 19, 1999); Issues Paper of the Task Force on Implementation of Standards, supra note 219, at 1; supra § IV(L).


\textsuperscript{263} See FSB Framework for Strengthening Adherence to International Standards, supra note 216.

recommendations, more generally and specifically with regard to FSB work on OTC derivatives, SIFIs, and compensation. This includes FSB chair letters to G20 leaders and overview progress reports.\footnote{265. See \textit{Publications - Crisis Resolution, supra} note 245.}

It is essential that the FSB report on implementation of relevant G20 measures, although this does create some confusion with regard to the distinction between implementation and adherence, especially with earlier FSF work on implementation being included within the FSB’s “Adherence to Standards” publications. It may be preferable to reserve the term “adherence” for use in connection with measures governing relations between FSB members and member authorities, such as with regard to cooperation and exchange of information. The term “implementation” would then be reserved for domestic application of relevant international standards. The separate term “adoption” may then be used to refer to other continuing initiatives on the negotiation and publication of relevant international standards in specific areas of G20 direction or recommendation. This distinction may then be reflected in the continuing progress reports produced by the FSB that could include separate sections on adoption, adherence, and implementation.\footnote{266. See \textit{supra} § V(J).}

Clarifying the meaning and use of these terms could be undertaken as part of a larger restructuring of the FSB Compendium and website more generally, as referred to above.\footnote{267. See \textit{supra} § V(I).}

\section*{L. Financial Stability and Financial Function}

With the primary purpose of promoting international financial stability under its Articles,\footnote{268. \textit{FSB Articles of Association, supra} note 96, art. 2; \textit{see supra} § V(B).} the FSB must ensure that a complete and coherent program of measures is adopted in all key regulatory areas at the international level. All relevant G20 recommendations must be given effect. A complete program of relevant global standards must be adopted, and must be presented in a clear, comprehensive, and accessible manner, with the FSB also promoting and reporting on relevant adherence and implementation as appropriate.\footnote{269. \textit{See supra} § V(I), (K).}

The FSB must also ensure that no significant residual gaps are left in the emerging new control framework. While a substantial amount of work has been undertaken in key specific areas to deal with the core lessons identified following the global financial crisis, difficult and sensitive issues remain. The FSB must ensure that all relevant global systemically important risks (GSIRs) are properly managed and contained, including with regard to Global Systemically Important Financial Institutions (GSIFIs) and Global Systemically Important Financial Groups (GSIFGs).\footnote{270. \textit{This} must also include relevant Global Systemically Important Markets (GSIMs), Global Systemically Important Systems (GSISs), and Global Systemically Important Activities (GSIAs).} This must also include relevant Global Systemically Important Markets (GSIMs), Global Systemically Important Systems (GSISs), and Global Systemically Important Activities (GSIAs).\footnote{271. \textit{Id.}}

In so doing, the FSB must attempt to deal with all aspects of too big to fail (TBTF),\footnote{272. \textit{See supra} § IV(A), (A) n.110.} including “too big to manage, govern, and understand” (TBTM, TBTG or TBTU), “too
big to close, restructure or resolve” (TBTC), “too big to support, rescue or bail” (TBTS), and “too big to oversee, direct or correct” (TBTO). All of this results from wider international changes and trends, including the continuous consolidation, concentration, integration, and innovation of financial markets and institutions, and the increased dangers of contamination, contagion, closure, crisis, and collapse.

Specific difficulties also arise with regard to the wider issue of incentives in addition to remuneration, as well as with the even more general problem of financial ethics within modern financial markets. The FSB has also avoided the highly sensitive issue of market support, with the implied intent being that no further major financial crises will arise with strengthened regulation and effective ongoing supervision. This cannot be guaranteed, and during the last crisis a number of new support mechanisms had to be developed on an ad hoc basis to contain specific market crises and wider contagion in a number of countries. Even if this is not discussed expressly or publically, FSB members must cooperate in the design and establishment of appropriate new support facilities that must be in place in the event of a future extreme crisis. These must specifically include necessary individual institution funding of last resort (FLR), market liquidity of last resort (MLR), guarantees of last resort (GLR), capital of last resort (CLR), and asset purchase of insurance of last resort (ALR).

Monitoring all of these risks and exposures must be carried out on a continuous basis through the establishment of effective new macro-prudential oversight and surveillance arrangements. These include the U.S. Financial Stability Oversight Counsel (FSOC), E.U. European Systemic Risk Board (ESRB), and U.K. Financial Policy Committee (FPC). Further guidance could be provided by the FSB on the determination of the most effective institutional and operational structures for macro-prudential oversight following a review of these initiatives in due course. The role of the FSB with regard to the conduct of global macro-prudential oversight could also be clarified with the parallel functions of the IMF and BIS. All of the new initiatives announced at the international, European, and domestic levels will have to be drawn together within these new macro-prudential arrangements, which must also operate in a complimentary and coordinated manner. The FSB could, for example, consider designing appropriate contact mechanisms between these macro-prudential agencies, such as through the production of a new Macro-prudential MoU (MpMoU) model.

The FSB should also assist in promoting the ultimate regulatory objective of continued market function. National and regional economies and the international trading and financial systems will only be able to grow and develop if they are supported by efficient and effective financial markets. The residual or default objective of authorities must be to restore and maintain financial function, rather than impose unnecessary financial control or restriction. Authorities must promote financial growth, expansion, and innovation by only imposing financial restrictions or obligations as necessary to ensure the continued provision of effective financial services. The presumption must be in favor of financial function, rather than financial restriction or contraction. At the international and European levels, there has been an understandable but unfortunate tendency to look to over-regulate and over-react since the global financial crisis. The FSB could discharge a further leadership role by attempting to create an appropriate balance with an intelligent,
informed, and proportionate package of financial regulatory and supervisory standards and control systems.

VI. Financial Stability Close

The establishment of the FSB has been one of the most significant and successful response initiatives adopted since the global financial crisis. This reflects both an extension of jurisdictional participation following the expansion of the G7/G8 to include the G20 and a further increasing role, function, and operational capability of the FSB beyond the earlier FSF. The FSB must now ensure that it has all necessary funding, personnel, and administrative resources to carry out its key role in as complete and effective manner as possible.

Since its inauguration, the FSB has been able to develop an original and substantial program of regulatory and supervisory reform. It has created an almost overwhelming body of new international financial reference material. The FSB must focus on ensuring that all of its documentation is made available in as clear and accessible a manner as possible, and that all residual areas of regulatory and policy gaps and omissions are corrected.

The FSB has assumed an almost unique role in international relations, particularly in acting as a connector or conduit between the central bank, regulatory, and finance operations of all of the major countries, and SSBs and IFIs at this time. Its operational principles of contact, cooperation, and consensus facilitate negotiation and agreement on necessary measures in difficult and sensitive areas of national interest, and international significance and importance. In so doing, the FSB has, to a significant extent, extended the earlier cooperative culture established by the Basel Committee in the early 1970s to create a new multi-functional, high-level standards production, adherence, and implementation model.

The FSB deserves the full support and commitment from its constituent member countries and organizations to ensure that it can carry out all further necessary reforms and revisions both to its own practices and operations and with regard to the construction of a complete and effective new body of global regulatory, governance, and market oversight standards at this time.
Foreign Corrupt Practices Act Compliance Issues for Import/Export Operations

JOHN F. MCKENZIE*

Abstract

A leading issue in international corporate compliance is the Foreign Corrupt Practices Act ("FCPA") and related anti-corruption legislation in various countries. Based on press reports of celebrated cases and compliance investigations, most of the attention devoted to FCPA compliance on the part of corporate counsel, compliance officers, enforcement authorities and legal scholars and commentators has been directed to the compliance challenges presented by contracting with foreign government agencies and departments, and with state-owned enterprises. Relatively little attention has been devoted to the FCPA compliance challenges presented by import and export operations.

Especially in emerging markets with relatively high levels of official corruption, such import and export operations present a "perfect storm" of FCPA compliance risk, involving the confluence of: (i) interactions with government officials (often poorly compensated); (ii) dependence upon third parties (customs brokers, freight forwarders, consultants and import/export agents) who may subscribe to very different (and lax) business ethical principles and standards; (iii) relatively high rates of customs duties and import and export taxes; and (iv) a lack of transparency in international trade laws, regulations and procedural requirements. This article, therefore, identifies the key FCPA compliance issues and challenges arising in connection with import and export operations, and presents a series of warnings and recommendations to mitigate the compliance risks associated with those operations.

I. Introduction

In the thirty-five years since the enactment of the Foreign Corrupt Practices Act (FCPA), there has been a great deal of commentary, both in the legal journals and in the popular press, about the application and interpretation of that statute. Moreover, in the past decade, FCPA enforcement has been a matter of high priority for the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC). Those enforcement efforts have resulted in judgments obtained and settlement agreements reached in which

* John McKenzie is a partner in the San Francisco/Palo Alto office of Baker & McKenzie LLP. His practice involves trans-border commercial transactions, international-anticorruption compliance, and international trade regulation. He is a graduate of Williams College and Harvard Law School.
prominent companies have been subject to very large fines and penalties.1 Generally, the most prominent (or notorious) FCPA enforcement actions have involved large payments to foreign officials in order to secure large contracts from foreign government agencies for the purchase of goods and services.

In response to increased attention and law enforcement efforts devoted to FCPA compliance, a great many business enterprises have dedicated substantial resources to FCPA compliance policies, procedures, and training. In large part, those compliance efforts have been designed to prevent improper payments in connection with soliciting, promoting, obtaining, and maintaining contracts and other business opportunities with foreign government agencies. In contrast, it appears that relatively little attention on the part of corporate compliance officials has been devoted to FCPA compliance issues in connection with corporate import and export operations. The relative lack of attention to FCPA compliance is unfortunate and fraught with peril because, as discussed in this paper, import and export operations—especially in emerging markets—pose significant risks to U.S. companies under the FCPA.

The import of merchandise into and the export of merchandise from any particular country invariably involve substantial interactions with government officials of that country (e.g., customs officials, import/export licensing officials, product safety certification and standards officials, etc.). In many emerging markets, imported merchandise is subject to relatively high import duties and taxes that adversely affect the competitiveness of that merchandise in those countries. Correspondingly, many emerging markets also have import and export licensing and other regulatory requirements that lack transparency and that may make the movement of merchandise into and out of those countries time-consuming, cumbersome, and expensive. Under these circumstances, especially in “high-risk” countries where local officials may be significantly underpaid and where official corruption is commonplace, the temptation to make payments or provide other benefits to those local officials in order to “facilitate” or “expedite” the import and export of merchandise may be very high. Such payments to foreign customs, tax, and import/export regulatory officials are, however, likely to run afoul of the FCPA.

In view of the FCPA compliance risks posed by import and export operations, corporate trade compliance officials need to be aware of requirements and restrictions of the FCPA, and the application of that statute to the various circumstances in which compliance problems may arise. The objective of this paper is, therefore, to highlight those situations in which the import and/or export of merchandise in international trade and commerce may cause FCPA compliance problems or may expose corporate importers and exporters to potential liability for violations of the FCPA. Although this paper is directed primarily at corporate trade compliance officials, it is extremely important that corporate counsel and corporate ethics and compliance officers understand this often-overlooked area of FCPA compliance exposure. As trade compliance professionals are generally the corporate officials with the greatest visibility into import and export operations, including the

1. The largest penalties to date were imposed upon Siemens AG and its affiliates. In December, 2008, Siemens paid fines in the total amount of $1.6 billion to the DOJ, the SEC, and German authorities in connection with guilty pleas to multiple violations of the FCPA. See Press Release, U.S. Dep’t of Justice, Siemens AG and Three Subsidiaries Plead Guilty to Foreign Corrupt Practices Act Violations and Agree to Pay $450 Million in Combined Criminal Fines (Dec. 15, 2008), available at http://www.justice.gov/opa/pr/2008/December/08-crm-1105.html.
activities of third parties acting on behalf of the company (e.g., customs brokers, freight
forwarders, logistics service providers, and trade consultants), those trade compliance pro-
fessionals can and should be key players in the company’s overall efforts to assure compli-
ance with its obligations under the FCPA.2

II. The Foreign Corrupt Practices Act

The FCPA was enacted in 1977 to prevent bribery of foreign officials by U.S. compa-
nies.3 There are two separate and distinct provisions of the FCPA, as follows: (i) the anti-
bribery provisions, which prohibit payments to foreign officials for certain specified im-
proper purposes; and (ii) the accounting provisions, which require publicly-traded compa-
nies to keep accurate books and records of account and to establish and maintain effective
internal accounting controls. As discussed below, each of these separate provisions of the
FCPA has significant implications for business practices in import/export operations.4

A. The Anti-Bribery Provisions of the FCPA

The anti-bribery provisions of the FCPA are set forth in two separate sections of the
statute: section 103,5 which applies to “issuers,”6 and section 104,7 which applies to “dom-
estic concerns.”8 Those anti-bribery provisions9 prohibit any issuer and domestic concern
and any officer, director, employee or agent, acting on behalf of an issuer or a
domestic concern from paying or giving, or promising or offering to pay or give, or au-
thorizing another person to pay or give, any money or any other thing of value to a “for-
eign official” for the purpose of (i) influencing any act or decision by that foreign official; (ii)
inducing that foreign official to do or omit to do any act in violation of his/her lawful
duty; (iii) securing any improper advantage; or (iv) inducing the foreign official to use his/
her influence to assist the payor in obtaining or retaining business, or directing business to

2. Two absolutely essential resources for any FCPA compliance program are (i) Dep’t of Justice & Sec.


4. Id.


6. An “issuer” is a company (i) whose shares are registered with the SEC under section 12 of the FCPA or
(ii) a company that is required to file reports with the SEC under section 15(d) of the FCPA. 15 U.S.C.


8. The term “domestic concern” is defined in section 104(h) of the FCPA, as amended, to include (1) any
individual who is a citizen, national, or resident of the United States or (2) any corporation, partnership,
association, joint-stock company, business trust, unincorporated organization, or sole proprietorship which
has its principal place of business in the United States, or which is organized under the laws of any State or
territory of the United States. The intent of broadly defining the term “domestic concern” is to assure that
all corporations and other business enterprises that are not “issuers” under the Securities Exchange Act are

another person. For purposes of this paper, there are five elements of the anti-bribery provisions of the FCPA that merit special consideration.

1. **Foreign Officials**

The FCPA prohibits certain improper payments to “foreign officials.” The term “foreign official” is defined in Sections 103(f)(1)(A) and 104(h)(2)(A) as:

[A]ny officer or employee of a foreign government or any department, agency, or instrumentality thereof, or any public international organization, or any person acting in an official capacity for or on behalf of any such government or department, agency or instrumentality, or for or on behalf of any such public international organization.

Officials and employees of a country’s customs service, import/export licensing agency, or other regulatory agency clearly come within the scope of the statutory definition of a “foreign official.” Importantly, officers and employees of private parties acting on behalf of a foreign government department or agency may also be “foreign officials” for purposes of the FCPA. This point may be of considerable importance for import/export operations because the various regulatory agencies and/or the customs service in a number of countries have engaged private companies, such as SGS, to conduct tests or pre-shipment inspections of merchandise to be imported into those countries, in order to assure that the merchandise conforms to the country’s product safety, environmental, and certification standards. A payment made to an employee of such a private inspection company (e.g., to issue a false inspection report or to certify non-conforming goods) could constitute a violation of the anti-bribery provisions of the FCPA, just as would a payment made to a foreign government customs inspector or regulatory enforcement officer under the standards discussed below.

2. **Business Purpose**

The anti-bribery provisions of the FCPA prohibit payments to any foreign official for the purpose of: (i) causing that foreign official to fail to perform his/her lawful duty, (ii) securing an improper advantage, or (iii) inducing the foreign official to use his/her influence to obtain or retain business for the payor or to direct business to any other person.

Based on the statutory language of this “business purpose” element of the FCPA, the principal focus of FCPA compliance and enforcement activities has been in preventing or punishing the payment by U.S. companies of bribes to foreign officials made to obtain procurement contracts and other business opportunities from foreign governments.

---


Nonetheless, the 2004 decision of the Federal Court of Appeals for the Fifth Circuit in United States v. Kay makes it clear that the “business purpose” element of the anti-bribery provisions of the FCPA extends beyond payments made to foreign officials to obtain government contracts.\(^\text{15}\) In the Kay case, the defendants were indicted under the FCPA for paying bribes to Haitian customs officials in order to avoid paying lawful duties and import taxes on the importation of rice into Haiti.\(^\text{16}\) The defendants challenged their indictments on the ground that payments made to foreign officials to avoid (or evade) the payment of duties and taxes were not within the scope of the prohibitions of the FCPA because they were not made “to obtain or retain business.”\(^\text{17}\) The Court of Appeals, however, rejected that argument and held that:

Congress intended for the FCPA to apply broadly to payments intended to assist the payor, either directly or indirectly, in obtaining or retaining business for some person, and that bribes paid to foreign tax officials to secure illegally reduced customs and tax liability constitute a type of payment that can fall within this broad coverage.\(^\text{18}\)

It is now well established (and should be assumed for purposes of designing and implementing compliance programs) that a payment made to a foreign customs officer or inspector for the purpose of avoiding the payment of lawful duties and taxes, or for the purpose of avoiding compliance with other regulatory requirements and formalities, in connection with the importation of merchandise into a particular country, will constitute a payment made for an improper business purpose as contemplated by the FCPA’s anti-bribery provisions.\(^\text{19}\)

3. Payments to Third Parties

The anti-bribery provisions of the FCPA prohibit payments for improper purposes made both directly to foreign officials and through third party intermediaries.\(^\text{20}\) Thus, sections 103(a)(3) and 104(a)(3) prohibit issuers and domestic concerns, respectively, from paying, giving, or offering or promising to pay or give any money or any other thing of value to any person with knowledge that all or a portion of that money or other thing of value will

---

\(^{15}\) United States v. Kay, 359 F.3d 738 (5th Cir. 2004), convictions affirmed, 513 F.3d 432 (5th Cir. 2007), rehearing denied, 513 F.3d 461 (5th Cir. 2008).

\(^{16}\) Id. at 740-41.

\(^{17}\) Id.

\(^{18}\) Kay, 359 F.3d at 755; see also H.R. CONFERENCE REP. NO. 100-576, pt. 1, at 918 (1988) (Conf. Rep.) (discussing the “business purpose” element of the FCPA in connection with the 1988 amendments to the statute. The “business purpose” element of the statute is “not limited to the renewal of contracts or other business, but also includes a prohibition against corrupt payments related to the execution or performance of contracts or the carrying out of existing business, such as a payment to a foreign official for the purpose of obtaining more favorable tax treatment.” [emphasis in the original]).

\(^{19}\) See, e.g., Plea Agreement, United States v. Panalpina, No. 10-CR-765 (S.D. Tex. Nov. 4, 2010) (payments made to Nigerian Customs Service employees to avoid Nigerian customs duties and taxes); Information, Vetco Gray Controls, Inc., supra note 12 (payments made to Nigerian Customs Service employees to secure preferential treatment in connection with customs clearance process and the avoidance of Nigerian customs duties and tariffs), Helmerich & Payne, Inc., Exchange Act Release No. 60,400, 2009 WL 2341649 (July 30, 2009), available at www.sec.gov/litigation/admin/2009/34-60400.pdf (payments made to Argentine and Venezuelan customs officials (1) to import merchandise without proper certifications, (2) to secure a lower duty rate that lawfully applicable, and (3) to import and export merchandise contrary to import/export regulations).

be offered, given, or promised, directly or indirectly, to a foreign official for an improper purpose. This element of the FCPA’s anti-bribery provisions presents particular compliance challenges in the context of import/export operations, because companies typically rely upon third parties to perform essential services in connection with international trade transactions. Thus, export clearance and international shipment of merchandise is typically handled for exporters by independent freight forwarders or logistics service providers. Under many countries’ customs laws and regulations, import and customs clearance formalities must be handled by licensed customs brokers or authorized import/export corporations; and, in those countries with complex import regulations and non-tariff barriers lacking in transparency, as a practical matter it may be necessary to engage a local trade consultant to handle compliance with regulatory requirements and import restrictions.

Under the foregoing sections of the anti-bribery provisions of the FCPA, a U.S. company may be subject to “imputed liability” under the FCPA in the event that a customs broker, freight forwarder, or other third party service provider makes an improper payment to a foreign customs or import/export regulatory official on behalf of that U.S. company.

An issuer or a domestic concern may be subject to imputed liability under the FCPA, based on an improper payment made to a foreign official by a third party intermediary, if that issuer or domestic concern makes a payment or provides some other thing of value to the third party intermediary with knowledge that some or all of the payment or other thing of value will be offered, given, or promised to that foreign official. For purposes of imposing such “imputed liability” on an issuer or a domestic concern, however, it is not necessary for the DOJ or SEC to prove that the issuer or domestic concern had actual knowledge of the improper payment by a third party intermediary if that person is aware of facts and circumstances indicating a high probability that the improper payment is likely to occur.

In effect, an issuer or domestic concern may be subject to penalties, including criminal penalties, under the FCPA if the evidence shows a “conscious disregard” or “willful blindness” on the part of the issuer or domestic concern to the activities of a third party intermediary acting on its behalf in dealing with foreign officials. Evidence of such a conscious disregard or willful blindness may take the form of various red flags suggesting a
FOREIGN CORRUPT PRACTICES ACT

heightened possibility that a third party intermediary may intend, or may have an incentive to, make improper payments to foreign officials in furtherance of the issuer’s or domestic concern’s business. As discussed in detail in Sections III(A) and III(B) of this paper, infra, an effective FCPA compliance program should, therefore, include: (i) comprehensive due diligence in engaging third party intermediaries—including freight forwarders, customs brokers, logistics service providers, and trade consultants—to determine if the intermediary or the proposed relationship presents any such red flags and (ii) carefully monitoring the activities of the third party intermediaries to assure that the intermediaries’ on-going performance does not indicate the presence of any such red flags.26

4. The Facilitating Payment Exception: Trap for the Unwary

Sections 103(b) and 104(b) of the FCPA include an exception to the anti-bribery prohibitions for facilitating or expediting payments made to foreign officials to expedite or secure the performance of a “routine governmental action.”27 For purposes of this “facilitating payment” exception, “routine governmental action” is defined to mean, and is limited to, actions ordinarily and commonly performed by foreign officials (ministerial or clerical officials) in connection with:

(i) Obtaining permits, licenses, or other official documents to qualify to do business in a foreign country;

(ii) Processing governmental papers, such as visas or work orders;

(iii) Providing police protection, mail pick-up and delivery, or scheduling inspections associated with contract performance or inspections related to transit of goods across country;

(iv) Providing phone service, power and water supply, loading and unloading cargo, or protecting perishable products or commodities from deterioration; or

(v) Actions of a similar nature.28

Especially in the context of import/export operations, it is submitted that this “facilitating payment” exception is a trap for the unwary and any issuer or domestic concern would be extremely ill-advised to rely upon the exception as a basis for ignoring or justifying payments made to foreign customs or other import/export regulatory officials in connection with the import or export of merchandise into or out of a foreign country. Thus, for

26. For a comprehensive list of “red flags” that may arise with respect to relationships with third party intermediaries, including agents and consultants, see Tarun, supra note 2, at 91-92.

27. 15 U.S.C. § 78dd-1(b), 15 U.S.C. § 78dd-2(b). This “facilitating payment” represents a codification, as part of the 1988 amendments to the FCPA, of Congress’ intent when the FCPA was first enacted in 1977. Thus, the legislative history of the 1977 version of the FCPA reflects Congress’ intent to exclude “facilitating payments” from the anti-bribery prohibitions of the statute, as follows: “The language of the bill is deliberately cast in terms which differentiate between such payments and facilitating payments, sometimes called ‘grease payments.’ In using the word ‘corruptly,’ the committee intends to distinguish between payments which cause an official to exercise other than his free will in acting or deciding or influencing an act or decision and those payments which merely move a particular matter toward an eventual act or decision or which do not involve any discretionary action. . . . For example, a gratuity paid to a customs official to speed the processing of a customs document would not be reached by the bill. Nor would it reach payments made to secure permits, licenses, or the expedientious performance of similar duties of an essentially ministerial or clerical nature which must of necessity be performed in any event.” H.R. REP. NO. 95-640, at 4 (1977) (Conf. Rep.).

example, payments made to foreign customs officers will almost invariably be character-
ized by the payor as made solely to “facilitate” or “expedite” the importation of merchan-
dise into the foreign country in question.  

The fact that a payment to a foreign official is characterized (or identified on a customs
broker’s or import/export agent’s invoice) as made to facilitate or expedite the customs
clearance and regulatory formalities for the importation of merchandise does not, however,
make that payment permissible under the “facilitating payment” exception to the
FCPA.  To the contrary, if the payment to a foreign official is intended to avoid (i) the
payment of lawful customs duties and import taxes; (ii) compliance with customs inspec-
tion or product certification requirements; or (iii) compliance with other import/export
regulatory formalities, the payment will be an illegal bribe under the FCPA, even if the
intent and effect of the payment is to “facilitate” or expedite the importation of merchan-
dise into the foreign official’s country.  

As discussed in detail in Section III(A) of this
paper, infra, the characterization of a payment on an employee’s expense report or on an
invoice submitted by a customs broker, freight forwarder, or import/export agent as a
payment to facilitate or expedite the import or export of merchandise should, in fact, be
seen as a red flag suggesting the possibility that an improper payment has been made to a
foreign official in connection with the movement of that merchandise.

5. De Minimis Payments to Foreign Officials

It is important to emphasize that there is no exception to the anti-bribery prohibitions
of the FCPA for de minimis payments to foreign officials.  A payment made by or on behalf
of an issuer or domestic concern to a foreign official, even if trivial in amount, may still
constitute an illegal bribe under the FCPA if made for an improper purpose (i.e., to obtain
or retain business or to secure some other improper advantage).  Thus, for example, in the
SEC’s administrative enforcement action against Helmerich & Payne, Inc. (H&P), it was
alleged that H&P made payments to Venezuelan customs officials in the total amount of
only $7,000 over a five-year period.  Nonetheless, those payments were treated as unlawful
bribes, as they were made to avoid customs inspections and compliance with Venezuelan
import/export regulation.

29. For example, in In the matter of Helmerich & Payne, Inc., the SEC charged that H&P made improper
payments to Argentine and Venezuelan customs officials to (i) avoid customs duties, (ii) import merchandise
without required customs inspections, and (iii) import merchandise that was not authorized for importation
under local law.  H&P had characterized the payments as “customs processing” or “customs facilitation”
payments.  Helmerich & Payne, Inc., supra note 19.  Similarly, the Plea Agreement in United States v. Panalpina,
indicates that improper payments made by Panalpina on behalf of its customers to Nigerian Customs Service
employees were invoiced to the customers as “local processing fees” or “administration/transport charges.”
Panalpina, No. 10-CR-765.

30. DOJ/SEC FCPA RESOURCE GUIDE, supra note 2, at 25.  A further problem with the “facilitating
payment” exception to the FCPA’s anti-bribery provisions is that even if a payment to a foreign official does,
in fact, come within the scope of that exception and therefore does not constitute a violation of the FCPA, it
is likely to be an unlawful payment under the laws of the foreign official’s home country.  Anti-corruption and
public service laws of most countries generally prohibit government officials from receiving, and private par-
ties from offering, consideration of any kind for the performance by those government officials of their
official duties.

amendments to the FCPA Congress considered adding an affirmative defense for nominal payments and gifts
to foreign officials, given as a courtesy or token of respect, of reasonable value consistent with local customs
B. The Accounting Provisions of the FCPA

Section 102 of the FCPA\(^32\) imposes two separate obligations on issuers, which are intended to supplement the anti-bribery provisions of the statute, by preventing “off books” accounts and other accounting irregularities that may be intended to disguise improper payments to foreign officials.\(^31\) Specifically, those “accounting provisions” of the FCPA require each issuer to:

(A) Make and keep books, records and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the issuer\(^34\);

(B) Devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that: (i) transactions are executed in accordance with management’s... authorization; (ii) transactions are recorded as necessary to... permit the preparation of financial statements in conformity with generally accepted accounting principles... and... to maintain accountability for assets; (iii) access to assets is permitted only in accordance with management’s... authorization; and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.\(^35\)

There are three key points regarding the accounting provisions of the FCPA that may be particularly relevant to understanding the application of those provisions to import/export operations of a multinational corporation. First, unlike the anti-bribery provisions of the statute, the accounting principles apply directly to those foreign subsidiaries of an issuer whose assets, operations, and financial results are included in the consolidated financial statements of the issuer. Thus, an improper payment to a foreign official made by a foreign subsidiary of an issuer and mischaracterized on the books and records of that foreign subsidiary may constitute a violation by the issuer of both the books and records provision and the internal accounting controls provision of the FCPA, even if there is no other jurisdictional nexus between the improper payment and the United States (i.e., the improper payment may not be within the jurisdictional scope of the anti-bribery provisions of the statute).\(^36\) This point may be especially important for issuers whose foreign subsidiaries act as importers and exporters of record in their respective countries.

---

\(^32\) Section 13 of the Securities Exchange Act of 1934, 15 U.S.C. § 78m(b). The legislative history of the FCPA's accounting provisions explains the importance of those provisions in preventing the payment of bribes to foreign officials as follows: “corporate bribery has been concealed by the falsification of corporate books and records... [T]he accounting provisions remove this avenue of cover-up... [T]aken together, the accounting provisions and the criminal anti-bribery provisions should effectively deter corporate bribery of foreign government officials.” S. REP. NO. 95-114, at 2 (1977).

\(^31\) Violations of the accounting provisions of the FCPA are punishable, in the case of issuers, by criminal fines of up to $25 million and, in the case of individuals, by criminal fines of up to $5 million and imprisonment for up to 20 years. 15 U.S.C. § 78ff(c).

\(^34\) The mandate of the “books and records” provision of the FCPA is implemented by SEC Rule 13b2-1, which provides that “No person shall directly or indirectly, falsify or cause to be falsified, any book, record or account subject to section 13(b)(2)(A) of the Securities Exchange Act.” 17 C.F.R. § 240.13b2-1.


\(^36\) See, e.g., Int’l Bus. Mach. Corp., Litigation Release No. 16839 available at http://www.sec.gov/litigation/litreleases/lr16839.htm (Dec. 21, 2000) (announcing the settlement of a civil action against IBM under the books and records provision of the FCPA for payments made by IBM’s Argentine subsidiary to officials of...
Second, although the accounting provisions were enacted as part of the FCPA and were intended primarily to prohibit the concealment of improper payments to foreign officials through “off books” accounts and falsified accounting records, the application of those accounting provisions is not so limited. To the contrary, the making of a false accounting record or the mischaracterization of a particular payment on the books and records of an issuer may constitute a violation of the accounting provisions of the FCPA, even where (i) the actual payment is lawful under the anti-bribery provisions of the FCPA or (ii) there is no evidence whatsoever that the false accounting record involved a payment to a foreign official. Accordingly, as discussed in more detail in Section III(B) of this paper, the issuance of a commercial invoice, to be used in connection with the import of merchandise into a foreign country in which the value of the merchandise is misstated and/or other false or inaccurate information about the merchandise is presented, may constitute a violation of the books and records provisions of the FCPA. A commercial invoice reflecting the sale of merchandise by an issuer to a foreign buyer is an “accounting record” for purposes of that books and records provision.

Third, there is no “materiality” element under the FCPA’s accounting provisions. A violation of those accounting provisions may occur if an issuer (or a person acting on behalf of the issuer) knowingly makes a false accounting document (such as an invoice) or makes a false entry on the issuer’s books and records of account, even if the inaccurate amount is relatively small. In many instances, the values of individual import or export transactions and individual customs entries are likely to be well below the company’s “materiality” threshold for SEC financial reporting purposes.

III. Import/Export Problem Areas for FCPA Compliance

The following are among the circumstances in which FCPA compliance risks and problems are most likely to be encountered in connection with import/export operations:

A. Avoidance of Customs Duties and Import Taxes

The import and customs laws and regulations in a number of emerging countries impose high customs duties and import taxes on imported merchandise, which has a severely negative impact on the competitiveness of imported merchandise as compared to similar goods produced locally (but which may be of lesser quality and/or technical sophistica-
As a result, in a highly competitive environment there may be a temptation to find ways to avoid or minimize those customs duties and import taxes. As the decision of the Court of Appeals in the United States v. Kay case shows, a payment made to a foreign customs officer for the purpose of avoiding (or evading) lawful customs duties and import taxes will constitute an unlawful bribe under the anti-bribery provisions of the FCPA.

In the United States v. Kay case, the defendants paid bribes to Haitian customs officials to induce those officials to accept false customs entry documents on which the quantity of imported merchandise and the value of that merchandise were understated, so as to minimize Haitian customs duties and import taxes.

For companies that have adhered to strict standards of business ethics and have implemented robust internal FCPA compliance policies and programs, the greatest FCPA compliance risk in the importation of merchandise into such emerging markets may arise in connection with dealings with and through third party intermediaries, such as customs brokers, import/export agents, and trade consultants. That risk may be highlighted by the facts and circumstances surrounding the United States v. Panalpina case. Panalpina is an international logistics services company that provides freight forwarding and customs clearance services on behalf of its clients.

In the Plea Agreement resolving that case, Panalpina admitted paying bribes to Nigerian customs officials to secure preferential customs treatment, including the avoidance of taxes and duties, for merchandise imported into Nigeria on behalf of Panalpina’s customers. Concurrently with the resolution of the Panalpina case, five of Panalpina’s customers also agreed to the payment of substantial fines and penalties to resolve FCPA violations. Those five customers acknowledged that they knew that Panalpina had made the improper payments to Nigerian customs officials.

A customs broker or other intermediary may make payments to a foreign customs official to avoid or reduce customs duties and import taxes in order to “assist” its customer (i.e., the U.S. issuer or domestic concern) in enhancing its competitive position in the country of importation. In such circumstances, the improper payments may be made by

---

40. For example, the effect of the imposition of customs duties, federal excise taxes, state value added taxes, and various municipal taxes and fees on merchandise imported into Brazil may be that the “landed” cost of that merchandise is approximately twice the FOB, port of shipment, sales price of that merchandise.

41. See United States v. Kay, 359 F.3d 738, 755 (5th Cir. 2004); see also H.R. CONFERENCE REP. No. 100-576, at 918-919 (explaining that the FCPA’s prohibition against corrupt payments includes payments to foreign officials for the purpose of obtaining more favorable tax treatment).

42. United States v. Kay, 359 F.3d at 740-41.


44. Id. at B-2, ¶¶ 2-4.

45. See 15 U.S.C. sec. 78dd-1(a)(1), 78-dd-2(a)(1); see also Vetco Gray Controls, Inc., supra note 12, ¶¶ 30-31 (discussing a situation where a customs broker made improper payments to Nigerian Customs Service officials in order to secure preferential treatment for merchandise imported into Nigeria for and on behalf of Vetco Gray, with knowledge and authorization by Vetco Gray of those improper payments).

46. In one instance with which the author is familiar, the effort by a foreign contract manufacturer located in a Southeast Asian country to reduce the cost of products that the contractor manufactured for a U.S. company exposed the company to a serious FCPA compliance risk. The parts and components used in the manufacturing process were subject to high customs duties upon importation into the Southeast Asian country in question, and the contractor was not able to recover those customs duties upon exportation of the finished goods to the U.S. company (i.e., no duty drawback or inward processing duty refund was available). The contractor, therefore, made payments without the actual knowledge of the U.S. company to local customs officers to cause those customs officers to “reclassify” the parts and components under a different tariff
the customs broker or other intermediary to those foreign officials without the direct authorization or actual knowledge of the issuer or domestic concern. Nonetheless, as explained in Section II(A)(3) of this paper, supra, “knowledge” of such improper payments may be inferred (for purposes of imposing “imputed liability” under the FCPA on the issuer or domestic concern) from the presence of “red flags” suggesting willful blindness or conscious disregard of FCPA compliance risks. Accordingly, in dealing with customs brokers and other third party intermediaries assisting with import/export operations, especially in “high risk” countries,47 international trade professionals working for U.S. companies should be on the lookout for the following: (i) arrangements that may suggest that merchandise is not being imported into those countries in strict compliance with local customs and import laws and regulations or (ii) unusual costs and expense charges that may be disguised requests for reimbursement for improper payments made to foreign customs officials. Examples of such “red flags” suggesting the possibility of improper payments to foreign customs officials include

• customs entry documents classifying the goods in question under an unusual or demonstrably incorrect tariff classification number;
• customs entry documents declaring the customs value of the goods at a substantially lower amount than the sales price stated on the U.S. supplier’s commercial invoice for those goods;
• requests for payment or reimbursement of “customs processing fees,” “customs expediting fees,” “administrative fees,” and “special handling charges,”48 and
• unusual shipping and routing arrangements.

To that end, any agreement with a third party intermediary that will handle any import/export operations on behalf of a U.S. company should include audit rights that authorize the U.S. company to conduct an audit of the third party intermediary’s books and records to confirm the third party intermediary’s compliance with its obligations under that agreement, especially FCPA compliance provisions. The U.S. company should then invoke those audit provisions in the event that any such “red flags” suggesting the possibility of an improper payment by the third party intermediary to a foreign customs (or other) official come to the attention of the U.S. company’s international trade professionals.49

classification number, which was subject to a much lower rate of customs duty. The U.S. company only learned of the improper payments by the contractor when that contractor sought reimbursement for “tea money” that it had paid to the local customs officers to secure that favorable customs treatment for the imported parts and components.

47. Transparency International, a non-governmental organization based in Berlin, Germany, publishes an annual corruption perception index (CPI), ranking 176 countries in terms of the perception of the level of official corruption. Any country with a CPI score of 5.0 or less is considered a “high risk” country from an FCPA compliance perspective. The Transparency International CPI may be found at http://www.transparency.org/cpi2012. For a discussion of how the DOJ and the SEC refer to the Transparency International CPI in evaluating corporate compliance efforts under the FCPA, see Tarun, supra note 2, at 92-93.

48. The improper payments by Panalpina on behalf of its customers were so characterized when charged back to those customers. See Panalpina, No. 10-CR-765, ¶ 68 (specifying that recording payments to a customs broker as “customs processing fees,” “special handling fees,” or “facilitating or expediting fees,” where an issuer knows that the payments are, in fact, reimbursements for improper payments to foreign customs officials, will also constitute a violation of the FCPA’s books, records, and internal accounting controls requirements); see, e.g., Noble Corp., No. 10-CV-4336, ¶¶ 18, 23, 27.

49. Any request from a customs broker or other third party intermediary for reimbursement of a “facilitating payment” to a foreign customs official should be subject to special scrutiny. As explained in Section
B. Under-Invoicing Schemes

In circumstances in which a customer, other than a U.S. company or its foreign subsidiary, is the importer of record for merchandise to be imported into a country with high customs duties and import taxes, the U.S. supplier may receive a request from the foreign customer to state on the commercial invoice accompanying the merchandise a declared value for that merchandise substantially lower than the actual price of sale of the merchandise. Invariably, the objective of such an “under-invoicing” request is to understate the declared value of the merchandise for local customs purposes, thereby avoiding lawful customs duties and import taxes on the importation of that merchandise. 50

The issuance of a knowingly false commercial invoice in response to a customer request may constitute a violation of the books and records section of the FCPA’s accounting provisions. Importantly, as explained in Section II(B) of this paper, supra, the issuance of such a false commercial invoice may violate those FCPA accounting provisions even though (i) there is no evidence whatsoever that any improper payment was made by the issuer or the foreign customer to a foreign customs official in connection with the importation of the merchandise in question, (ii) the amount of the understatement of the value of the merchandise on the issuer’s commercial invoice is immaterial, and (iii) the issuer declares the correct value of the merchandise in the “electronic export information” filed with the U.S. Census Bureau at the time of exportation of the merchandise from the United States. 51

International trade professionals should be aware of the fact that acceding to customer under-invoicing requests in connection with the importation of merchandise into a foreign country may also expose the U.S. supplier to potential criminal liability under other federal criminal statutes, most notably the federal mail fraud and wire fraud statutes. 52 Thus, in Pasquantino v. United States, the U.S. Supreme Court upheld the convictions of two defendants for violation of the federal wire fraud statute in connection with a scheme

---

2(a)(4) of this paper, the fact that a payment to a foreign official is described by the customs broker or other third party intermediary as a “facilitating payment,” does not necessarily make it a lawful payment under the facilitating payment exception to the anti-bribery provisions of the FCPA. There may be a temptation to characterize any payment to a foreign customs official as a “facilitating payment” because it is intended to “facilitate” the importation of merchandise into the foreign country in question and/or to disguise the actual purpose for the payment.

50. In most countries of the world, customs duties and various other import taxes (e.g., import value added taxes, goods and services taxes, or their equivalent) are assessed on an ad valorem basis (i.e., the duties and taxes payable are a percentage of the “customs value” of the imported merchandise). The “customs value” of imported merchandise in virtually all countries that are members of the World Trade Organization (WTO) is determined in accordance with the valuation principles set forth in the WTO Valuation Code (the Agreement Implementing Article VII of the General Agreement and Tariffs and Trade 1994). Under Article 1(1) of the WTO Valuation Code, the customs value of imported merchandise is, in almost all instances, the total price actually paid or payable by or on behalf of the buyer for the merchandise when sold for exportation to the country of importation.

51. The United States Foreign Trade Regulations, 15 C.F.R. Part 30, require that “electronic export information” must be filed by or on behalf of the exporter with the Census Bureau through the Automated Export System (AES) for most exports of goods from the United States. Among the data elements to be included among the “electronic export information” is the value of the exported merchandise, which is defined in section 30.6(a)(17)(1) of the Foreign Trade Regulations as the selling price at the United States port of exportation. 15 C.F.R. 30.6(a)(17)(1).

52. 18 U.S.C. §§ 1341 (mail fraud), § 1343 (wire fraud).
to smuggle alcoholic beverages into Canada so as to avoid Canadian customs duties and alcohol import taxes. The federal wire fraud statute prohibits the use of the instrumentalities of interstate or international telecommunications in furtherance of any scheme or artifice to defraud. The Supreme Court held that a scheme to deprive a foreign government of lawful duties and taxes comes within the scope of a “scheme or artifice to defraud” within the intent of that federal wire fraud statute. Thus, based on the precedent of the Supreme Court’s decision in the Pasquantino v. United States case, a U.S. supplier that issues a false commercial invoice with knowledge that the customer intends to use that false commercial invoice to avoid (evade) customs duties and import taxes may be subject to liability under the mail and/or wire fraud statutes if there has been any use of the mails or the instrumentalities of interstate or international telecommunications (telephone calls, e-mails, etc.) in connection with the under-invoicing request. Alternatively, the U.S. supplier may be asked by its foreign customer to overstate the value of the merchandise on the supplier’s commercial invoice, especially where the merchandise in question is duty-free, upon importation into the customer’s country. Such over-invoicing arrangements are typically proposed in furtherance of tax evasion schemes (e.g., by overstating the cost of goods sold, thereby allowing the customer to declare lower taxable income for local income tax purposes). Although such over-invoicing schemes typically do not involve avoidance of customs duties and import taxes, those over invoicing schemes are subject to the same legal considerations as are under-invoicing schemes, from the U.S. supplier’s perspective. Thus, by issuing an overstated commercial invoice, the U.S. issuer is making a false accounting record in violation of the FCPA’s books and records requirements. If the U.S. supplier knows that the customer has requested the overstated invoice in furtherance of a tax evasion scheme, that U.S. supplier may also face potential criminal liability under the mail and wire fraud statutes.

C. AVOIDANCE OF IMPORT REGULATORY REQUIREMENTS AND RESTRICTIONS

In an effort to restrict imports, a number of countries have adopted complex import regulatory programs. Such import regulatory programs may include (i) import licensing requirements, (ii) product certification and detailed technical data filing requirements, and (iii) product testing and inspection requirements. In many instances, the import regulatory regimes are less than transparent, such that understanding the compliance obligations is problematic. In other instances, especially those circumstances in which products are subject to testing, inspection, and/or detailed technical data filing requirements, compliance may pose a practical risk of loss or theft of trade secrets and confidential technical information related to the products. In all such cases, the process of obtaining required import licenses and product certifications and of complying with other non-tariff regulatory requirements is likely to be time-consuming and costly. Under the circumstances, there may be a significant temptation to avoid or otherwise overcome such import regulatory requirements and restrictions. A payment made to foreign customs or other import

57. See 18 U.S.C. §§ 1341, 1343; see also Pasquantino, 544 U.S. at 349-53.
regulatory officials for the purpose of avoiding compliance with import regulatory requirements or restrictions will, however, constitute an unlawful bribe under the anti-bribery provisions of the FCPA. The FCPA compliance issues presented by payments made to foreign customs and import officials in order to overcome import regulatory requirements and restrictions are highlighted by the facts of certain conduct described in the Plea Agreement in United States v. Panalpina. In that case, certain of Panalpina’s customers had imported offshore drilling rigs into Nigeria on a duty-free basis under a temporary import permit procedure. Under that procedure, upon expiration of the temporary import permit, the offshore drilling rig had to be exported from Nigeria, and if use of the drilling rig in Nigerian waters was still required, that equipment would then have to be reimported under a new temporary import permit. The failure to export the drilling rig upon expiration of its temporary import permit was subject to a fine of up to six times the value of that drilling rig. In order to assist its customers in avoiding the costs and business disruption associated with the exportation and reimportation of those offshore drilling rigs, Panalpina made payments to Nigerian customs officials to adopt a “paper process” for the issuance of new temporary import permits, falsely reflecting the export and reimportation of the drilling rigs, when no such activities with respect to the drilling rigs had occurred. Those payments to the Nigerian customs officials were treated as unlawful bribes under the anti-bribery provisions of the FCPA in the Panalpina plea agreement. The FCPA anti-bribery compliance issue applicable to payments made to foreign customs officials in connection with the temporary import permit procedure in the Panalpina case is similarly applicable to payments made to foreign customs officials in order to avoid other forms of import regulatory requirements or restrictions. For example, in the Helmerich & Payne case, certain payments made to Argentine and Venezuelan customs officials that were held to be unlawful bribes under the FCPA were made in order to import merchandise that (i) was not in compliance with local product certification requirements, (ii) had not undergone required product inspections, or (iii) could not be lawfully imported into the country. That last set of circumstances (i.e., payments made to customs officials to overcome statutory or regulatory prohibitions on the importation of certain merchandise) may pose a special FCPA compliance challenge for international trade professionals working for U.S. companies in the electronics industry. Many of those electronics companies “recycle” parts and components from defective equipment for use as spare and warranty re-

60. Panalpina, No. 10-CR-765, ¶¶ 36-42.
61. Id.
62. Id.
63. Id.
64. Id.
placement parts and components for products sold their customers. Such recycling of “good” parts and components taken from defective products offers substantial cost savings in providing customers with warranty service and support and serves important environmental objectives in reducing the amount of electronic waste in the waste stream. Nonetheless, the import laws and regulations of a number of major countries prohibit or restrict the importation of “used” or “refurbished” electronic equipment. If the importation of recycled parts and components into one of those countries is challenged by a local customs official, there may be a temptation to find ways to overcome that import prohibition, particularly if the parts and components are required to meet a local customer’s urgent need for product service (e.g., a “machine down” situation). A payment made to a customs officer to waive or overlook a regulatory restriction on the import of such “used” electronic equipment will constitute an unlawful bribe under the FCPA.

D. Offshore Payments to Third Party Intermediaries

In dealing with third party intermediaries, including customs brokers, import/export agents, and trade consultants, U.S. companies frequently encounter requests that fees payable for bona fide services performed by those third party intermediaries in connection with import/export operations be paid to an offshore bank account or to an affiliated company (frequently located in a tax haven country). Such an offshore payment, by itself, would not constitute a violation of either the FCPA’s anti-bribery provisions or the FCPA’s accounting provisions. Nonetheless, a request by a third party intermediary that a

66. For example, the importation of “used” equipment into Brazil is restricted pursuant to Portaria DECEX No. 08/91, de 13 de Maio de 1991 (Braz.), as amended by Portario MDIC No. 235/06, de 7 de dezembro de 2006 and Portaria SECEX No. 23/11 de 14 de julho de 2011 (Braz.). The importation of “used” items into China is restricted under (1) Order of the General Administration of Quality Supervision, Inspection and Quarantine Concerning the Issuing of the Administrative Measures for Inspection and Supervision of the Old Imported Mechanical and Electrical Products (promulgated by the General Administration of Quality Supervision, Inspection and Quarantine (AQSIQ), May 1, 2003) (China); (2) the Provisions on Inspection and Supervision Procedures for Import of Old Mechanical and Electrical Products (promulgated by the General Administration of Quality Supervision, Inspection and Quarantine (AQSIQ), October 1, 2008); and (3) the Measures for Administration of Import of Specified Old Mechanical and Electronic Products (promulgated by the Administration of Quality Supervision, Inspection and Quarantine (AQSIQ) and the Ministry of Commerce (MOFCOM), May 1, 2008).

67. One of the ways in which FCPA compliance issues can arise, effectively inadvertently, from the import or attempted import of used equipment into one of the countries that restricts or prohibits such imports may be illustrated by a situation with which the author is familiar. In that situation, a U.S. company shipped surplus office equipment to its Brazilian subsidiary for the purpose of outfitting a newly established sales office in that country. The equipment was not described as “used” on the U.S. company’s commercial invoice or shipping documentation. The equipment was, however, identified as used by a Brazilian customs official, who threatened the Brazilian subsidiary and its management with criminal prosecution for (i) attempting to import prohibited products into Brazil and (ii) making a false customs declaration (failing to describe the equipment as used). The customs officer subsequently indicated to the Brazilian subsidiary’s local attorney that the “problem could go away” if he was paid a substantial sum of money. The Brazilian attorney suggested to the U.S. company that he would pay the requested amount to the customs officer and then would invoice that amount to the U.S. company or the Brazilian subsidiary as “legal fees”. In view of the problems presented under both the anti-bribery provisions and the accounting provisions of the FCPA, the U.S. company refused to make or authorize the payment to the Brazilian customs official and immediately terminated its relationship with the Brazilian attorney. The Brazilian subsidiary incurred a very substantial fine for the attempt to import prohibited products, and those products were seized and forfeited by Brazilian customs.
U.S. company make payments to an offshore account raises a number of very serious FCPA compliance challenges.

Proposals for payments for services performed in one country be made to an account or an entity in another country are typically made in furtherance of schemes to avoid local currency control requirements and/or local income tax obligations. Thus, receipts that never appear on the third party intermediaries’ books may not be converted into local currency under applicable currency control regulations and may not be reported as taxable income on the third party intermediary’s local income tax returns. The fact that the third party intermediary is apparently willing to engage in actions contrary to local currency control and tax laws may suggest that the person or entity has a cavalier attitude toward compliance with other legal obligations (including anti-corruption laws such as the FCPA). Moreover, a request for payments to an offshore account may be made in furtherance of scheme to establish an “off books” account from which improper payments to foreign officials may be made with minimal risk of detection.68 Under the circumstances, any such request for offshore payments of service fees payable for customs brokerage services or other import/export services performed by third party intermediaries should be seen as a “red flag,” suggesting a heightened risk that the third party intermediary may make improper payments to local customs or import officials in furtherance of import/export operations on behalf of the U.S. company for which it is performing services.69 If a U.S. company were to make a payment, even a bona fide service fee payment, to a third party intermediary with reason to believe that that third party intermediary is trying to evade income taxes on that service fee, and thereafter the DOJ or SEC were to learn that the third party also made improper payments to foreign officials, it would be extremely difficult for the U.S. company to maintain successfully that it had no reason to suspect that such improper payments might be made by that third party intermediary.

Requests for offshore payments of service fees to third party intermediaries may also present significant compliance issues under the books and records section of the FCPA’s accounting provisions. If those payments are mischaracterized on the books and records of account of a U.S. issuer, a violation of the FCPA books and records section will have occurred. Moreover, even if the nature of the service fees payments are properly described on the issuer’s books of account, potential violations of both the books and records section and the internal accounting controls section of the FCPA’s accounting provisions may have occurred if the service fees, while owed to the third party intermediary in one country, are actually paid to another (affiliated) company in another country.

Finally, consistent with the discussion set forth in Section III(A) of this paper, supra, if the U.S. company knows that the request for payments to an offshore account are made in furtherance of a scheme by the third party intermediary to avoid or evade income taxes lawfully payable by that third party intermediary in its home country, the U.S. company may be exposed to criminal liability under the federal mail and wire fraud statutes on the basis of the legal principles enunciated by the Supreme Court in its decision in the Pasquantino v. United States case.70

69. See Tarun, supra note 2, at pp. 91-92 (identifying requests by third party intermediaries for payments to offshore accounts, and payments to entities located in tax haven countries as “red flags” under the FCPA).
Under the circumstances, it is recommended that any request by a customs broker, import/export agent, trade consultant, or other third party intermediary for payment of service fees to an offshore account should be summarily rejected. Instead, international trade professionals for U.S. issuers and domestic concerns should insist that all payments of service fees to third party intermediaries that perform services in connection with import/export operations must be made through normal banking channels (e.g., wire transfers, etc.) to the third party intermediary’s bank account in the country in which that third party intermediary performs the services for that U.S. company.  

E. HOSPITALITY AND GIFTS FOR FOREIGN CUSTOMS OFFICIALS

Significant and difficult FCPA compliance issues may arise with respect to the furnishing of hospitality or gifts to foreign officials, including customs and import regulatory officials. On one hand, a small gift may simply be a token of respect or friendship, as a normal professional courtesy consistent with local customs and practices. There is, however, no “de minimis” exception to the anti-bribery provisions of the FCPA, and in 1988, Congress considered but rejected creating an affirmative defense to those anti-bribery provisions for nominal payments and gifts to foreign officials given as a courtesy or token of respect. Accordingly, the furnishing of hospitality or gifts to foreign officials, including customs officials, may constitute a violation of the anti-bribery provisions of the FCPA if given for an improper purpose (i.e., to obtain or retain business or to secure some other improper purpose).

A gift given to a foreign customs official, even if relatively modest in value may, therefore, constitute a bribe under the FCPA if the U.S. company’s intent in providing that gift is to secure some improper advantage, such as preferential customs treatment; avoidance of customs duties, import taxes, or import regulatory restrictions; or resolution of prior non-compliance with customs and import requirements. Intent to secure an improper advantage may be evidenced by (i) the actual results (e.g., was merchandise imported into a particular country in a manner contrary to applicable customs laws and regulations?), (ii) the value of the gift given, (iii) the circumstances in which the gift is given (in the open or “behind closed doors”), and (iv) how the gift is recorded on the books and records of the company.

71. Although not directly related to FCPA compliance issues, such offshore payments, especially where implemented to avoid local currency controls, may pose a risk of significant disruption of important business operations. The author is familiar with one instance in which a number of leading U.S. companies relied upon a particular Chinese logistics service provider to handle the importation, warehousing, and supply of warranty and replacement parts for Chinese customers. The logistics service provider had requested that all fees payable by the U.S. companies for those services be made to an account maintained by an affiliate of the logistics service provider in Hong Kong. When the Chinese authorities learned that the logistics service provider was receiving fees in Hong Kong for services performed in China, in violation of Chinese currency control regulations, those authorities shut down the operations of the logistics service provider in a “dawn raid.” One of the effects of that shut down was that the U.S. companies were unable to fulfill their warranty and service obligations to their Chinese customers for several months, until alternate logistics service providers could be identified and supported.

72. For a general discussion of the FCPA compliance issues arising in connection with the furnishing of hospitality and gifts to foreign officials, see DOJ/SEC FCPA Resource Guide, supra note 2, at 15-19.

73. See H.R. CONFERENCE REP. NO. 100-576, at 922.

74. See, e.g., United States v. Liebo, 923 F.2d 1308 (8th Cir. 1991).
FOREIGN CORRUPT PRACTICES ACT

U.S. company. FCPA compliance risks associated with the giving of gifts to foreign officials may, therefore, be mitigated by:

- strict corporate guidelines for such gift giving, with dollar limits on the value of any gift and clear approval procedures for any such gift;
- documented justification for any proposed gift as a condition of approval;
- transparency in the giving and receiving of such gifts;
- confirmation that the giving and receiving of the gift is lawful under the laws of the foreign official’s home country; and
- proper recording of the gift on the books and record of the U.S. company, in conformance with the FCPA’s accounting provisions.\(^{75}\)

Questions frequently arise regarding the FCPA compliance implications of furnishing gifts to a foreign government agency. As the anti-bribery provisions of the FCPA prohibit improper payments and gifts to foreign officials, a bona fide gift to a foreign government agency or department should not, in most instances, constitute an improper payment under those anti-bribery provisions.\(^{76}\)

Nonetheless, FCPA compliance issues can arise in the context of the furnishing of a gift to a local customs office. For example, it may be proposed (typically by local managers) that a Chinese subsidiary of a U.S. corporation give boxes of “moon cakes” on the occasion of the celebration of Chinese New Year to the local customs office where the subsidiary’s imports are processed. Although the “moon cakes” would be delivered to the local customs office, rather than given to a particular customs official, if the intent of the gift is to furnish an incentive to local customs officials to provide or to furnish a reward to those local customs officials for providing preferential customs treatment contrary to applicable Chinese customs and import laws and regulations, the gift of those “moon cakes” ostensibly to the local customs office may, in fact, be characterized as an improper payment under the anti-bribery provisions of the FCPA.

F. FCPA Compliance with Respect to the Export of Defense Articles

The Plea Agreement in the United States v. BAE Systems case illustrates the intersection between the FCPA and export compliance requirements with respect to the export of defense articles under the International Traffic in Arms Regulations (ITAR).\(^{77}\) Under the Arms Export Control Act and ITAR, an export license from the State Department’s Directorate of Defense Trade Controls (DDTC) is required for the export of “defense articles” or “defense services” to any foreign country.\(^{78}\) Under section 130.9 of ITAR, in any application for such an export license, the applicant must disclose to the DDTC whether it has paid (i) any political contributions of $5,000 or more or (ii) any fees or commissions.

---

76. See, e.g., Opinion Procedure Release, U.S. Dep’t of Justice, 06-01 (Oct. 16, 2006), available at www.jus tice.gov/criminal/fraud/fcpa/opinion/2006/0601.pdf. In that opinion, the Department of Justice approved a proposal by a U.S. company to contribute $25,000 to the Customs department in an African country as part of a pilot project to enhance anti-counterfeiting enforcement by local customs officers.
of $100,000 or more in connection with the proposed sale of defense articles or defense services for which the export license is sought.79

Among the charges against BAE Systems that resulted in the March 1, 2010, plea agreement were violations of that section 130.9 of ITAR.80 According to the plea agreement, BAE Systems failed to disclose to DDTC, on its export license applications, the commissions paid to so-called “market advisors” who had been retained by BAE Systems to assist in securing sales of defense articles.81 The rationale for failing to disclose the commissions paid to those “market advisors,” as stated in the plea agreement, was to conceal the relationships between BAE Systems and the “market advisors,” especially because BAE Systems was aware that there was a high probability that the “market advisors” would pay a portion of their commissions to foreign officials to secure favorable decisions in the purchase of defense services.82

For those international trade professionals working for U.S. companies that are engaged in the export of defense articles and defense services, it is, therefore, imperative that they have a very clear understanding of their companies’ relationships with all third party intermediaries; including sales representatives, commission agents, sales consultants, and “market advisors.” It is only with that clear understanding that the international trade professionals can assure compliance with the commission reporting requirements of section 130.9 of ITAR. In addition, through that understanding, the international trade professionals can perform an important role in FCPA compliance (i.e., in preventing market advisor arrangements of the kind at issue in the United States v. BAE Systems case).83

G. MERGER AND ACQUISITION TRANSACTIONS

Corporate merger and acquisition transactions raise special FCPA compliance challenges for acquirers that are issuers or domestic concerns. If, at the time of the acquisition, the acquirer fails to identify and take remedial action with respect to prior non-compliance by the target company, there is a substantial risk of successor liability on the part of the acquirer under the FCPA. In addition, if ongoing compliance problems on the part of the target company under either the anti-bribery provisions or the accounting provisions (or both) of the FCPA remain undetected and persist following the completion of the acquisition transaction, the acquirer is exposed to the risk of direct liability under the FCPA for post-acquisition non-compliance. For that reason, FCPA practitioners recommend, and the DOJ and SEC encourage, U.S. companies to include a robust FCPA compliance program in any merger or acquisition transactions.84

---

79. 22 C.F.R. § 130.9.
80. See BAE Systems plc, 10-CR-035, ¶ 19.
81. See id. ¶¶ 26-32.
82. See BAE Systems plc, 10-CR-035, ¶¶ 21-29. The steps BAE Systems took to conceal its commission payments to those “market advisors” were also deemed to be a violation of the FCPA’s accounting provisions.
83. U.S. companies engaged in the export of defense articles and defense services should be aware that a criminal conviction for violation of the FCPA is grounds for statutory debarment under the ITAR. Section 127.7(c) of the ITAR prohibits the DDTC from issuing any export license or other authorization for the export of defense articles or defense service for a period of three years to any person or entity that has been convicted of violating the FCPA for any one of the United States criminal statutes enumerated in section 120.27 of the ITAR. Section 120.27(a)(6) of the ITAR lists among those criminal statutes the anti-bribery provisions of the FCPA.

VOL. 47, NO. 1

PUBLISHED IN COOPERATION WITH SMU DEEDMAN SCHOOL OF LAW
compliance element in their pre-acquisition due diligence review of prospective acquisition targets.\(^{84}\)

Based on the foregoing, many U.S. companies and their outside legal and accounting advisors have incorporated FCPA compliance into their pre-acquisition due diligence reviews. Similarly, many of those U.S. companies, particularly those companies that are major importers of merchandise into the United States and/or deal regularly in commodities and technologies that are restricted for export control purposes, have an international trade compliance element in their pre-acquisition due diligence protocols.\(^{85}\) In most cases, however, those two elements of the due diligence review are conducted separately, and corporate international trade compliance professionals are seldom involved in the analysis and assessment of the FCPA compliance risks presented by a potential acquisition target.

The failure to engage international trade professionals in the FCPA compliance pre-acquisition due diligence process is unfortunate and poses a significant risk that improper payments to foreign officials in connection with the target company's import/export operations will be missed in that due diligence process. Through the trade compliance due diligence process, corporate international trade professionals may be best positioned to identify "red flags" suggesting the possibility of such improper payments and/or accounting irregularities of the kind discussed in the paper in connection with the target's import/export operations. To that end, however, those corporate international trade professionals must (i) have a clear understanding of the application and scope of the FCPA and (ii) be integral members of the FCPA compliance pre-acquisition due diligence team.

IV. Conclusion

As discussed in this paper, import/export operations, especially in high-risk corruption countries, pose significant FCPA compliance risks. Those FCPA compliance risks are inherent in such import/export operations, especially because (i) by their very nature, they involve direct and substantial interactions with foreign officials in transactions in which substantial sums of money may be involved (both in terms of the value of the merchandise and the amounts of customs duties and taxes potentially payable) and (ii) of the need to rely upon third party intermediaries, such as customs brokers and import/export agents, for the performance of key elements of such import/export operations. An effective FCPA compliance program for any issuer or domestic concern that is involved in import/export operations (including merely supplying products to customers located abroad) should include the full engagement of the company’s international trade professionals. To that end, corporate international trade professionals require a clear understanding of the requirements, restrictions, and scope of application of both the anti-bribery and accounting pro-

\(^{84}\) See DOJ/SEC FCPA Resource Guide, supra note 2, at 28-33. For a template of an FCPA compliance pre-acquisition due diligence checklist, see Tarun, supra note 2, at 110-11.

visions of the FCPA, and corporate ethics and compliance officers must have an appreciation of the nature and scope of FCPA compliance risks arising out of import/export operations. It is hoped that this paper will make a contribution to those processes.
The Role of External Auditors in Bank Supervision: A Supervisory Gatekeeper?

DR. DALVINDER SINGH*

Abstract

A recent response to the financial crisis has been to reinvigorate the use of external auditors in financial regulation. The U.K. Prudential Regulation Authority and Financial Conduct Authority-

* Dalvinder Singh, Professor of Law, School of Law, University of Warwick, United Kingdom, would like to thank those in the auditing and accounting profession for feedback on the paper. I would also like to thank Vincent O’Sullivan, PwC Financial Services Centre of Excellence; Professor Emilios Avgouleas, School of Law, University of Edinburgh; Katrina Halster, World Bank, Washington, D.C., United States; and Emily Benson, Kinetic and Prof. J Cox, Duke University, School of Law, at the Scholars’ Conference at Brooklyn Law School, 9th November 2012, for their comments and suggestions. I would also like to thank the anonymous reviewers for their comments and suggestions. All views and errors are the author’s responsibility. I would also like to thank Christian Mecklenburg-Guzmán L.L.M. Warwick and Jayatileka, Damithri, third year L.L.B. student, for excellent research assistance.

List of Acronyms:

FSA: Financial Services Authority
PRA: Prudential Regulation Authority
FCA: Financial Conduct Authority
FSA 2012: Financial Services Act 2012
AIU: Audit Inspection Unit
AQR: Audit Quality Review
APN: Audit Practice Note
AADB: Accountancy & Actuarial Discipline Board
CC: Conduct Committee
FRC: Financial Reporting Council
PwC: PricewaterhouseCoopers L.L.P.
JPMSL: J.P. Morgan Securities Limited Client Money
BCCI: Bank of Credit and Commerce International
ENF: Enforcement Handbook
AADB: U.K. Accountancy & Actuarial Discipline Board
IAS: International Audit Standards
FDIC: Federal Deposit Insurance Corporation
C&L: Coopers & Lybrand
SUP: Supervision Handbook
ENF: Enforcement Handbook
FSAP: International Monetary Fund and World Bank, Financial Sector Assessment Programme.
ity are to use external auditors in a more systematic way than was the case with the Financial Services Authority. The use of external auditors is not new. This paper evaluates the U.K. experience and international use of external auditors in bank supervision. It suggests the current U.K. approach does not go far enough in explaining how external auditors in bank supervision will be used, and this could lead to a possible expectations gap in banking supervision. This is suggested to be the case in light of the limited levels of accountability and oversight over the auditing profession.

To overcome the expectations gap, the paper proposes some further ideas from the international experience of using external auditors in order to improve the way we use external auditors and manage the different roles and interests such auditors have in a twin private and public role. It is suggested those ideas and proposals would go some way to improve how external auditors are used in bank supervision: to better coordinate intense judgment-based supervision between the regulator-bloodhound and the auditor-watchdog. The paper argues that the level of reliance on third parties, such as external auditors, to undertake regulatory and supervisory tasks needs to be worked out in advance to efficiently allocate regulatory resources rather than leaving it in an ad hoc manner.

I. Introduction

The use of external auditors has been brought to the fore recently as part of the United Kingdom’s reforms since the banking crisis. The Treasury Committee has, in this post-mortem, recommended better use of “audit knowledge.” It now appears the avoidance of direct criticism during the banking crisis has merited the revival of external auditors in banking supervision to assist the new Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) and, indeed, the Bank of England as the separate role of supervisor of Central Counterparties (CCPs). The recent suggestion by the Bank of England that the relationship between external auditors and the Financial Services Authority (FSA) had “broken down” somewhat obscures and simplifies the point about the past. I will establish, post the Barings Bank failure in 1995, that a considerable level of mistrust existed in financial regulatory circles, and that subsequently the FSA followed the footsteps of the Bank of England and moved away from relying on external auditors to undertake on-site supervision. Whether the current approach makes better use of “audit knowledge” is called into question. This is analyzed in light of the international experience of using external auditors in financial supervision. It is suggested that the United Kingdom’s approach to using external auditors does not go far enough to define the reliance the PRA, FCA, and indeed the Bank of England will place on them to form a coherent supervisory strategy to protect depositors and financial stability and could create an

expectation in bank supervision. The uncertainty associated with the level of reliance the
regulators seek to place on external auditors is exacerbated by the lack of confidence in the
level of accountability and oversight of the general accounting and auditing profession.
The paper also revisits some of the unintended consequences of using external auditors in
the supervision of banks.

The paper will assess holistically the measures introduced recently to improve the use of
external auditors in bank regulation and supervision. It argues the relationship between
the regulator and auditor requires a formal structure to best utilize what the external audi-
tor can offer the supervisory process—so it can act as a “supervisory gatekeeper.” A for-
mal, structured relationship would go some way to mitigate risks of ambiguity and
inconsistency associated with the informal, discretion-based approach currently offered.
A formalized and structured approach is suggested to provide some degree of coherency to
the relationship of regulator and auditor—to deal with the challenges banks pose to regu-
lators and external auditors during the life of a bank and indeed during times of distress.
The second part introduces the idea of an external auditor acting as supervisory gate-
keeper in bank supervision and the principal features of bank supervision. The third part
explores how the Bank of England and FSA used external auditors as supervisory gate-
keepers and the relationship between them and external auditors. The fourth part sets out
and analyzes the key features of the new reforms; notably, the revised Audit Practice Note
19, the memorandum of understanding (MOU), and the code of conduct relating to bilat-
eral and trilateral meetings (meetings between the regulator and external auditor; and
regulator, external auditor, and the individual bank, respectively). It is suggested that re-
establishing the relationship between the regulator and external auditor does not go far
enough, and if the regulator is going to rely on external auditors, then measures need to
be put in place to mitigate some of the underlying issues of external auditor independence
and accountability. More importantly, what is actually expected of the external auditor as
a “supervisory gatekeeper” is explored here and further in the paper. The fifth part looks
at the issue of qualifying financial accounts and the role of external auditors when banks
are in distress and may require emergency liquidity assistance. Part six looks at the extent
to which external auditors are accountable to the professional bodies. It is argued that the
profession may not be meeting the expectations of the PRA or FCA of being a more
intensive regulator. A historical examination is undertaken of some of the key tribunal
decisions and of the recent decision in December 2011 to fine PricewaterhouseCoopers
LLP (PwC) £1.4 million for its failures concerning reports to the FSA of the segregation
of client assets at J.P. Morgan Securities Limited Client Money (JPMSL). The general
conclusion of the tribunal in the case draws specific attention to the limited sanctioning
regime of the accounting profession. The conclusions imply the sanctioning regime is
simply out of line with the enforcement regime regulators are expected to have in place to
safeguard the public interest. Finally, in part seven, a review of the international experi-
ence of using external auditors is provided, and further improvements to the way external
auditors are incorporated in banking supervision are suggested. These ideas and sugges-
tions primarily look at the way the regulator and the external auditor work together to
oversee a bank’s activities while undertaking their responsibilities: the regulator in terms

5. The paper refers to banks and bank supervision for simplicity. The author is aware that external audi-
tors are used widely in financial supervision.
of future “performance” and the external auditor in terms of past “performance” of a bank. The international experience offers ideas around the structuring of the relationship and also how the regulators and the external auditors can best work together during times of distress.

II. The Supervisory Gatekeeper and Bank Supervision

In the context of bank supervision, the external auditor is referred to here as a “supervisory gatekeeper,” as distinct from the gatekeeper role generally, the term was first coined by Kraakman. In the context of bank supervision, the external auditor as a supervisory gatekeeper has additional responsibilities and interests to serve. These are distinct from the role of the external auditor generally of expressing a view about the stewardship of a corporation in line with accounting standards. The capital markets rely primarily on the work of the Big 4 for a variety of areas, such as audit opinions, tax, and advisory services and this has generated a considerable amount of reliance on their services by the markets as well as scrutiny when those views are found to be wanting. Moreover, the level of reliance markets can place on the assurances attached to, for instance, audited accounts is


also limited with the passage of time as more up-to-date sources of information are published that provide a better idea about the performance of the firm.9

The private relationship between the auditor and the client is a contractual relationship that is set out in the audit engagement letter.10 Implicit in the relationship is the duty to exercise the audit engagement with reasonable care and skill.11 But the auditor is not required to enter the audit engagement with suspicion, but should undertake it on the basis that if suspicion does exist, then an obligation exists to “probe it to the bottom.”12 When circumstances suggest the possibility of fraud or error, the degree of inquisitiveness and skepticism should increase concomitantly and be expressed by seeking to obtain evidence from independent sources to verify the evidence from the corporation. For example, do the representations made by management indicate sufficient concern to raise a suspicion?13

The auditor is primarily required to exercise skepticism only when audit evidence gives rise to a suspicion that material misstatements may exist in the accounts and not at the commencement of the audit. If such issues exist at the commencement of the audit then they would influence the intensity and focus of the audit. The duty of care would be breached if the auditor fails to investigate discrepancies when issues required them to probe further.

The potential liability on external auditors for failure to undertake their responsibility with reasonable care to audit the accounts of a client is much more straightforward in comparison to their potential liability to a third party that may not be privy to the contractual relationship but relies on their findings.14 In the United Kingdom, the law has developed in a class-by-class basis determined by the extent to which the work done for a client is going to be relied on by a third party (like a regulator), and the third party is likely to suffer loss as a result of the negligent work. Law Society v. KPMG15 is an interesting case, as it relates to the potential liability of a reporting accountant to the Law Society (as the regulator of solicitors) for damages in the tort of negligence for the accountant’s failure to

---

11. In In re Kingston Cotton Mill, Vaughan Williams J. said there is “[n]o doubt he is acting antagonistically to the directors in the sense that he is appointed by the shareholders to be a check upon them.” [1896] 1 Ch. 6 at 11 (U.K.).
15. Law Society v. KPMG Peat Marwick and Others, [2000] 4 All E.R. 540 [¶ 25] (Eng.). The Court of Appeal decision in the case affirmed Vice Chancellor Sir Richard Scott’s decision, thus cementing in principle the expansion of the incremental approach of the tort for claims for economic loss by not restricting the duty of care to cases where it is only “fair, just, and reasonable” to do so.
qualify its report about a firm that was commissioned by the Law Society. In this case, provisions of the Solicitors Act 1974 required the accountant to alert the Law Society to the possibility of improprieties in the conduct of the solicitors’ practice.\textsuperscript{16} According to Sir Richard Scott, who wrote the original opinion, the relationship between the reporting accountant and the Law Society was “sufficiently proximate” to warrant due care.\textsuperscript{17} While the accounting industry may want to avoid a direct agency relationship, it might be impossible in the circumstances when the financial regulator relies significantly on their work to form regulatory decisions.

A. BANK SUPERVISOR AND EXTERNAL AUDITOR: THE INTERPLAY BETWEEN PUBLIC AND PRIVATE INTERESTS

In the context of bank supervision, the bank regulator may require audited accounts from the bank on an annual basis. The level of reliance placed on those accounts and on the work of the external auditor can vary.\textsuperscript{18} So much so that in some jurisdictions, not only is the external auditor providing a view on the annual accounts of a bank—as they would do for the market as a whole—but also may be required to also assist the regulator in other ways, for instance to work with the regulator to oversee the bank and its activities in the supervision process. This section of the paper will set out the way bank supervision could be modeled in a jurisdiction and how the financial regulator and external auditor work with one another. It primarily sets out, in the context of bank supervision, the public and private interests of the financial regulator and the external auditor, respectively, before exploring in detail the U.K. historical experience of using external auditors in bank supervision.

The financial regulators and external auditors of banks seem to undertake similar functions, while they broadly serve different purposes—public and private, respectively. The regulator and the external auditor look at banks from different viewpoints, with the former attending to future viability and the latter to past performance and viability.\textsuperscript{19} The interests they serve also diverge. The regulator is given statutory responsibility for regulation and supervision of financial services, with the ultimate aim of protecting market confidence and depositor and investor interests. “For example, the regulator is not necessarily interested in how the bank is ensuring shareholder value, but is more concerned about protecting the interests of depositors and investors.”\textsuperscript{20} The external auditor, on the other hand, serves the primary interests of company shareholders by expressing an opinion as to whether the financial statements provide a “true and fair” view.\textsuperscript{21} As noted above, the

\begin{itemize}
\item \textsuperscript{16} Id. at 540.
\item \textsuperscript{17} Id. ¶ 12.
\item \textsuperscript{19} Dalvinder Singh, \textit{Banking Regulation of UK and US Financial Markets} 153-78 (2007).
\item \textsuperscript{20} Id. at 153.
\item \textsuperscript{21} Companies Act, 2006, c. 46, § 495(3) (U.K.); see also Lawrence Robert Dicksee, \textit{Auditing: A Practical Manual for Auditors} (Arno Press 1976) (1892); Michael Power, \textit{The Audit Society: Rituals of Verification} (2nd ed. 1999); Gene Brown, \textit{Changing Audit Objectives and Techniques}, 57 The
\end{itemize}
private interests associated with risk capital of shareholders in comparison to the public interests associated with compliance with prudential regulatory requirements means the obligation on the regulator is set higher. To fulfill their respective responsibilities, the regulator and external auditor undertake a process of verifying information and representations provided by the directors and management of a bank as to the information’s accuracy and reliability.\textsuperscript{22} A considerable level of reliance is placed on the bank to provide accurate information, and specific enforcement actions are taken if the accuracy of the information is found to be wanting.\textsuperscript{23} In the context of complex capital and liquidity requirements, the need for accurate information is even more crucial. In the context of the external auditor, these types of issues would be raised at board level and could, in an extreme case, lead to discussions about whether or not the financial accounts should be qualified or not.

In the banking sector, these issues have required a unique form of oversight by a separate regulator that also has a continuing obligation to oversee the activities of a corporation and ensure it is managed prudentially to safeguard the interests of depositors and wider system stability.\textsuperscript{24} In this respect, the financial regulator is another gatekeeper that uses the external auditor as a supervisory gatekeeper for the corporation as well. The regulator confers the right on the bank to undertake regulated business once certain preconditions for authorization are fulfilled and there is reasonable assurance that those preconditions will be continuously met.\textsuperscript{25} The bank is required to report regularly on its activities and be open to on-site inspections.\textsuperscript{26} But while the regulator provides the bank with a license to undertake regulated activities, it does not explicitly certify and verify its soundness in the form of a “going concern” statement, as an auditor is expected to do on the basis of the financial statements.\textsuperscript{27} A key feature of the bank regulator is that it can deal with a range of regulatory failures using a range of enforcement powers. The external auditor, on the other hand, has somewhat limited enforcement powers, the primary one being the power to qualify or refuse to sign off on the accounts, which would signal to the market that there are problems that call into question the accuracy of the financial statements.\textsuperscript{28} The relationship between the regulator and the bank is continuous, which is not the case between the bank and the external auditor. The regulator places its...

\textsuperscript{22.} See generally Companies Act, c. 46, §§ 393-394, 414.
\textsuperscript{23.} See generally id. §§ 387 (duty to keep accounting records: offense), 414(4) (offenses for approval and signing of accounts), 418(4) (offenses of the duty to prepare director’s report), 418(5) (offenses for disclosure to auditors in director’s report), 419(3) (offenses for approval and signing of director’s report), 425 (default in sending out copies of accounts and reports: offenses), 429 (summary financial statements: offenses), 451 (default in filing accounts and reports: offenses), 453 (civil penalty for failure to file accounts and reports), 463 (liability for false or misleading statements in reports), 501 (auditor’s rights to information: offenses).
\textsuperscript{24.} See generally Basel Comm., supra note 18, at 12.
\textsuperscript{25.} Id. ¶¶ 30, 32.
\textsuperscript{26.} Id. ¶ 39.
\textsuperscript{27.} Id. ¶ 46.
\textsuperscript{28.} Id. ¶ 25.
tional capital” at risk politically but not legally, as it is immune from private actions, except those in bad faith. A loss of credibility can result in the loss of responsibilities, as we have recently experienced. The bank is in a more precarious position, to an extent, because it is placing reliance on the feedback from the regulator on its soundness through compliance; if the regulator were to signal that it considers the bank compliant, then that is a signal to the bank as a whole that things are going reasonably well. For example, Northern Rock was given an extension to its next supervisory visit in light of its level of compliance with regulatory requirements.

The model of oversight and supervision can be traditionally divided into on-site and off-site approaches to supervision; but the demarcation between the two can be blurred, as most jurisdictions tend to adopt a mixture of both models. The key element of an on-site approach is the regulator or the auditor undertaking an assessment of the bank in accordance with the requirements of authorization and continuous monitoring of capital, large exposure requirements, internal controls, and management resources to oversee the risks of the bank. This includes regular on-site examinations, both routine and ad hoc, to ensure institutions are not simply orchestrating compliance for the on-site supervisory inspection. A significant amount of this time will be placed on interviewing key people, namely the directors and senior management, and reviewing processes.

In off-site supervision, reliance is placed on the reports banks are required to submit, whether on a monthly, bi-quarterly, or annual basis. Those reports are reviewed by the regulator or auditor, and an assessment is made on whether the bank is compliant or not. This forms the basis for further dialogue with the bank regarding any concerns that may be identified.

A considerable level of weight is placed on accurate reporting. This enables the regulator or external auditor to make an accurate assessment and possibly initiate enforcement actions to deal with any failures.

29. See Minories Fin. Ltd. v. Young, [1989] All E.R. 105 (Q.B.D.) 110 (U.K.). Saville J. distinguishes the relationship between the Bank of England and a bank and that between a nurse and mental patient, stating “private banks in this country are commercial enterprises whose raison d’etre is to make profits though providing financial services. [Banks] may act prudently or imprudently, carefully or carelessly, and depending on how good or bad they are as bankers they will make profits or losses. Unlike the mental patient, whose responsibility for himself is diminished to such an extent that others must assume that responsibility, there is nothing in the alleged relationship between the Bank of England and private banks . . . to suggest that the latter should be protected from themselves by the former. I take the view that there is nothing just or fair or reasonable in making the Bank of England assume or share any part of the commercial responsibilities which it can be said private banks owe to themselves to conduct their commercial dealings prudently and carefully so as to make profits and avoid losses.”


33. Id. ¶¶ 39-41.

34. Id. ¶ 66.

35. Id. ¶ 39.

36. Id. ¶ 40.

37. Id.

38. Id. ¶ 54.

39. Id. ¶ 53.
The relationship between the regulator and the auditor can be either “indirect and implicit” or “direct and explicit.”\(^4^0\) In the former, the regulator places limited reliance on the audited accounts that are simply expected to be submitted to the regulator to assist with their assessment of the bank’s current financial status. In the latter case, specific tasks are undertaken by the auditor on the regulators’ behalf, and reliance is placed on the findings to make regulatory decisions.\(^4^1\) Moreover, the use of ad hoc external reports commissioned by a regulator, called in the United Kingdom an s.166 skilled report, adds another interesting paradox to the way supervision and investigations are conducted because it is neither purely on-site nor off-site.\(^4^2\) In many respects, it is a privatization of supervision with the use of external consultants (predominantly the big 4 accounting firms) to undertake work on behalf of the regulator, meaning it is neither on-site nor off-site.

In many respects, the use of external auditors in banking supervision is harnessing a market tool for regulatory public ends. This has resulted in a large volume of external consultancy work to assist firms to, for instance, prepare for regulatory visits. The roles of the regulator and external auditor share some similarities, for instance, verifying the accuracy of the representations made by management.\(^4^3\) Whether there is a sufficient amount of effort devoted to verification of the accuracy of those statements by the regulator and external auditor is a different and somewhat more contentious matter. This paper suggests that the regulator needs to ensure the model of supervision avoids either an over- or under-accommodation of external auditors with more structure to the relationship and the level of reliance placed on them. An expectations gap could arise when using external auditors—which may be unrealistic, especially when auditors and regulators look at the bank from different viewpoints, namely the past and the future respectively—and can be equally prone to failure. The history of the bank is something the regulator should be familiar with, so the utility of the audit for regulatory purposes is somewhat limited.

The financial crisis has highlighted the fact that the regulator and the external auditor will need to focus more attention on the representations of management, verify the accuracy of these representations, and take a skeptical approach to such representations. It appears both the regulator and the external auditor, to varying degrees, are prone to accept management representations with little critical assessment or indeed evidence to assess whether the representations made by management can be substantiated with internal or external evidence.\(^4^4\) The auditing field work undertaken by Trotman and Wright suggest that more external evidence needs to be incorporated into the opinion-making process rather than overly relying on internal evidence to verify management representations.

\(^{40}\) I would like to thank Katia Hulster for this point that is explored extensively in the paper.

\(^{41}\) See Basel Comm., supra note 18, ¶¶ 46-55.

\(^{42}\) See generally Skilled Persons Reviews (s166 and s166A), FIN. CONDUCT AUTHORITY (July 31, 2013), http://www.fca.org.uk/about/what/regulated/how-we-supervise-firms/reports-by-skilled-persons. However, it is beyond the scope of this paper to explore in great detail.

\(^{43}\) Basel Comm., supra note 18, ¶ 46.

\(^{44}\) The auditor is required to undertake the audit process with “professional skepticism” and “professional judgment.” The idea of “professional skepticism” underpins the audit, and in the literal sense, suggests a “questioning mind” that does not accept the audit evidence at face value but questions the soundness of the information and data given. A certain degree of vigilance builds on this by pointing out that the auditor needs to be circumspect and cautious about accepting at face value audit evidence.
that is exposed to the risk of being manipulated to meet their own interests. This could mean that the regulator and external auditors could work more closely to better triangulate evidence from various sources, so that part of the external evidence external auditors may require in order to verify the accuracy of management representations could be gained from the regulator and vice-versa. Moreover, external data about a sector of the industry could be used to evaluate the credibility of management representations. In such circumstances, it could be information the regulator has about a competitor in the same sector that suggests the representations made by another do not seem to reflect the business realities of the sector as a whole and thus requires more scrutiny, as it appears to be an outlier in comparison to the industry as a whole.

In this section, the broad public and private interests of supervision and auditing were explored to go on to look at the U.K. approach of using external auditors in detail. The following part traces how the level of reliance U.K. regulators placed on external auditors changed due to a level of mistrust of external auditors. It then fleshes out the role of external auditors and the relationship between banking supervisors and external auditors. It argues the current proposals lack substance and could lead to coordination problems between the bank supervision and external auditor.

III. The Use of External Auditors in the U.K.: Historical Context

The compulsory audit of bank financial statements was first introduced in the United Kingdom with the Companies Act 1879, after the failure of City of Glasgow Bank. The post-war period saw a move to build on the audit function, with greater emphasis on disclosure policies complementing the audit. This process continued later with the introduction of the Bank Accounts Directive and through the work of the Basel Committee on Banking Supervision. The Banking Act 1987 formally introduced the role of the external auditor in the supervision of banks after the Johnson Matthey affair, from which point the role of the auditor grew in terms of involvement in banking supervision. The Bank of England model of regulation and supervision relied heavily on external auditors, including their role of reporting accountant, to assist it in its decision-making. The heavy dependence on external auditors brought a considerable level of criticism after the

---


46. E. Cooper, Chartered Accountants as Auditors of Companies, 12 THE ACCT. 644 (1886).


51. Id.
BCCI closure and later with the failures at Barings.\textsuperscript{52} A specific concern was that poor audits of these firms undermined the capability of the supervisor to identify problems in a timely manner, and thus put depositors’ interests at risk.\textsuperscript{53}

The introduction of the FSA in 1997 brought in what was considered to be a new regime with a significant emphasis on on-site supervision, which was effectively a move away from the Bank of England’s approach of relying on external auditors for more technical reporting requirements. The experience just before the setting up of the FSA was influenced by the Barings experience and the failure of the auditors at the time to pick up on Nick Leeson’s activities in Singapore when several red flags existed.\textsuperscript{54} Moreover, the introduction of a risk-based approach by the Bank of England after Barings resulted in some decline in the number of reports completed by external auditors (explored more fully below).\textsuperscript{55} The policy of using the external auditors of a bank to act in the capacity of reporting accountants was subsequently reduced.\textsuperscript{56} A possible problem with this policy reversal was that the FSA did not counter it with an increase in the number of staff to supervise the financial system to offset the limited dialogue with external auditors and the use of skilled persons’ reports.\textsuperscript{57} But, as the figures for the number of reports commis-

\textsuperscript{52} Id.


\textsuperscript{54} These conflicts of interest were raised in the Arthur Andersen Report into banking supervision after Barings Bank, which noted the concern of staff at Supervision and Surveillance about the independence of reporting accountants. \textit{See Arthur Andersen, FINDINGS AND RECOMMENDATIONS OF THE REVIEW OF SUPERVISION AND SURVEILLANCE,} 1996, at 13, ¶ 68. Although the reporting accountant’s role did not figure in the Baring debacle, according to the Treasury Select Committee, the weaknesses that transpired after the collapse of Barings questioned the capacity of a firm to provide both auditing roles. The committee recommended that a bank should use a different firm, fully independent from the auditors of the financial statements, to conduct the s.39 reports (Banking Act 1987). \textit{See also TREASURY COMMITTEE, BARINGS BANK AND INTERNATIONAL REGULATION, FIRST REPORT,} 1996-97, at xii, ¶ 22.

\textsuperscript{55} Ian P. Dewing & Peter O. Russell, \textit{The Role of Auditors and Reporting Accountants and Skilled Persons in UK Financial Services Supervision vii} (2005) [hereinafter Dewing & Russell, Role of Auditors].

\textsuperscript{56} Id.

\textsuperscript{57} See Dalvinder Singh, \textit{Enforcement Methods and Sanction in Banking Regulation, 4 INT’L. AND COMP. CORP. L.} \textit{J.} 337 (2002). The s.166 skilled person report was not used to the same extent as its predecessor, the reporting accountant s.39 reports—the predecessor of the skilled person reports. The recent, post-financial-crisis trend towards using skilled person reports, while high in comparison to the previous usage, does not even remotely touch the numbers of s.39 reports the Bank of England was initiating. For example, in 1991-92 it commissioned 728 s.39 reports, 414 of which were on foreign branches (Banking Act Report, 1991/92, p. 26) and in 1992-93 there were 681 reports (Banking Act Report 1992/93, p. 33) followed by 620 in 1993-94 (Banking Act Report 1993/94, p. 33) and 610 in 1994-95 (Banking Act Report 1994/95, p. 36). However, after Barings and the introduction of risk-based regulation the number of s.39 reports commissioned dropped by approximately 20–40 percent, to 482 in 1997, 391 in 1998, and 334 in 1999. Thus, the move to reducing reliance on auditors started long before the establishment of the FSA, contrary to suggestions by the Bank of England.
sioned by the Bank of England show, the use of accountants to undertake the specific reports declined significantly prior to the FSA taking on the responsibilities for regulation and supervision. But the move toward on-site supervision by the FSA did not come with additional resources to offset the reduced use of external auditors or the replacement of the reporting accountants’ ad hoc reports with the s.166 Skilled Person Reports. Indeed, prior to the financial crisis there were even suggestions of actually reducing the level of staff; this was quickly reversed post-Northern-Rock review.

A significant feature of the current reforms is re-establishing the dialogue between the regulator and the auditor. It is suggested that simply re-establishing this relationship does not go far enough because it does not make transparent the extent to which the regulator will rely on the external auditor in terms of a “source of information” and “compliance” with the regulators’ rules. Moreover, regulators’ reliance on the accounting profession to hold external auditors accountable with professional standards may lead to unintended consequences when the financial regulator is reluctant to hold external auditors accountable, even when they have the authority.

IV. The Relationship Between the External Auditor and the Supervisor: The Regulatory Reforms

The post-mortem of the financial crisis brought to the fore questions of whether the external auditors should once more communicate formally with the financial regulator on a more regular basis. The introduction of bilateral and trilateral meetings between the regulator, external auditor, and banks to explore matters relating to supervision has been the principal reform since the financial crisis in the context external audit and regulator relations. This was following the Treasury Committee recommendation to re-introduce the meetings following the failures of the FSA as regulator and the minimal criticism received by the external auditors during the financial crisis. This section explores (1) the background to the relationship between the external auditor and the regulator and (2) the bilateral and trilateral meetings. It is suggested the relatively limited guidance offered by the recent reforms to improve the way the regulator and the external auditor work together leaves a considerable level of ambiguity.

58. SELECT COMMITTEE ON ECONOMIC AFFAIRS, AUDITORS: MARKET CONCENTRATION AND THEIR ROLE, 2011, H.L. 119-I, 45 (U.K.). “The working relationship between external auditors and the prudential supervisors had broken down in the period prior to the financial crisis. Prior to 2007, formal meetings between supervisors and external auditors no longer formed part of the routine supervisory framework and the informal channels of communication that existed when the Bank had responsibility for supervision had fallen away. The FSA had also in this period made much less frequent use of skilled persons’ reports as a routine supervisory tool [these had been another innovation of the 1987 Act]. The regular meetings that these had previously engendered helped reinforce the links between the auditor and supervisor.”

59. As shown in the statistical evidence provided in note 57.


62. SUP, supra note 61, 2.3.1, 3.8.3.
The financial crisis brought in a new regulatory framework to replace the FSA’s single regulatory authority with principally two regulators: the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). Furthermore, from a regulatory standpoint the Bank of England is conferred a specific responsibility to supervise Central Counterparties (CCPs). The two new regulators (the PRA and FCA) form the micro-prudential arm of the official safety net, broadly speaking, and will have distinct roles as a prudential regulator and a conduct of business regulator, respectively. The Bank of England, on the other hand, has the role of macro-prudential supervisor as the central bank to fulfill its role as the overseer for financial stability. Bridging the relationship between the macro-prudential regulations and the macro-prudential supervisor, the new regime also introduces the Financial Policy Committee to link the two facets of the official safety net together with the mandate of monitoring issues within the financial and economic system that could pose systemic problems. While it is beyond the scope of this paper to provide a detailed analysis of the regulatory structure, it suffices to say the new regulators are expected to use external auditors to assist them in the task of supervising financial institutions and exchanges to fulfill their regulatory and supervisory mandates. The legislative reforms mandate the regulator and external auditor work together to oversee their respective remits of the U.K. financial system, either through authorized persons or recognized investment exchanges.

The Financial Services Act 2012 (FSA 2012) amends FSMA 2000 to provide a new framework for the relationship between the regulator and auditor. The PRA is mandated to generally have in place arrangements to share information and opinions with the external auditor. The new legislative framework enables the PRA to change the way it works with the external auditor, providing it with a significant degree of flexibility. The legislation requires the PRA to put in place a code of practice to articulate how it expects to work with external auditors; the existing code of practice is explored below. But the new, amended FSMA 2000 gives the PRA the discretion to replace the code of practice when it considers it necessary. The provision enables the PRA to work out, as a new regulator, how best to utilize external auditors in the supervision of banks and insurance firms. More specifically, the PRA is mandated to put in place rules the external auditor is required to adhere to in order to enable it to cooperate with the PRA in the task of supervision. The FCA is also given the power to enable it to change the duties the external auditor needs to fulfill when cooperating with the FCA. The power to change

---

63. See Financial Services Act, c. 21, § 339, sch. 13.
64. Financial Services and Markets Act, 2000, c. 8, § 288 (U.K.).
66. Id. § 13.
67. SUP, supra note 61, 5.1.1A.
68. For guidance, see the FCA and PRA Supervision Handbook. SUP, supra note 61, 3.2.1.
69. Financial Services Act, sch. 13, § 339A(1)(a)-(b).
71. Financial Services and Markets Act, c. 8, § 339A(2).
72. Financial Services Act, sch. 13, § 339A(2)-(7).
73. Financial Services and Markets Act, s. 340(3A)(a),(b),(d),(ii); Financial Services Act, sch. 13, 3 (4).
74. Financial Services and Markets Act, s. 340(3B); Financial Services Act, sch. 13, 3(4).
the rules governing the use of external auditors needs to be considered “necessary or expedi- 
dent” for both the FCA and the PRA to advance their objectives.  

The broad mandate in the amended FSMA 2000 provides a significant amount of discretion on the PRA and the FCA to work out how they expect to work with the external 
auditor.  

The relationship between financial regulator and external auditor, as mentioned before, is not a new one. It is therefore opportune to explore how the relationship has worked in the past. The following section explores the relationship and the current code of practice that sets out how the regulator and the external auditor are expected to work together.  

The traditional relationship between external auditor and client is one of confidentiality, within which the auditor does not have the authority to communicate its findings to others. But the financial services industry is an exception to that rule. It provides a statutory duty for the auditors of a regulated entity to bring to the attention of the regulator information they come across during the ordinary course of performing the audit. Such information could include any matter considered relevant to the regulator’s remit of responsibility and any matter of material significance to the regulator. It takes into account the fact that information about the audit client can be obtained either directly or indirectly when parties involved in the audit also act in another capacity for the client. As the auditor will have to seek further management representations and possibly independent evidence to verify the accuracy of the representations, some form of disclosure to the bank is inevitable. Whether a matter gives rise to a reasonable cause to communicate it to the regulator is a matter determined by the external auditor. In the past, external auditors placed the onus implicitly on the firm to notify the regulator, so defeating the object of the requirement on the auditor to act independently. In this respect, a form of “regulatory tipping off” exists, which could imply a bank has been proactive in disclosing a matter to the regulator when in fact it was suggested to the bank by the external auditor. The Bank of England, when it was responsible for bank supervision, first introduced bilateral and trilateral meetings for auditors and banks with the introduction of the Banking Act of 1987. The bilateral and trilateral meetings with the external auditor and reporting accountant gave the Bank the opportunity to discuss matters that it regarded as pertinent to its understanding of a bank’s business and any problems either the external 

75. Financial Services and Markets Act, s. 340 (8)(a)-(b); Financial Services Act, sch. 13, 3(9).  
76. See id.  
77. Basel Comm., supra note 18, ¶ 63.  
80. Id.  
82. Id.  
83. Id. at 30. “The auditor’s approach to report as described above, if true, suggests an emphasis on the auditor-client relationship and client confidentiality in preference to disclosing information to a regulator in the public interest.”  
A SUPERVISORY GATEKEEPER

85. Id.
86. Id.
87. Id.

89. DEWING & RUSSELL, ROLE OF AUDITORS, supra note 55.
91. Id.
92. Financial Services and Markets Act, c. 8, § 342.

A route map for formal dialogue between the auditor and the regulator is quite possibly a first step to engage the auditor in bank supervision and builds on the duty to report. The principles provide a very broad context for the parties to deal with one another, and it will ultimately come down to the experience of the audit partner and the supervisor to
decide what needs to be shared and when. The auditor is not expected to rely on the bank to report findings, as in the past, so reneging on its responsibilities to report.93 This transpired to be a regular occurrence when the statutory requirement expected auditors to communicate with the regulator.94 The external auditor’s “regulatory tipping off” to the bank to notify the regulator of material issues puts the bank in a more positive light. If an investigation were initiated, the bank would have had the opportunity to reduce the severity of the possible enforcement sanction if it was seen to be cooperating with the regulators by raising the alarm itself rather than leaving this to the external auditor to communicate who first came across the issue. This is particularly important in the U.K. context because formal cooperation with the regulator results in a reduction in any subsequent penalty.95

Politicians seem to think external auditors will be another line of defense against bank failure. But what the profession is proposing is much the same as the current audit approach and aims to avoid the idea of the external auditor being the supervisors’ agent.96 Each party seems to have a misconceived idea of what each other expects and the level of reliance the supervisor seeks to place on external auditors. While the PRA and FCA propose to question “business judgments” through a judgment-based approach to supervision,97 the audit profession on the other hand seems to be reluctant to engage in the

93. ENHANCING THE AUDITOR’S CONTRIBUTION TO PRUDENTIAL REGULATION, supra note 81.
94. Id.
95. See Financial Services and Markets Act, c. 8, §§ 206, 210 (provisions relating to the Regulator’s discretion in imposing penalties).
96. ASS’N OF CHARTERED CERTIFIED ACCOUNTANTS, AUDIT UNDER FIRE: A REVIEW OF THE POST-FINANCIAL CRISIS INQUIRIES 13 (May 2011), available at http://www.accaglobal.com/content/dam/accaglobal/global/PDF-technical/audit-publications/pol-af-auf.pdf [hereinafter ACCA]. The paper provides: “Nonetheless, the distinct roles of regulator and auditor should never been confused. Auditors should never be seen as agents of the regulator—if this would change the relationship between auditor and client company to the detriment of both.”
A SUPERVISORY GATEKEEPER

process of assessing business judgments. This follows the point explored before, which is the external auditor needs to assess management representations with both external and internal evidence. Auditors do not consider it their responsibility to judge business strategy or other business decisions, as they are primarily considered to be the responsibility of management. Although external auditors do not want to explicitly take on the role of assessing business strategy, it seems to be more the case that assessing business strategy occurs implicitly in the external auditor's role because management representations about business strategy are reviewed in the process of formulating an opinion on the financial accounts.

If reliance is placed on the external auditor to undertake tasks for the regulator, then surely their approach needs to coincide and it should be worked out what role they are expected to perform in advance. Moreover, the auditor would be expected to look more to the possible future performance of a bank rather than simply its past performance. This could be a feature of the external auditor's role as a supervisory gatekeeper, making them—for the purposes of the regulator—take a long-term view of the bank rather than what is expected to fulfill the going-concern requirements. The flexibility offered in the new legislation means new duties could be worked out to better enable external auditors to act as supervisory gatekeepers. Whether those and the following issues could also be worked into a new code is open to debate. A key issue would be working out how the regulator and the external auditor can work together when a bank may be in distress. This issue is explored further in the section below.

V. Qualification of Bank Accounts

The qualification of bank accounts had been a controversial area during the financial crisis, as people started to ask why the banks had been given a clean bill of health when, during the same year, they received vast amounts of public support to save them from collapse. In the recent crisis, the banks that sought government assistance had received unqualified audits shortly before the rescue. In light of the financial circumstances and the vulnerability of many banks at the time, it is necessary to ask whether the failure to qualify bank accounts is a concern and, if so, how it can be managed so as to balance the need for disclosure and limit the spill-over effects from a bank failure. In many respects, the question of qualification brings to the fore the issue of audit focus on the past and the regulators', and possibly the market's, concerns for the future. This is due to the auditors' focus on past financial performance to gauge how it is likely to perform in the future.

Whereas the regulator is presented with “real-time” data and, on the basis of that information, sets the target for asset growth (15–25% year-on-year) and for profit growth; a low net interest margin; a low cost: income ratio; and relatively high reliance on wholesale funding and securitisation. As a result of this business model, it was able to increase its share of the UK mortgage market at an extraordinary rate. Northern Rock's market share of net residential lending jumped from 11.2 percent in 2004 to 18.9 percent in the first half of 2007. We are astonished that PwC appeared not to recognize an amber light that flashed so brightly. Id. at 40–41.

98. PRA'S APPROACH TO BANKING SUPERVISION 2013, supra note 97, ¶ 67.
99. Trotman & Wright, supra note 45, at 51.
information, is required to gauge the likely impact of the bank’s activities on existing and future depositor or investors.\textsuperscript{102}

The auditors are required in accordance with section 495(4) of the Companies Act 2006 to state whether their audit report is qualified or not.\textsuperscript{103} Banks are also expected to notify the FSA of a possible qualification of the annual financial statements, even if this is no more than a comment on an aspect of its accounts. Consequently, qualification of the financial accounts of a bank is not a simple decision.\textsuperscript{104}

A review of the financial accounts of U.K. banks for 2002–2011 found that a number of financial statements were qualified by their auditors.\textsuperscript{105} In this period, 17 out of 5,864 banks in this category had qualified accounts for either one or two of the years.\textsuperscript{106} The majority of these are not prominent institutions, but a few well-known names—such as Northern Rock Asset Management Plc in 2008 and RBS Financial Products Plc in 2006—did have their accounts qualified.\textsuperscript{107} But these qualifications did not cause a loss of confidence, possibly because they were not widely publicized or clearly applied to a part of the banking group that was not so well known. In the case of Northern Rock Asset Management, it is perhaps no surprise as it is essentially the “bad” bank separate from the “good” bank that has recently been sold to Virgin Money.\textsuperscript{108} But for deposit-taking institutions, the matter of qualification of accounts may need to be considered separately; the probability of a loss of confidence that could pose a significant risk of a bank run is technically much higher. The qualification of financial statements would also have an impact on the bank’s credit rating, so its cost of borrowing would also be adversely affected.

\textsuperscript{102} Id.

\textsuperscript{103} Id.; see Companies Act, c. 3, § 495(4).

\textsuperscript{104} Id.


\textsuperscript{106} Id.

\textsuperscript{107} James Kirkup, Northern Rock to Repay 270m Due to Paperwork Error, The Telegraph (Dec. 11, 2012, 6:46 PM), http://www.telegraph.co.uk/finance/newlysector/banksandfinance/9738285/Northern-Rock-to-repay-270m-due-to-paperwork-error.html; Id.

The qualification of financial statements therefore raises serious dilemmas for auditors 
balancing past performance with future performance, especially when a problem arises 
more than six months after an audit and losses are exposed or, worse, the institution col-
lapses or is subsequently bailed out with taxpayers’ money.

An issue particularly pertinent to the qualification of financial accounts is whether the 
bank is a going concern. As highlighted by the House of Lords in 2011, “an auditor might 
properly regard a bank as a going concern even when a non-bank in a similar position 
might not be so regarded, since a bank that got into difficulties would be bailed out.”

As the banks were able to access liquidity via the central banks while the markets were 
closed, the question of whether they were going concerns is difficult to address. 
Moreover, the primary role of the auditor to assess past performance means its ability to assess 
future performance is limited or non-existent. This, albeit a recent reality, epitomizes 
an acute form of moral hazard, which requires not so much more regulation, but a cultural 
shift away from the presumption of bail-out and back to the presumption of letting the 
market decide whether a bank or non-bank should survive, with the regulator making sure the 
resolution of a bank or non-bank in distress is orderly.

At the height of the financial crisis a more cautious approach was arguably necessary 
when it was seen that the crisis was threatening the systemically important, financially 
sound institutions, as well as the financially unsound. So much so that the financial 
accounts of the banks did not mention the dialogue between the regulators and auditors 
during these periods of stress. One could argue the disclosure of even that kind of 
information could have possibly resulted in a panic and so necessitated avoiding being 
disclosed. In those circumstances, concerns about financial stability may rightly need to 
outweigh concerns about market integrity when panic on the scale in 2008 saw all ration-
ality in the market disappear.

The auditors, while liaising with the financial regulator, may have to take into account wider public interest concerns, although they are not actu-
ally mandated to do so.

A view seems to have nevertheless developed, however, that emergency liquidity assistance offered to banks experiencing liquidity problems is of right and not something that

109. ACCA, supra note 96, at 13. The Paper provides: “The auditors’ responsibility as regards going con-
cern does not, in fact, require them to give any guarantee that the company will survive for the foreseeable future.”

110. Sikka, supra note 100, at 870-71.

111. ECONOMIC AFFAIRS COMMITTEE, AUDITORS: MARKET CONCENTRATION AND THEIR ROLE, 2010-

112. ACCA, supra note 96, at 13. The Paper provides: “Auditors need only assess whether the going con-
cern assumption is appropriate as a basis for preparing the current financial statements. They must consider 
whether any events or liabilities (contingent or otherwise) might threaten the company’s solvency but the 
responsibility does not require them to make any assessment of the company’s financial health beyond an 
assessment of the company’s prospects in so far as they affect the chosen basis of reporting.”

113. See ECONOMIC AFFAIRS COMMITTEE, supra note 111, ¶ 144; cf. G. Wood, TOWARDS A COHERENT CRISIS 
RESOLUTION MANDATE, in FINANCIAL CRISIS MANAGEMENT AND BANK RESOLUTION 57 (John Raymond 
LaBrosse, Rodrigo Olivares-Caminal & Dalvinder Singh eds., 2009).

114. ECONOMIC AFFAIRS COMMITTEE, supra note 111, ¶ 140.

115. See Roger McCormick, UNITED KINGDOM, in THE INT’L BAR ASSOCIATION’S TASK FORCE ON THE FIN.
CRISIS, A SURVEY OF CURRENT REGULATORY TRENDS 55, 77-78 (2010), available at http://www.lse.ac.uk/
could be rejected. While the recent crisis certainly seems to imply a culture of rescue with public funds, the historical record of the Bank has been one of firmly letting banks in such circumstances sink or sink in an orderly way, if sinking could be done in an orderly manner. The Bank’s record as Lender of Last Resort (LOLR) would suggest caution against a presumption that such assistance should be considered “normal practice.” The assistance in the past has traditionally been extremely limited and on the basis of a penalty rate, with a view that some form of mismanagement has likely led the Bank to need LOLR assistance given the Bank’s raison d’être is its skill of managing the maturity mismatch of asset and liabilities.

VI. The Accountability of Auditors

The fallout from corporate failures ultimately focuses attention on apportioning blame among the various culprits. The auditor, as a gatekeeper, is an obvious target, considering its responsibility for verifying the stewardship of the company as a going concern. When issues of fraud come to light the first question is the following: what did the auditors know and why didn’t they raise the alarm earlier? Assessment of enforcement action by the profession suggests it does not provide sufficient deterrence against poor auditing. This is exacerbated in some ways by the Companies Act 2006, which enables auditors to limit their liability. Limitation of liability is possible provided it is “fair and reasonable” to all parties and gets shareholder approval. Individual companies and auditors can negotiate the extent of any limitation. In this respect, the auditor may negotiate for the bank to hold the auditor proportionately liable when the loss or fraud was primarily caused by another party. The limitation agreement does not allow the auditor to disregard its professional duty of care in completing the audit.

The U.K. Financial Reporting Council’s (FRC) Conduct Committee (CC) set up in 2012 and replaced the FRC’s, Accountancy & Actuarial Discipline Board (AADB) deals

117. Id.
119. See THE SHARMAN INQUIRY, supra note 116.
120. Lastra & Wood, supra note 118. In this paper, mention is made of applying a different rate, not necessarily a penalty rate of interest, at 13. This was not the policy adopted with the Dunfermline Building Society. See Dalvinder Singh, The UK Banking Act 2009, Pre-Insolvency and Early Intervention: Policy and Practice, 1 J.B.L 20, 35 (2011).
121. See Patricia Jackson, Deposit Protection and Bank Failures in the United Kingdom, 1 FIN. STABILITY REV. 38, 43 (1996).
123. Id.
124. Id. ¶ 5.14.
125. Id. ¶ 3.2.
with “cases which raise . . . important issues affecting the public interest.” The number of cases investigated by the CC, and formerly by the AADB, suggests it has an insufficient deterrent effect on the behavior of accountants. For example, data from the CC’s own website, which includes those cases being investigated by the AADB indicate it is presently investigating nineteen cases which date back to 2005. Of those, the CC, formerly the AADB, is currently investigating three cases that relate to the financial crisis.

One is the 2007 audit of Lehman Brothers prepared by Ernst & Young LLP and Ernst & Young LLP’s inadequate reporting of Lehman Brothers’ inadequate separation of client assets prepared for the former FSA. Another case, also having to do with compliance with the former FSA client asset reports, was an audit by PricewaterhouseCoopers LLP for J.P. Morgan Securities Ltd. One could argue there is little enforcement activity, albeit these are some of the most prominent cases, so their number could arguably be limited, and the bulk of the disciplinary cases are handled by the professional bodies themselves, skewing the overall number of enforcement actions.

The Institute of Chartered Accountants of England and Wales (ICAEW) is responsible for maintaining professional standards of its members. A review of the enforcement activity shows some interesting findings. First, the fines for what are considered to be serious reprimands are relatively small, at about £2,000–6,000. Secondly, the enforcement activities in 2010–2011 centered around the regulatory decisions of relatively smaller firms; no individual at the Big Four was reprimanded, and further data gathered from other years leads to the same conclusion. It is argued that the sanctions lack the appropriate deterrence effect and the level of transparency of those decisions is questionable as well.

The problems of poor auditing and the limited fines the professional bodies administer are further illustrated by looking at the most prominent bank failures before the 2007 financial crisis, and indeed the recent J.P. Morgan Securities tribunal decision.

---

127. Id.
128. Id.
129. Id.
134. Compilation of ICAEW cases showing no Big Four firms are involved is on file with author.
136. Final Notice to J.P. Morgan, supra note 131.
VII. BCCI, Barings Bank, and J.P. Morgan Securities Case Studies

When BCCI was closed, many questioned the work of the auditors involved with BCCI. This case became one of the most controversial cases both in the United Kingdom and around the world. Numerous senior directors were prosecuted for fraud, and the losses totaled £9 billion. PricewaterhouseCoopers (PwC), the external auditor, was fined a total of £975,000 by the JDS Tribunal for failing to give a true and fair view of BCCI’s management and financial affairs, which constitutes conduct that falls short of what an external auditor is reasonably expected to do. Although these charges related to the 1987 and 1988 audits, the JDS Tribunal decision fined PwC in 2006 for failing to prepare the 1987 and 1988 audits in accordance with International Accounting Standards (IAS). One of these violations was that PwC did not comply with IAS 24 in its 1987, 1988, and 1989 audits because it failed to disclose the link between BCCI and the ICIC Group as a “related part relationship” and the share ownership between the two, which provided security for the lending to ICIC by BCCI. PwC also failed to disclose whether the loan loss provision for the 1987 accounts reflected the level of lending and bad debt provision for the year for major clients, such as CAH and Gulf Group. The JDS Tribunal found that PwC did not obtain sufficient audit evidence to “enable it to draw reasonable conclusions therefrom,” which it could only have done if it “obtained additional appropriate evidence about the value of the security and its enforceability” and “the adequacy of claim loss provisions against the Gulf Group related lending.” The important question of whether auditors should take all the blame was discussed above.

Barings collapsed as a result of Nick Leeson’s trading activities in Singapore, which led to massive losses totaling £827 million and caused the parent company, Barings Bros & Co, to be placed in the hands of administrators. Complaints against Coopers & Lybrand’s (C&L) audit engagement partner, Andrew Charles Turner, were dismissed, however, and the fine for C&L was £250,000. A fine for Gareth Maldwyn Davies, a

---

138. Complaints against PwC, supra note 137; Singh, supra note 19, at 162.
139. Complaints against PwC, supra note 137; Singh, supra note 19, at 162.
140. Complaints against PwC, supra note 137; Singh, supra note 19, at 162.
141. Complaints against PwC, supra note 137; Singh, supra note 19, at 162.
142. Complaints against PwC, supra note 137; Singh, supra note 19, at 162.
143. Complaints against PwC, supra note 137; Singh, supra note 19, at 162.
144. Complaints against PwC, supra note 137; Singh, supra note 19, at 162.
146. Id. of Banking Supervision, Bank of Eng., Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings, (July 1995); Michael Choo San Lim & Nicky Ng Kuang Tan, Barings Futures (Singapore) Pte Ltd: Investigation Pursuant to Section 231 of the Companies Act (Chapter 50); The Report of the Inspectors Appointed by the Minister for Finance (Sept. 6, 1995); Andersen, supra note 54; Re Barings plc (No. 5), Secretary for Trade and Industry v. Baker and Others (No. 5), [1999] 1 B.C.L.C. 433, ch. D.
148. Perry, supra note 147.
C&L partner, was £25,000.149 “The complaints before the JDS Tribunal identified a number of failures at Barings that could have been discovered if the approach to the audit had been effectively evaluated to ensure the integrity of the work.”150 The case fundamentally called into question the reliance placed on the internal controls at Barings and a lack of observance of audit guidelines to determine whether the accounts gave a “true and fair view.”151 For example, the discrepancy in the margin payments to Leeson could have been uncovered if C&L had independently verified the data with the Singapore International Monetary Exchange, as it should have done, rather than relying on information provided by Barings.

The recent case of PwC, and its inaccurate reporting of J.P. Morgan Securities Limited Client Money’s segregation of client funds between 2002 and 2009, resulted in the former AADB issuing a fine of £1.4 million in December 2011.152 The issue of segregation of client assets is an elementary part of managing a client’s business activities.153 J.P. Morgan was fined a record £33 million for its failures to segregate client assets.154 The problems J.P. Morgan Securities experienced were a result of the earlier merger between J.P. Morgan & Co. and the Chase Manhattan Corporation to form J.P. Morgan Chase & Co. in and around 2000.155 This caused a lack of harmonization of computer systems, which meant the client money in the futures and options division of the business was placed by the treasury overnight into a desegregated account.156 J.P. Morgan Securities reported the error to its accountants at PwC and the FSA.157 The failure exposed the inadequacy of PwC’s past reporting of J.P. Morgan’s compliance with the FSA’s rules on client money.

The AADB found PwC to have fallen short of the professional standards expected of a member firm, and decided to reprimand it severely.158 In arriving at its decision, the AADB found it immensely difficult to decide on the size of the fine due to the current professional guidelines on financial penalties.159 The largest fine ever imposed was in the

149. Id.
150. SINGH, supra note 19, at 162.
151. Id. at 156.
153. This issue rose in prominence with the bankruptcy of Lehman Brothers in 2008 and difficulties the administrators experienced getting clients their money back. Alistair Osborne & Helia Ebrahimi, Auditors Face Probe Over Client Assets, TELEGRAPH (Oct. 5, 2010, 6:00 AM), http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8042354/Auditors-face-probe-over-client-assets.html.
156. AADB v. PwC, supra note 152 at 1-2.
157. See id. at 2.
Robert Maxwell affair, where the JDS, the predecessor to the AADB and now the CC, imposed a fine of £1.2 million. The general conclusions of the decision highlight the inadequacy of the current guidelines inter alia to protect the public interest and maintain the standards expected in the profession through the imposition of a penalty appropriate to the severity of the matter and so to deter others in the future. It is implicit in the decision that the level of fines had not risen in light of the size of the audit fees now commanded and the profits generated by the member firms.

It concluded that decisions such as these needed to take into account a number of factors, and required an increase in the level of fine to £2 million to ensure:

1) Protection of the public from risk;
2) The marking of sufficient disapproval of the conduct in question;
3) Deterrence of future misconduct by Member Firms or individuals (whether the respondent to the instant case or others);
4) The size and scope of the business of the Member Firms conducting audits of and reporting on global financial services firms.

This preliminary review of the kind of enforcement action taken by the profession against its members does provide evidence of a lack of deterrence. Whether one looks at the prominent cases or cases against individuals by the professional association, the level of accountability and the level of penalties seem to offer a limited level of deterrence. And the move to limiting liability via contractual means adds up to a lack of overall deterrence when the level of actions seems to be one of the reasons for the limits. The limited level of professional accountability is not fully countered by the reputational risk auditors are exposed to, such as the catastrophic experience of Arthur Andersen post-Enron. Moreover, the FSA’s power to disqualify auditors for poor reporting follows a similar line because, rather than the FSA undertaking a disqualification action, it relies on the professional bodies to investigate and decide on these cases, side stepping the matter and making the power benign.

As these are essentially extremely rare events, to rely on this as a deterrence distorts the kinds of issues that could go on under the radar that require a more coherent and effective enforcement strategy that addresses the various forms of non-compliance and breach of professional standards that may occur.

The recent review of bank audits commissioned by the FSA under its new special arrangements with the FRC highlights a number of areas of concern. These were prominent during the recent crisis and considered by the former AIU, which was replaced with the Audit Quality Review (AQR), to be significant. A theme that is highlighted throughout this paper is the lack of overall scrutiny of audit evidence and its independent verification, and more specifically the testing of techniques adopted by management in completing the accounts. The level of scrutiny of management representations was simply

161. Id.
164. ENHANCING THE AUDITOR’S CONTRIBUTION TO PRUDENTIAL REGULATION, supra note 81, at 38.
165. See id. at 12.
not robust enough, thus calling into question the level of skepticism shown by auditors. A principal reason for this is the pressure to complete the audit within the designated period of time so that it does not exceed the allocated budget.

The recent PwC case confirms that the sanctioning policy of the profession is less than what regulators are expected to have in place. The guidance, by the profession, for the tribunal to apply was considered wanting. The former AADB decision made reference to the Macrory Report on regulatory sanctions and highlighted what the key principles should be in deciding a penalty: to "change the behaviour of the offenders," eliminate any financial gain or benefit, make sanctions proportionate, justify their choice of enforcement actions year on year, enforce in a transparent manner, among others. In view of the size of the Big Four accountancy firms and the considerable profits they generate, the size of the proposed new minima is not quite what one would consider proportionate to the profits they generate from an individual audit client.

A. The Powers of the FCA and PRA

The regulators, particularly the former FSA, clearly set out that they sought to rely on the professional standards of the auditing profession and what it considered reasonable, rather than the FSA trying to duplicate and hold auditors separately accountable. This is notwithstanding the fact that the previous regime, like the new regime, confers on the regulators powers to take disciplinary actions against external auditors.

The FCA has the authority to take disciplinary action against an external auditor, and the PRA is in the curious position of the U.K. Treasury, deciding whether or not it should have disciplinary powers against auditors. This is possibly because the PRA is responsible for the larger systemically important banks, so any decision to take action against an external auditor of such a firm could have wider market repercussions. The powers of the FCA and the PRA are, in substance and detail, the same, albeit in the latter case, the HM Treasury will need to confer those powers on the PRA. The FCA and the PRA have the authority to take disciplinary action if an external auditor has failed in his duty or failed to communicate information to them. The FCA and the PRA could decide to either disqualify them from acting as auditors, publish a statement to the effect that the regulator is of the view the auditor has failed to comply with his duty, or impose a penalty. The power of the FCA and the PRA to disqualify an auditor can be removed if they are of the view that the auditor has been rehabilitated and will comply with his duty in the future.

167. See id. at 9.
170. See Financial Services Act, c. 21, § 345(1), sch. 12, § 345A(2).
171. Id. §§ 345, 345A.
172. Id.
173. Id. §§ 345(1), 345A(2).
174. Id. §§ 345(2), 345A(4).
175. See Financial Services and Markets Act, c. 8, §§ 354(7), 345A(7); see also Financial Services Act, §§ 345(6), 345A(7).
The power to take enforcement action against the external auditor is certainly necessary in order to manage the relationship between the bank and the external auditor and the requirements the FCA and the PRA expect the external auditor to adhere to. The likelihood of the FCA and the PRA actually taking action against the external auditor is, however, remote if past experience with the FSA’s approach is anything to go by. The FSA was of the view that it would rely on the professional bodies to decide whether or not enforcement action, as highlighted above, is appropriate. As has been shown above, there is considerable doubt cast over whether the profession will adopt a more intensive enforcement approach in order to ensure external auditors do what the regulators expect of them. The sanctions model of the auditing profession does not even remotely reflect the one that exists to ensure the financial services industry is kept in line. It is difficult to see any change in this regard unless the PRA and the FCA put pressure on the profession to get its enforcement approach in line so that the enforcement approach reflects the more intensive approach now expected.

The following section looks at the international experience and suggests what procedures other jurisdiction have put in place to address some of the coordination problems highlighted above. These could be reviewed in light of the discretion the new regulatory structure confers on the new regulators.

VIII. Further Reflections on the Use of External Auditors as Supervisory Gatekeepers: With Some Reference to the International Experience of Using External Auditors

The use of external auditors is wide and varied, and a review of some of the issues highlighted by the IMF and World Bank through the Financial Sector Assessment Programme is a useful basis to assess some of the concerns that have arisen. International experience suggests that where there is a lack of regulatory resources, the use of external auditors is an option that can bridge that resource gap. But the experience also shows that effective regulation of the relationship between the regulator and auditor is crucial to overall success. Effective oversight needs to address the possibility of over- or under-accommodation in supervision.

177. See Financial Services Act §§ 345(1), 345A(2).
179. The use of FSAP reports to delineate international experience of regulation is often referred to in official publications. See generally DOUGLAS W. ARNER, FINANCIAL STABILITY, ECONOMIC GROWTH, AND THE ROLE OF LAW (2007); Dalvinder Singh, The Role of the IMF and World Bank in Financial Sector Reform and Compliance, in REDEFINING SOVEREIGNTY IN INTERNATIONAL ECONOMIC LAW 331 (Wenhua Shan, Penelope Simons & Dalvinder Singh eds., 2008); IAN P. DEWING & PETER O. RUSSELL, THE CONTRASTING ROLE OF AUDITORS IN UK AND SWISS BANKING SUPERVISION 25-26 (2010), available at www.icas.org.uk/site/cms/download/res/Dewing_Russell_Report_Dec_2010.pdf (following this specifically in the auditing context) [hereinafter DEWING & RUSSELL, CONTRASTING ROLE]; Ian P. Dewing & Peter O. Russell, Auditors as Regulatory Actors: The Role of Auditors in Banking Regulation in Switzerland, 21 EUR. ACCT. REV., 1, 1-28 (2012) (exploring the issues by comparing the UK and Swiss models). The research for this paper takes a much broader look at the issues highlighted in other countries that use external auditors in banking supervision, so a wider picture can be gained of their use and indeed the limitations associated with poor oversight.
A key issue with the relationship between external auditor and regulator is the extent to which the regulator has relied on the audit findings. The United States experience highlights the importance of having a coherent approach to taking action against auditors.\(^{180}\) The level of reliance on the external auditor needs to be assessed by looking at what the regulator and the auditor are expected to do.\(^ {181}\) The level of oversight of external auditors needs to be sufficient to protect the public objective of the regulator with better professional oversight.\(^ {182}\) Alternatively, the regulator needs to be confident that the auditing profession can meet its expectations in terms of professional enforcement action against its own members. A general conclusion is the importance of supervision bridging the knowledge, insight, and responsibility gap between regulators and auditors about individual banks.

Conflicts of interest between the external auditor and the client bank need to be identified, and the risk of them materializing or undermining the objectives of the regulator needs to be monitored.\(^ {183}\) This ensures that the impartiality of the auditor’s decision-making is monitored by the regulator.\(^ {184}\) For example, in Switzerland the bank audit firm has to disclose the extent of the non-audit work provided to the client, and additional special audits are commissioned.\(^ {185}\) The risks associated with using external auditors have been the focus of additional efforts by the Swiss regulators to police the work of external auditors, including better coordination with the auditor’s cross-border and foreign regulators.\(^ {186}\)

---

180. The relatively recent (2004) decision by the OCC to take action against Grant Thornton regarding its audit of First National Bank of Keystone was taken after it transpired the insolvency of Keystone Bank was not discovered. The OCC took action on the grounds that the audit firm had recklessly engaged in an unsafe and unsound banking practice by failing to audit the accounts of the bank properly and failing to bring to its attention the non-existent $98 million of income and $450 million of assets. The FDIC’s role is a lot broader in its role of official receiver in terms of claims and recoveries once a bank is liquidated, as was the case against Grant Thornton regarding its audits of Keystone Bank, explored earlier. The OCC also fined Grant Thornton $300,000. Grant Thornton, LLP v. F.D.I.C., 535 F. Supp. 2d 676 (S.D.W. Va. 2007) rev’d sub nom. Ellis v. Grant Thornton LLP, 530 F.3d 280 (4th Cir. 2008).


182. In many respects, the Swiss trade-off between more supervisory staff or more use of external auditors resulted in the increase use of external auditors.

183. The IMF report on Austria even goes as far as to suggest the rotation of external auditors, which goes beyond the remit of most corporate governance expectations. See Int’l Monetary Fund, Austria: Financial Sector Assessment Program Update: Technical Note—Factual Update and Analysis of the Basel Core Principles for Effective Banking Supervision, 13, Country Report No. 08/205 (Jul. 2008).

184. IMF 02/108, supra note 181.


The regulator needs to ensure that the use of external auditors in banking supervision is designed so the gaps between on-site and off-site inspections and reports do not leave loopholes that could result in missed opportunities to deal with red flags because either the regulator or the auditor thought the other was responsible for handling the matter. The risk of auditors forbearing from acting on “audit evidence” that questions the viability of a bank is equally an issue as it is with regulators forbearing from taking decisions when regulatory evidence suggests the bank is not viable. Therefore, as we have recently experienced, a move to minimizing regulatory forbearing external auditors would logically be required to implement similar measures if the external auditor is going to be heavily relied upon with early intervention powers.

The relationship between the regulator and the auditor needs to be set in the context of some form of coherent framework rather than left in an informal, piecemeal fashion. The risk of regulator and auditor forbearance is credible and requires a robust structure to curtail it. The focus of attention is the wider public objectives set by the regulator; one cannot simply assume that the expectations of the auditors’ mandate to the company and the “enlightened shareholder” will suffice to meet and protect those public objectives. This is based on the argument that the regulator and auditor do not sing from the same “hymn sheet” and an expectations gap is inevitable. The recent review by the Swiss Financial Market Supervisory Authority (SFMSA) of using external auditors has suggested it intends to go further to overcome the expectations gap. Even with the SFMSA’s more robust oversight of external auditors, it has concluded that the perception firms have is still that the auditor is the auditor of financial statements in accordance with the adopted accounting standards and the financial regulator is the financial regulator to protect the perimeter of the authorized activities, regardless of the fact that the auditor is

187. A conclusion in the FSAP report for Germany highlighted the fact that reliance on external auditors without effective oversight of the use of them creates gaps and time lags to act promptly if the external auditor is not overseen by the regulator properly. The report also implies that without additional requirements on the external auditor, gaps in the reporting requirements could be missed. This gap exists because the supervisor has not put in place sufficient mechanisms to monitor reporting requirements. Int’l Monetary Fund, Germany: Financial System Stability Assessment, Including Reports on the Observance of Standards and Codes on the Following Topics: Banking Supervision, Securities Regulation, Insurance Regulation, Monetary and Financial Policy Transparency, Payment Systems, and Securities Settlement, Country Report No. 03/343 (Nov. 2003). The reports expected from the auditor require further guidance from the regulator to identify issues that are pertinent to its concerns about the banks. See Int’l Monetary Fund, Austria: Financial System Stability Assessment—Update, Country Report No. 08/190 (June 2008) [hereinafter IMF 08/190].

188. An example is where the speed of decision making of the external auditor poses risks to the Austrian financial system as it means the regulator cannot take action as promptly as it might like to. IMF 08/190, supra note 187, at 15.

189. See generally G.G.H Garcia, Failing Prompt Corrective Action, 11 J. BANKING REG. 171 (2010); see also Sikka, supra note 100, at 868.


undertaking work essentially of a financial regulator as a supervisory gatekeeper.\textsuperscript{193} It is therefore moving towards separating the dual role of the external auditor into the financial audit and the regulatory audit and setting out distinct requirements for the latter.

The idea of auditing the auditor is useful to check the quality of the auditor’s work. The former FSA was of the view that it lacked the technical expertise to undertake such a task, so the role of the AQR, formerly the AIU, was considered helpful.\textsuperscript{194} Currently, it is considered to be the responsibility of the profession itself through the work of the AQR.\textsuperscript{195} A recommendation has been made for the financial regulator to work with the AQR, formerly the AIU, to devise a quality review mechanism for auditors of financial services firms.\textsuperscript{196} This is certainly necessary; in its 2010–2011 report, even the AIU found it difficult to review audits due to their complexity.\textsuperscript{197} The report suggests very few files are actually reviewed. For example, for the Big Four firms, only sixty-eight files were reviewed in 2009-10 and fifty-four in 2008, which do not look like sufficient numbers to generate a level of confidence about audit quality.\textsuperscript{198} Of these files, 15 percent were from the banking, finance, and insurance sector, so the confidence and assurance of audit quality provided by the former AIU are limited.\textsuperscript{199} The 2010–2011 AIU annual report indicates how the banking sector was one of the specific areas it reviewed in light of the financial crisis and the overall concerns about audit confidence.\textsuperscript{200} To make this effective and useful for the regulator, it might be an idea to have mandatory reviews of systemically important financial institutions and possibly expand this practice to other important financial services firms. This is due to the small number of reviews presently undertaken and the systemic problems posed by banks and non-banks. It is important to highlight that recent experience indicates both banks and non-bank financial services firms can pose a systemic threat to the financial system.

While the United Kingdom is not moving towards a dualist approach of relying completely on the external auditor to undertake supervisory examinations like the Swiss system, the gaps in terms of responsibilities and expectations need to be bridged formally.\textsuperscript{201} The move to reinvigorate the meetings between the supervisor and the auditor will not go far enough, and a number of other steps have to be taken. It has been argued the FSA did not replace the use of auditors with additional resources.\textsuperscript{202} The resourcing of financial regulators has been a persistent problem: looking back at some of the post-mortems for banking failures, a key recommendation has generally been to improve staff levels. In the Swiss system, we have seen a concerted effort to bridge that problem with the use of auditors, but the recent financial crisis has required it to go further.\textsuperscript{203}

\begin{thebibliography}{9}
\bibitem{193} See id. at 23.
\bibitem{195} \textit{Enhancing the Auditor’s Contribution to Prudential Regulation}, supra note 81, at 37.
\bibitem{196} See id. at 39.
\bibitem{198} \textit{Audit Inspection Unit}, supra note 166, at 13.
\bibitem{199} Id. at 14.
\bibitem{200} Id. at 22.
\bibitem{201} Dewing & Russell, \textit{Contrasting Role}, supra note 179, at 37-38.
\bibitem{202} Id. at x.
\bibitem{203} Fin. Stability Board, supra note 192, at 24.
\end{thebibliography}
The U.K. PRA and FCA need to take a similar decision over the extent to which they will rely on external auditors in the supervision of banks. In the recent MoU between the PRA and FCA, no mention is made of how they propose to coordinate their responsibilities and oversight of the external auditors in supervision. This is necessary if reliance is going to be placed on them to undertake supervisory tasks. Moreover, it would be likely that the PRA and the FCA will receive audit reports for the separately regulated entities, but it is not quite clear who will receive the audit reports for those dual regulated firms where the PRA and the FCA take part responsibility for prudential supervision and conduct of business.

The regulator needs to be seen to be monitoring the relationship of auditor and client. The regulator does have the right to disqualify auditors and take action, but relying on the audit profession to decide and administer any sanctions is called into doubt, as explained above. This is primarily a matter of political willingness to take direct action, as seen in the United States, albeit it failed on technical grounds. If the regulator is placing a significant amount of reliance on the auditor’s work, then there should be sufficient grounds to take action if the findings of the auditor prevent the regulator from doing its job. Furthermore, as explained above (with reference to the Tribunal decision in JP Morgan Securities) if the enforcement approach of the accounting profession is not in line with the enforcement approach of the financial regulator, this could exacerbate the expectations gap. If the financial regulator is to protect its reputational capital, then it needs to set the tone for enforcement—in terms of both intensity and sanctions. The MoU between the former FSA and the FRC in relation to the work of the former AIU, now the AQR, does iterate the powers to be able to take action. It seems as though the provision is a veiled threat to the profession that if it does not take appropriate steps, then the PRA or FCA will initiate its own proceedings.

Another option could be to extend regulatory immunity against actions in negligence covering the regulator to external auditors, as in the Australian framework, which includes third parties. The rationale of extending protection is to allow auditors and/or skilled persons during ad hoc reports—a free rein to report and tackle matters of a regulatory concern and bring them into the regulatory framework as formally as possible. This could create the incentives to report supervisory matters more freely by dismantling the link between the auditor and the firm and re-aligning it with the regulators remit of responsibility so that it eliminates the possibility of the auditor taking a defensive position to guard the interests of the client. On the other side of the coin, and as this paper emphasizes, providing immunity to an already relatively immune external auditing profession will simply exacerbate the already limited environment of accountability.

The onus on the U.K. regulator to decide whether a bank is “failing or is likely to fail,” to satisfy the threshold conditions for the purpose of deciding on initiation of the special resolution regime, will certainly put an indirect responsibility on the auditor to judge whether or not the bank is or was a going concern at the time of the audit. There are

---

204. Draft Memorandum of Understanding (MoU) between the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA), Bank of Eng., available at http://www.bankofengland.co.uk/financialstability/Documents/overseeing_fs/fca_pra_draft_mou.pdf (last visited Aug. 14, 2013) [hereinafter Draft MoU].

205. Ser Humphrey, Moizer & Turley, supra note 53, at 158.

206. Draft MoU, supra note 204.
limits here; as shown above, the audit is not a continuous relationship of monitoring akin to a supervisor, but more a snapshot of the bank’s past performance over a specific period of time. Moreover, the going-concern requirement does not equate to the expectations of the supervisor, for whom existing and future consumer interests are the primary concern. The move towards the requirement in Australia might be worth considering, where auditors are formally required to report if the “auditor has reasonable grounds for believing that the bank is insolvent, or is at risk of becoming insolvent.”

In the U.K. context, if this were in place, then it might have perhaps meant the U.K. authorities would have had to act earlier rather than later in 2008 with its emergency measures to rescue the banks in light of the clean audit reports they had received early on in the year. An explicit responsibility relating to insolvency matters such as this would certainly tie in better with the supervisor’s responsibility on such matters. Ultimately, the ability to deal with distressed banks and minimize the potential fallout from a failure needs to be coordinated at all levels, in a timely manner.

This is further exacerbated if the issue of qualification of financial accounts is put into the equation as well and is left solely within the discretion of the external auditors and not sufficiently linked to the role of the regulator and the central bank as the lender of last resort, notwithstanding the requirement to report. As the decision to qualify the accounts of Resona Bank clearly highlights, it led to the need for emergency liquidity assistance by the authorities in Japan due to the potential risk of Resona Bank collapsing due to the disclosure of its insolvency and causing the risk of contagion in the Japanese banking system.

---


208. The case of Resona in Japan provides an interesting case study of the risks associated with qualification of financial statements of a bank. In more recent times, the authorities in Japan experienced the possible fallout of a bank failure after the auditor threatened to qualify the bank’s accounts. The auditors decided to qualify the accounts of Resona Group, one of its largest banks, after they revealed its poor capital levels and the inability of the bank to rectify this before the accounts were signed off. The announcement led other banks to fear that their accounts could also be qualified, causing a systemic panic that prompted the authorities to intervene. The government recapitalized Resona Group to the sum of ¥1.96 trillion to avert a systemic crisis. The auditors were alleged to have been signing off Resona Group’s accounts for a number of years when it was effectively insolvent. This policy was reversed in 2003 after new guidelines were introduced that stopped banks continuing to use deferred assets to inflate their capital levels. The regulatory authorities lacked the formal channels of communication with bank auditors, thus the auditors had been acting alone in such matters. News Release, Resona Holdings Inc., Receipt of Subscription Payments for New Common and Preferred Shares (Capital Increase with Public Funds) (June 30, 2003), available at www.resona-gr.co.jp/holdings/english/news/newsrelease/pdf/030630_1a.pdf; see News Release, Resona Holdings, Inc., Announcement Regarding Change in Principal Shareholder of Resona Holdings, Inc. (Aug. 7, 2003) available at www.resona-gr.co.jp/holdings/english/news/newsrelease/pdf/030807_1a.pdf; see Japan’s Auditors: A Slight Resonance: Japanese Auditors May be Getting Tougher, The Economist, May 31, 2003, at 77, available at http://www.economist.com/node/1820738. “Resona’s predicament could be just the tip of the iceberg, with other major banks running perilously close to the minimum required capital-adequacy ratio as a percentage of overall assets, a key yardstick of financial health. . . Should the so-called Resona shock spark a fall in bank shares and bring down the whole stock market, the shares held by the banks could also plummet in value, further eroding the banks’ core capital in a vicious circle,” the article stated. Joe Lopez, Japanese Bank Bailout Reveals Deepening Economic Crisis, World Socialist Web Site (May 28, 2003), http://www.wsws.org/en/articles/2003/05/japa-m28.html.
Finally, one cannot forget the cross-border dimension to dealing with bank failures across borders. In such circumstances, some form of coordination is logically required for the external auditor as well as for regulators if they are to be relied on for the purposes of supervision. For example, if one were to look at large, complex global banks operating in various jurisdictions, there is a concerted need to coordinate the efforts of the external auditor and indeed the differing requirements so that the risk to the home or the host can be identified and reported to the respective regulator. Therefore, cross-border bank resolution needs not only coordination between the different regulators, but also support from the global linkages of the external auditor in such matters so that they assist the supervisory decision-making process with timely information.

An expectation gap in terms of the intensity of supervision between what the regulator expects and what the auditor intends could develop without better coordination. If the new regulator is going to harness the use of auditors, then this gap needs to be minimized. A regulator relying on auditors simply to do the right thing can lead to unintended consequences because the professional requirements do not necessarily suggest a move towards a more intense audit if the audit engagement and plan do not consider it necessary.

IX. Conclusion

The policy response post-banking crisis has been one of reestablishing the relationship between the external auditor and the regulator. In many respects, this policy objective has been fulfilled, but this paper has tried to explore whether that is sufficient. In many respects, the issue is what type of supervision the regulator wants to adopt and how will responsibilities between the regulator and the external auditor be divided? This paper has suggested that reestablishing the relationship does not go far enough when it comes to including external auditors in the bank supervision equation. Through the analysis of the international experience, a number of unintended consequences arise that formally need to be addressed to formulate a coherent and coordinated supervisory strategy clearly setting out where the responsibilities of regulator and the external auditor start and stop.

It seems as though the accounting profession has seized the moment during this financial crisis, with a weak regulator licking its wounds and politicians desperate to show they are making reforms by reinvigorating the role of auditors in financial regulation. There is evidence to suggest that relying on the profession may not yield the outcomes the PRA and the FCA might be expecting, in light of their enforcement strategy.

The experience of using external auditors indicates the risks of over- or under-accommodating their use. In the former context, a risk arises of unmonitored conflicts of interest that effectively spill over into neglect of regulatory interests. In the latter context, the risk is failing to utilize auditors to safeguard regulatory objectives by capitalizing on their insight into the affairs of the regulated. The middle ground needs a significant level of regulatory oversight so that the issues that arise in both contexts are incorporated into the supervisory strategy. The auditor needs to be clearly accountable to the regulator, and the regulator needs to monitor the work of auditors. The international experience suggests more could be done at critical points, namely when a bank experiences distress. There is evidence to suggest that relying on the profession may not yield the benefits the regulators might expect. The regulator and the auditor both run the risk of forbearance in decision-
making, and so structuring both their responsibilities to ensure early intervention needs to be coordinated.

It is argued that unless the reforms are thought through properly, we will simply end up by moving the regulatory deck chairs around on the Titanic, which will be to no one's benefit. What will be important is for the new regulators to delineate clearly what each will do and expect the other to do at various stages of supervision life cycle, during periods of both stability and intense distress. The amended FSMA 2000 certainly enables the PRA and the FCA to do that and address in more detail how they will rely on external auditors to do supervisory tasks; so let's hope they seize the moment.
Harmonizing the Shield to Corporate Liability: A Comparative Approach to the Legal Foundations of Corporate Compliance Programs from Criminal Law, Employment Law, and Competition Law Perspectives*

GÖNEÇ GÜRKAYNAK & DERYA ĐURLU**

Abstract

A range of legal regimes from employment law to corporate and securities law foresees a reduction or elimination of “enterprise liability” for organizations that can demonstrate the existence of “effective” internal compliance structures. The pervasiveness of corporate conduct codes and internal compliance programs, while reflecting the importance ascribed to these codes and programs by different jurisdictions, also raises questions regarding the extent to which companies are willing to take measures to encourage compliance with the law and nip corporate misconduct in the bud before courts and agencies detect such errant behavior. With a compliance industry that has developed over the past decade at an insurmountable pace, the previously defined borders of criminal law, employment law, and antitrust law are hazier and their relationship more intertwined. This article aims to lay out the interaction between these fields of law by particularly examining whistleblowing and elements of setting up effective compliance programs.

* An extended version of this article was originally presented as a scientific report on the theme discussed during the joint session of the Competition Law, Labor Law, and Criminal Law Commissions at the 56th Union Internationale des Avocats Congress, in Dresden, Germany, on October 31-November 3, 2012. This article has not been published before.

** Göneç Gürkaynak is a managing partner at ELIG, Attorneys-at-Law in Istanbul, Turkey. Mr. Gürkaynak is qualified to practice in Istanbul, New York, England and Wales. He heads the Regulatory & Compliance Department at ELIG. He is a member of faculty at the Bilkent University Faculty of Law in Ankara and the Bilgi University Law School in Istanbul. E-mail: gonen.rock@elig.com. Derya Đurlu is an attorney-at-law, qualified to practice in Istanbul. Ms. Đurlu is also a research assistant at Bilkent University Faculty of Law in Ankara, Turkey, in the field of Private International Law/Conflict of Laws. E-mail: derya.durlu@bilkent.edu.tr.
structures. With competent and committed management teams, internal compliance structures “may play a central role in the organization’s preventive approach to organizational misconduct, depending on the size and structure of the specific organization.” The pervasiveness of corporate conduct codes and internal compliance programs (collectively, internal compliance structures) reflect the importance ascribed to these codes and programs by different jurisdictions, while raising questions regarding the extent companies are willing to take measures to encourage compliance with the law before courts and agencies detect such errant behavior.

With a compliance industry that has developed over the past decade at an insurmountable pace, the previously defined borders of criminal law, employment law, and antitrust law are hazier and the relationships more intertwined. Internal corporate compliance structures are dispersed across a multitude of jurisdictions and regulated under various laws, either in the local criminal legislation, local labor laws, antitrust/competition laws, or even separate bodies of corporate governance laws. Corporate compliance questions raised across three fields of law—criminal law, employment law, and antitrust law—may challenge parties from both sides of the dais; enterprises may be placed in the good or bad category depending on whether they have an effective compliance program, designed to ostensibly detect violations. Courts and agencies, on the other hand, must embrace the task of interpreting whether criminal liability hinges on the effectiveness of a compliance program or whether companies will be required to meet prescriptive standards rather than specific industry needs. The latter need arises from courts and agencies having limited expertise, time, budget, and imperfect guidance on what will serve as compliance with law.2

Bearing in mind existing incentives to implement internal compliance structures, this article examines compliance programs and the interaction between criminal law, employment law, and antitrust law in resolving corporate compliance questions by examining whistleblowing and elements of setting up effective compliance programs. Section I follows a segmented approach to whistleblowing, which forms a central topic of this article for its vital role in detecting and preventing corporate misconduct. Canvassing international law and domestic law perspectives, this section discusses implications of divergence between the United States and European Union for assessing whistleblowing practices. Section II concludes by outlining the elements of an effective compliance program and the different standards established by the Organization for Economic Cooperation and Development (OECD) and the U.S. Federal Sentencing Guidelines (USSG)3 for interpreting the effectiveness attribute.

I. Whistleblowing

The existence of a whistleblowing policy within an organization can influence an employee’s legal status in several ways. First, the inevitable question concerning the extent employees have a duty to follow the compliance program arises: do they have an actual legal duty to blow the whistle in the prescribed cases? Furthermore, questions arise regarding the legality of data storage during investigation. As external companies are often involved in compliance (especially whistleblowing) policies, issues may emerge following the transfer of data relating to misconduct (and personal data of whistleblowers). Protecting an employee’s rights is a relevant concern after an employee has blown the whistle. As whistleblowers experience retaliation, more often than not, the protection of employees against such negative consequences is considered crucial for effective compliance programs.

This section mainly addresses the legal consequences of whistleblowing policies, starting with a brief introduction to this topic. The facilitation of internal whistleblowing is increasingly recognized as a valuable policy in both the public and private sector, and several guidelines created by international and national organizations serve as models for the construction of whistleblowing policy.\(^4\)

Whistleblowing is generally regarded as a form of corporate dissent.\(^5\) An area of controversy amongst scholars over the definition of this concept is whether the definition of whistleblowing should be limited to external (i.e. public) whistleblowing (i.e. directly alarming the media without flagging the matter internally within the company).\(^6\) For the purpose of this article, in indicating reasons for employees (not) to act further to observed misconducts, the definition will not be limited to external (i.e. public) whistleblowing.

To create an internal framework, an organization’s management decides on significant areas of consideration including the following: who can blow the whistle (can ex-employees benefit from this policy?); issues and misconducts covered by whistleblowing; who would be the addressee to receive such concerns; how these concerns would be raised (by using “hotlines”\(^7\)); whether to facilitate confidential and anonymous reporting; whether to address the means of protection of whistleblowers; what system to use for recording and tracking complaints; whether whistleblowing is an employee right or a duty; dealing with malicious reporting; how whistleblowers are rewarded; what would the method of providing advice to whistleblowers be; determining and outlining the roles and responsi-

---

4. *Black’s Law Dictionary* 1734 (9th ed. 2009) (defining whistleblower as “[a]n employee who reports employer wrongdoing to a governmental or law-enforcement agency.”).


bilities of individuals during investigation; and operating, monitoring, and reviewing the whistleblowing policy, as well as training employees to effectively handle complaints.\textsuperscript{9}

A. \textbf{Whistleblowing Component to Corporate Compliance}

One of the most important elements of a corporate compliance program is a policy encouraging transparency and honesty through the disclosure of anticompetitive activities. The whistleblowing component of a corporate compliance program is essential to promote appropriate corporate actions at different levels in the corporate structure. Establishing effective whistleblowing programs is subject to varying definitions, requirements, protections, and enforcement.

Whistleblowing, as a means of reporting, inter alia, corruption, fraudulent behavior, and/or misconduct, is challenging to define and, therefore, there is “no generally accepted definition.”\textsuperscript{10} It is difficult to provide a broad and accurate definition of corruption because it cuts across moral values and social or cultural norms; therefore, international conventions tend to provide specific actions that are deemed as constituting corruption by signatories.\textsuperscript{11} This, in turn, affects the contours within which whistleblowing is understood and contextualized.

Whistleblowing intends to promote transparency in corporations through advancing the truth and encouraging individuals to report violations. Regardless of the noble intention behind whistleblowing, there remain barriers to effective whistleblowing.\textsuperscript{12} Some of these barriers include employees lacking awareness of whistleblowing mechanisms, lacking trust in the company to combat corruption, feeling guilty for the effect of disclosures on employees and shareholders, fearing retaliatory effects from disclosure, and cultural constraints that indicate a negative perception of whistleblowers.\textsuperscript{13}

An effective whistleblowing mechanism provides legal remedies for retaliatory actions, rewards whistleblowers, and provides processes that encourage disclosure of suspected illegal actions.\textsuperscript{14} These protective mechanisms could include protection from job termination or transfer, preference to requests for work transfer, confidentiality, legal immunity (including protection from defamation lawsuits), penalties to those who retaliate against the whistleblower (such as imprisonment or disciplinary action), and police protection for a whistleblower and his/her family.\textsuperscript{15}


\textsuperscript{10} \textit{What is WB?}, \textit{Whistleblower Protection in the Central and Eastern Europe Region}, http://www.whistleblowing-cee.org/about_whistleblowing/ (last visited July 10, 2013).


\textsuperscript{14} \textit{Id.}

\textsuperscript{15} \textit{Id.}
B. INTERNATIONAL LAW PERSPECTIVES

This section addresses the rise of international and regional agreements on corporate governance; it specifically addresses compliance programs and whistleblowing practices, which are simultaneously based on and influencing domestic whistleblowing laws. It provides a summary of relevant agreements and their impact on domestic criminal and employment law.

The increase of international business transactions and corporate interactions recognize the necessity of global compliance programs. Most national laws on corruption, however, are inadequate to deal with cross-border corruption issues.16

Whistleblowing is an important component of successful corporate compliance programs recognized by international efforts to promote global support. Increasing international business transactions and corporate interactions necessitate a rise in global compliance initiatives, which have an effect on national criminal laws, employment laws, and antitrust laws.17 International standards established to promote competition require integration with international standards for compliance, indicating an overlap between compliance and antitrust law.18 Additionally, most national laws on corruption are inadequate to deal with cross-border corruption issues.19 International anti-corruption agreements also attempt to address these cross-border corruption issues by providing an adequate standard that all nations can support. International efforts to produce corporate compliance frameworks include whistleblowing as an important component of successful programs.

International agreements bridge gaps between divergent national laws to create a synthesized approach to handling corruption across multiple jurisdictions. International agreements that address whistleblowing at a global level include the United Nations Convention on Corruption,20 the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions,21 and the International Chamber of Commerce Guidelines on Whistleblowing.22 There are also regional agreements that include provisions on whistleblowers within a specific geographic area. The European Council has produced both the Civil Law Convention on Corruption23 and the Criminal Law Convention on Corruption.24

---

17. Id. at 53, 79.
19. Carr & Lewis, supra note 11, at 53.
22. ICC GUIDELINES ON WHISTLEBLOWING, supra note 5.
International and regional anti-corruption conventions interact with national criminal laws, employment laws, and antitrust laws. In Europe, national laws and regional rules provide two levels for managing whistleblowing programs.

The international agreements on whistleblowing, however, create only a broad framework to ensure that signatory states agree to the general principles of whistleblowing while allowing flexibility in the implementation. An international perspective on whistleblowing poses certain challenges to implementation and investigation. Individual nations, while agreeing with the overall scheme of international agreements, continue to implement whistleblowing laws through national, social, and cultural-based legal frameworks.

The United States does not have significant data protection legislation in place. There are several specific laws covering particular business sectors and self-regulations in other sectors. European data protection law is significantly more comprehensive. As the E.U. Member State countries began adopting varying data protection regulations, the cross-border information flow was restricted. This encouraged the European Union to adopt a Directive for Member States to incorporate into their national laws. Directive 95/46 EC on the protection of individuals with regard to the processing of personal data and on the free movement of such data establishes when the processing of personal data is lawful and acceptable. The main requirements for such processing are (i) transparency, (ii) serving a legitimate purpose, and (iii) proportionality.

In response to developments in France, where the French data protection agency published guidelines on the lawfulness of anonymous whistleblowing policies (CNIL Guidelines), the European Article 29 Working Party (Working Party) issued an opinion on “the application of EU data protection rules to internal whistleblowing schemes in the fields of accounting, internal accounting controls, auditing matters, fight against bribery, banking and financial crime.” Following this opinion, the main points of considerations for whistleblowing mechanisms are: “fair and lawful processing,” “legitimate purpose,” “relevance,” “accuracy,” “retention,” “security,” and “data transfer.” While this opinion is not legally binding and is limited in scope, it is, however, the main document expressing collective European policy.

As indicated above, the American and European standards on whistleblowing policies and data protection standards are not coherent. These differences have significant conse-

26. Id.
27. Id.
28. Id.
31. See supra Section I.B.
quences for companies involved in international business. Additionally, American companies operating in Europe face difficulties in their effort to comply with both the Sarbanes-Oxley Act (SOX)\textsuperscript{32} and the European data protection laws.\textsuperscript{33}

1. **General Whistleblowing Policies**

   International and regional anti-corruption conventions heavily influence national criminal laws, which in turn influence the development of national antitrust law and employment law.\textsuperscript{34} International whistleblowing creates a broad framework for domestic laws to work within, which shapes the domestic approach to corporate compliance laws, through employment and criminal law. In Europe, there remain two levels for managing whistleblowing programs—national laws and regional rules that derive from the European Council and European Union.\textsuperscript{35}

   In providing an international perspective on whistleblowing policies, certain issues can be challenging—particularly, data protection and whistleblower protection under nationally enforced practices. Furthermore, individual nations, while agreeing with the overall scheme of international agreements, continue to implement whistleblowing laws through national, social, and cultural-based legal frameworks.

2. **Company Implementation of Whistleblowing and Data Protection and Privacy Matters**

   Data protection includes important components of employment law and criminal law; international conventions have, therefore, applied a very broad framework that allows nations to determine data protection requirements independently.\textsuperscript{36}

   An example of an American law that requires publicly traded companies to incorporate a whistleblowing mechanism is SOX, which demonstrates what international covenants do for data protection components of whistleblower laws.\textsuperscript{37} Section 301(4) of this Act can be explored in detail. Notwithstanding these provisions, fears that subsequent government or third-party access to information produced by internal compliance structures may inadvertently deter the implementation of such structures, which are better addressed through privilege rules.\textsuperscript{38}

---


\textsuperscript{33} For more on this, see generally Pulina Whitaker, *Multinationals Dance to Two Whistleblowing Tunes*, *European Lawyer* (2007); Paul Lanois, *Sarbanes-Oxley, Whistleblowing, and European Union Data Protection Laws*, *The Practical Lawyer* 59 (Aug. 2007); see also MySafeWorkPlace 2006, supra note 25, at 1.

\textsuperscript{34} Carr & Lewis 2010, supra note 11, at 78.


\textsuperscript{37} 116 Stat. 745, § 1514A.

\textsuperscript{38} Krawiec, *Organizational Misconduct*, supra note 1, at 577-78.
Attorney-client privilege can be invoked to shield corporate audits from discovery and disclosure; these are “rules mandating that any information produced through internal policing measures will not be used against the organization, provided that the organization cooperates with any government investigation.”

Internal investigations, with the principal objective of “find[ing] the facts and rem[edy][ing] the problems, including blunting public speculation of the degree and extent of wrongdoing,” can be intrusive. Data protection law has a significant influence on the action undertaken by the investigating party, which directly affects the legal position of employees involved in internal investigations.

European data protection law requires companies to comply with several principles while collecting, retaining, and processing information. These principles are “fair and lawful processing,” “legitimate purpose,” “relevance,” “accuracy,” “security,” and principles relating to data transfers.

The law serves to strike a balance between the effective investigation and the right of the employee while promoting transparency. Ideally, employees should be notified before the investigation enters the actual data collection phase.

During data collection, the investigator must ensure that the data processing is “legitimate” under local laws. A distinction is made regarding whether the data is merely personal data or whether it is “sensitive” personal data. “Sensitive” data provides strong evidence and relates to the commission of an offense. This difference enhances the legitimacy of processing such information. For example, personal data can be legitimized by indicating the required compliance with money-laundering regulations, while “sensitive” data can be legitimate for funding a legal claim.

If data qualifies as “sensitive,” the rules are stricter for legitimate processing.

Employees are also protected by the requirement of collecting personal data up to a proportionate extent. The proportionality is tested by the aim of the investigation (is it an alleged criminal offense, or does it concern an internal policy?), compared to the intrusiveness of such action (is the information highly personal, or is it publicly available?). Following the conclusion of an investigation, personal data may only be retained as necessary. This necessity depends on the nature of the information found and the extent it is useful for legitimate purposes. If the material is used for a legal process, the personal data may be retained during the process and for some time after completion.

39. Id. at 578.
41. For a brief indication of these principles see Cooper, supra note 30.
42. Id. at 34.
43. Id. at 36.
44. Id.
45. Id.
46. Id. at 38.
47. Id. at 45.
48. Id. at 15.
49. Id.
50. Id. at 55.
51. Id.
52. Id.
European data protection rules that can influence an employee’s rights include the requirement to ensure security of the retained data, the considerations relating to data transfers to another country, and the principle of “finality.” This latter principle requires that the collected data is only used for the intended purposes of the collection. A company cannot change this purpose and use the personal data beyond the investigation. Additionally, employees can request to access their data that was gathered during the investigation.

3. Whistleblower Protections

Protecting the whistleblower involves specific components of employment law and criminal law under antitrust law. International agreements, again, provide a broad framework for individual states to adapt.

Another specific area of law that has significant consequences for the legal position of employees is that of whistleblower protection against retaliation. Defining retaliation has been considered impossible because “retaliation—as with wrongdoing—resides in the eye of the beholder.”

To indicate the importance of protection, the threat of negative consequences following reported misconduct is the primary reason employees do not disclose alleged misconduct. Consequently, when the threat of retaliation is low, employees are more likely to blow the whistle. Besides being made redundant in an organization, common consequences following the reporting of misconduct include being blacklisted, being treated as mentally instable or even insane, losing life savings following lawsuits, and even losing a marriage.

a. United States

SOX intended to promote strong corporate accountability. Following this Act, employees of publicly traded companies, including their contractors, subcontractors, and agents, are protected when blowing the whistle on conduct that they “reasonably believe”
involves several securities regulations and other fraud against shareholders. Consequently, the protection extends to mistaken allegations. Both current and former employees are protected by SOX against discharge, demotion, suspension, threats, harassment, and other discrimination with respect to employment terms, conditions, and privileges. The protection extends to employees providing information and assisting in investigations and to employees filing, testifying in, participating in or otherwise assisting in a proceeding.

b. European Union

There is no European-wide legislative protection for whistleblowers against retaliation. The necessity of legal protection of whistleblowers against retaliation is, however, stressed by the Parliamentary Assembly of the Council of Europe (PACE). On September 14, 2009, PACE published a report from the Committee on Legal Affairs and Human Rights entitled “The Protection of Whistleblowers,” which urges the Committee of Ministers to take action in drawing up guidelines while taking the Resolution principles into account. It also calls upon Member States to review legislation on compliance parallel to the guiding principles.

The report notes that “[m]ost member states of the Council of Europe have no comprehensive laws for the protection of ‘whistle-blowers.’” In the United Kingdom, employees are protected against any detriment on grounds that they made a “protected disclosure” about their employer or co-worker by the Public Interest Disclosure Act of 1998 (PIDA). Such disclosures may be related to a wide range of acts, including criminal offenses, legal obligations, miscarriages of justice, danger to health and safety, and damage to the environment. In a recent case, the Employment Appeal Tribunal held that when a claimant’s act falls within the scope of protected disclosures and suffered detriment, the burden of proof is on the respondent that the treatment did not relate to the protected disclosure.

65. Id.
66. Id.
67. Id.
69. See EUR. PARL. ASS. RESOLUTION, supra note 35, § 6.2.2. (“this legislation should protect anyone who, in good faith, makes use of existing internal whistle-blowing channels from any form of retaliation (unfair dismissal, harassment, or any other punitive or discriminatory treatment)”); see also EUR. PARL. ASS. REP., supra note 35; EUR. PARL. ASS. REP., Protection of “Whistle-Blowers”, Recommendation 1916, § 2 (2010), available at http://assembly.coe.int/Main.asp?link=/Documents/Adopted Text/ta10/EREC1916.htm.
70. EUR. PARL. ASS. REP., supra note 35.
72. Id. § 43B(1).
C. Domestic Law Perspectives

International efforts to harmonize corporate governance and antitrust practices across borders remain subject to domestic implementation. A comparative analysis of whistleblowing laws in the United States and Europe demonstrates the interrelation of criminal laws, employment laws, and antitrust laws with the social and cultural norms that influence compliance programs. Corporations in both areas are subject to compliance programs that use whistleblowing mechanisms, but whose application differs under domestic laws.

SOX and the Dodd-Frank Act provide the foundation for whistleblowing policies within corporate compliance programs in the United States. SOX requires public companies to maintain a forum for addressing issues related to “questionable accounting or auditing matters.” It also provides reasonable protections against retaliation to individuals that disclose information regarding these questionable practices. The Dodd-Frank Act was developed in the aftermath of the 2006-2007 financial crisis as an effort to overhaul the financial regulatory system. Dodd-Frank incorporates new regulations regarding whistleblowers to improve regulations in the financial sector through internal disclosure mechanisms. It introduces financial incentives and strengthens anti-retaliatory protections to encourage individuals to address potentially illegal corporate activity. The Dodd-Frank Act has significantly changed the landscape for whistleblowing in the United States. While it caused serious concern amongst many companies based on its reward-based incentives for using external whistleblowing mechanisms, it also increased recognition of the necessity for transparency within businesses.

Within Europe, states enforce domestic practices that are compatible with European Union and European Council policies while abiding by social and cultural interpretations of effective corporate governance policies. This adds an additional layer to the structure of whistleblowing programs in Europe, holding states accountable to strong international and regional ideas of effective whistleblowing mechanisms.

It is essential to recognize the challenges corporations face with whistleblowing policies in implementing and investigating compliance programs in both the United States and Europe. Although international agreements provide an adequate framework for whistleblowing, the actual application through domestic laws produces recognizable divergence.

1. General Whistleblowing Policies

In the United States, SOX and the Dodd-Frank Act provide the foundation for corporate compliance programs. SOX significantly expands the importance of internal compli-

76. See id. § 806.
ance structure in securities law. Together with the Securities and Exchange Commission (SEC) rules implementing it, SOX requires the disclosure of information relating to internal controls over financial reporting, the company’s conduct and ethics codes, and whether the company has an audit committee meeting certain criteria.

E.U. Member States continue to enforce domestic practices that are compatible with E.U. policies while abiding by social and cultural interpretations of effective corporate governance policies.

In determining the effectiveness of whistleblowing provisions for criminal law, antitrust law, and employment law in an international context, it is essential to recognize the challenges corporations face in implementing and investigating compliance programs.

2. Company Implementation

This section addresses the manner in which companies implement whistleblower policies in the United States and in Europe. It focuses on data protection and employee obligations to highlight the differences in the systems and their interaction with existing criminal and employment laws.

Implementation of whistleblowing policies involves two important considerations for corporations—employee’s reporting obligations and data protection laws. Divergences between the preferred models in the United States and within European countries, however, remain important considerations for implementation. The differences not only challenge the implementation and investigation of whistleblowing policies, but also impact the different roles of criminal law, employment law, and antitrust law in corporate compliance programs.

82. Top Ten Considerations for Whistleblowing Schemes in Europe, Association of Corporate Counsel (Sept. 1, 2010), http://www.acc.com/legalresources/publications/topten/whistleblowing-scheme-in-europe.cfm/makepdf=1; Steven A. Lauer, EU Data Privacy for Whistleblower Hotlines: Variation Among EU Countries’ Laws Requires Flexibility in Hotline Scope and Operations, Global Compliance Services, Inc. (2008), https://www.globalcompliance.com/pdf/eu-data-privacy-for-whistleblower-hotlines-variation-among.pdf (last visited July 10, 2013) (quoting at n. 20: “The number of issues raised by the implementation of whistleblowing schemes in Europe in 2005, including data protection issues, has shown that the development of this practice in all EU countries can face substantial difficulties. These difficulties are largely owed to cultural differences, which themselves stem from social and/or historical reasons that can neither be denied nor ignored”).
a. Employee Obligations

Imposing a duty on employees to disclose antitrust violations straddles criminal law, employment law, and competition law. Voluntary disclosure, however, remains an option under some structures.

Within whistleblowing programs there are different approaches for encouraging employee disclosure. Some programs obligate employees to report or face penalties while other programs prefer policies that encourage voluntary disclosure. A required disclosure can subject an individual to sanctions or even criminal penalties for failing to notify the appropriate contact of suspected or known violations.\(^83\) In addition to obligations imposed on employees through whistleblowing laws, employment laws can also provide the basis for a duty to disclose.

Under SOX, certain employees are obligated to divulge information on anticompetitive behavior.\(^84\) Although obligatory disclosures are subject to criticism, there are certain benefits associated with compelled whistleblowing programs—including risk allocation, social penalty reductions, improved efficacy of voluntary programs, and speedier disclosures.\(^85\) Additionally, employees in non-managerial positions may not be required to disclose suspected illegal behavior, but incentives can encourage disclosure through reward-based systems.\(^86\)

The United Kingdom recognizes similar obligations for employees in certain sectors or positions based on employment laws.\(^87\) The duty to report through “express terms,” “implied terms,” or “equity” is not typically imposed on ‘ordinary’ employees; this duty is usually reserved for managerial positions.\(^88\) The British Standards Institute, however, recognizes challenges to obligatory reporting—including negative ramifications on an open and accountable work culture, issues of fairness in the dispensation of sanctions, and potential over-reporting to avoid sanctions.\(^89\) The Council of Europe places greater emphasis on voluntary disclosure, encouraging whistleblowing schemes that indicate that disclosure is non-obligatory and voluntary at the discretion of the whistleblower.\(^90\)

Employee obligations influence data protection and whistleblower protection protocols, particularly with regards to voluntary notifications. An employee is more likely to voluntarily provide information on illegal corporate activity if they feel secure in both the disclosure methods and the post-disclosure protections.\(^91\)

Under SOX, certain employees are obligated to divulge information that suggests fraud within a corporation or collusion within a market. This requirement is occasionally sup-
implemented with rewards for the whistleblower. In Europe, however, there is greater emphasis on voluntary disclosures and ensuring that employees are not required to divulge suspected illegal activity.

Employee obligations are an important component of whistleblower laws because of the influence on data protection and whistleblower protection protocols. In Europe, the laws are inclined to promote voluntary action rather than obligatory reaction because of the stigma against anonymous reporting and data protection laws.

b. Data Protection Issues

The establishment of a whistleblower policy requires mechanisms that facilitate rather than impede effective reporting. International agreements related to whistleblowers provide vague frameworks; effective mechanisms are, therefore, subject to national laws. Divergence in data protection requirements in the United States and Europe pose the most significant challenge to uniformity of whistleblowing policies.

In the United States, SOX section 301(4) dictates the importance of anonymous complaints. SOX requires audit committees to establish procedures for the “confidential, anonymous submission by employees regarding questionable accounting or auditing matters.”

Within Europe, data protection laws tend to oppose the use of anonymous complaint systems. Traditionally, the European Union has placed significant emphasis on the respect for individual rights, which led to E.U. Directive 95/46/EC. Corporations that operate within specific data protection laws are required to balance whistleblowing programs with applicable data protection laws. The Working Party published Opinion 1/2006, addressing the application of E.U. data protection rules to internal whistleblowing programs, finding that it was possible to construe foreign statutes and regulations as non-legislative obligations under E.U. Directive 95/46/EC. The “proportionality principle” brings the Directive and Opinion together to protect data while enabling effective whistleblowing mechanisms by limiting the type of data collected and the type of employee with access to the reporting scheme. In January 2012, however, the European Union unveiled a draft General Data Protection Regulation.

To facilitate the development of effective whistleblowing mechanisms in conjunction with existing data protection laws, European nations have adopted strategies to protect individuals and comply with international and national ideas on corporate governance.

---

93. Mathieu Bouville, Whistle-Blowing and Morality, 81 J. BUS. ETHICS 579, 579 (2007); Top Ten Considerations for Whistleblowing Schemes in Europe, supra note 82.
96. Banks & Murphy, supra note 18, at 368-369.
97. Lauer, supra note 82.
98. Top Ten Considerations for Whistleblowing Schemes in Europe, supra note 82.
Some of these strategies include limiting the individuals that may file whistleblowing complaints, limiting the issues that can be addressed in whistleblowing complaints, and limiting the mechanisms or regulatory bodies that can receive complaints from whistleblowers. Individual states enacted national laws designed to protect individual data, which were upheld over implementation of certain whistleblowing mechanisms. A 2011 French court decision suspended a whistleblower program implemented by the French affiliate of an American company because the program was not limited in terms of employees that could report and the scope of activity that could be reported. Additionally, the website and the hotline were not consistent in the implementation of personal disclosure—the website encouraged anonymous reporting while the hotline encouraged identified reporting. Germany’s modification to its whistleblowing laws received significant attention for attempting to make whistleblowing laws compatible with data protection laws.

Implementation of SOX provisions for corporations established in both the United States and Europe are the cause of significant tensions between U.S. whistleblowing requirements and European data protection requirements. Conflict between these two dominant perspectives indicates the challenges facing international corporations implementing effective whistleblowing mechanisms.

As explained previously, in the United States, SOX section 301(4) dictates the importance of anonymous complaints. Within Europe, however, data protection laws view anonymous hotlines differently. Individual states have also enacted national laws designed to protect an individual's data; these laws were subsequently upheld over implementation of certain whistleblowing mechanisms. The conflict between these dominant perspectives on data protection laws indicates the challenges facing international corporations attempting to implement effective whistleblowing mechanisms.

The positions of the United States and European Union with regard to the interface of employer and employee protection in compliance matters are significantly different. European countries take a strong pro-employee approach by focusing on the rights of the accused, while the United States offers greater employer protection in the compliance

101. Lewis & Vandekereckhove, supra note 9, at 254-55.
102. Hunton & Williams LLP, supra note 81.
103. Id.
105. Lanois, supra note 33.
106. See supra § I.C.2.b.
108. Opinion 1/2006, supra note 29; Council Directive 95/46/EC, supra note 95, at 31-50. The “proportionality principle” brings these two documents together to protect data while enabling effective whistleblowing mechanisms by limiting the type of data collected and the type of employee that has access to the reporting scheme. See also Top Ten Considerations for Whistleblowing Schemes in Europe, supra note 82.
110. Lanois, supra note 33.
process. Ideas on the value of anonymity in reporting lead to a different valuation of the rights of the reporting party and the accused.  

3. **Company Investigations**

This section addresses the next phase in whistleblower policies—after the whistleblower has alerted the company to potentially fraudulent practices there must be an effort to protect the whistleblower from retaliation. At this phase, the United States and Europe provide more consistent practices. A company is required to conduct an investigation following a fraud allegation, which requires provisions protecting whistleblowing individuals involved in the disclosure (under criminal law and employment law).

International agreements indicate the need for companies to conduct an internal investigation following allegations of anticompetitive or fraudulent activity. Companies have frequently engaged in anti-retaliation remedies and reward-based approaches to encourage disclosure. Reward-based approaches alone are insufficient; to promote disclosure it is imperative that provisions exist to protect whistleblowers during and after the investigation.

Whistleblower laws include specific provisions to protect whistleblowers from retaliation. In the United States, for example, the Occupational Safety & Health Administration (OSHA) operates a Whistleblower Protection Program to ensure that employees in certain sectors are protected when reporting alleged violations. Resolution 1729 of 2010 by the Council of Europe emphasized specific protections necessary for whistleblowers. The resolution stressed the necessity for comprehensive whistleblowing legislation focusing on providing a safe alternative to non-disclosure, monitoring by independent external bodies to ensure compliance with whistleblower protection initiatives, and improving the general corporate cultural attitude toward whistleblowing.

Regardless of these provisions, there remain problems with protecting whistleblowers. Disclosure provisions can still foster disincentives to disclose; employees may be afraid of retaliation, social ostracism, and psychological strain related to their role in whistleblowing.

Corporate governance programs recognize the importance of protecting whistleblowers, whether they are acting voluntarily or under an obligation and whether they are anonymous or identified. Protecting whistleblowers promotes honesty and transparency by encouraging individuals to recognize and report anticompetitive behavior. Protecting
whistleblowers is one of the crucial elements of an effective corporate governance policy because it promotes honesty and transparency in corporate practices to avoid anticompetitive behavior.

D. Implications of Divergence

The different perspectives on anonymous disclosures and the additional obstacles the new E.U. data protection regulation might provide challenges to identifying a duty to disclose and to converging these differing ideas on the scope of disclosure. In this respect, an examination into the US and European models may illustrate the potential implications for divergence.

1. United States

In its corporate governance provisions, SOX imposes duties on several professionals. First, attorneys have a duty to report evidence of securities fraud to the chief legal officer of the company. Second, executives must certify that the financial statements comply with securities law. Third, the audit committee members of the board of directors are required to take an active role in investigating and receiving whistleblowing complaints. Interestingly, employees have a general duty to cooperate with internal investigations, even if this leads to disclosing personally incriminating material. The Fifth Amendment right against self-incrimination does not apply in this situation. Additionally, corporate evidence may not be withheld by employees reasoning that this falls within their right to remain silent.

2. European Union

As previously explained, in the United Kingdom, the obligations of employees follow from the “express terms” in the employment contract, the “implied terms” (including the duty of good faith and fidelity), and “equity,” imposing fiduciary obligations. There is no general duty to report or investigate imposed on “ordinary” employees. But a manager can have such a duty. In the case of Swain v. West Ltd, the general manager was obligated to report his managing director’s wrongdoing, following the duty to “provide, extend and

120. 15 U.S.C. § 7245.
121. Id. §§ 302, 906.
122. Id. §§ 301, 207, 407.
123. U.S. CONST. amend. V (“[n]o person shall . . . be compelled in any criminal case to be a witness against himself”).
126. See supra § I.C.2.a.
127. Carr & Lewis, supra note 11, at 52.
develop the interest of the company." A consequence of not abiding by the duty to report colleagues was dismissal on the grounds of misconduct. Even if there is no express duty established in a code of conduct or contract, the employer could base its decision on “some other substantial reason” as a fair reason for dismissal since it suffices for employers to genuinely believe a reason to be fair.

In another UK case, a company allegedly collapsed because of the misappropriation of $400 million. The judge determined that whether the executive was under a duty to report the wrongdoing by its colleagues depended on several factors, including the terms of his employment contract, his duties and his seniority in the company, the nature of the wrongdoing, and the potentially adverse effect on the company.

II. Introspecting on Setting Up Effective Compliance Programs: Aligning the Integrated Components of Corporate Compliance

There is a lack of judicial guidance for corporations and the compliance industry to evaluate the effectiveness of a compliance program. Nonetheless, there are certain accepted standards and elements to understand how an “effective” compliance program can be set up, with the approach of several commentators favoring that a less detailed compliance program model set in law would be better; otherwise companies face the risk of being constrained to adapt to a stricture which they do not essentially need. Tailored compliance programs provide the ideal method for addressing these issues.

A. SETTING OUT THE STANDARDS FOR “EFFECTIVE” COMPLIANCE PROGRAMS: WHAT IS AN “EFFECTIVE” COMPLIANCE PROGRAM?

U.S. law reduces or eliminates organizational liability for enterprises that demonstrate the existence of “effective” internal compliance structures. The Organizational Sentencing Manual lists the minimum steps that an organization must take to qualify for consideration of a reduced sentence, “effective” compliance structures result in a reduction of the organization’s fine; this fine can be reduced by up to 60 percent.

First, an effective internal compliance structure contains a written ethics code or similar code of conduct that sets the ostensible limits of acceptable behavior within the firm. Mechanisms of code enforcement—such as internal reporting and information gathering,
policies regarding the investigation of reported violations, procedures and policies for protecting whistleblowers against retaliation, and internal procedures and sanctions for conduct or ethics code violations—exist in many corporate codes.136

“Second, the organization must take steps to ensure that the code of conduct is communicated to employees and other agents . . . through training programs designed to familiarize personnel with the code and/or through dissemination and publication of the code.”137 Company newsletters, employee manuals, and organization websites are some of the common mechanisms for dissemination.138

“Third, an effective internal compliance structure will contain monitoring and auditing systems reasonably designed to detect prohibited conduct by employees and other agents.”139

Fourth, “a reporting system that enables employees to report violations of the conduct code or of laws and regulations by others within the organization without fear of reprisal” is necessary for an internal compliance structure to be effective.140

Fifth, high-level personnel within the organization must have oversight responsibility for compliance with the code of conduct.141

The U.S. Sentencing Guidelines Manual lists other necessary minimum steps including requiring the organization to use due care not to delegate authority to employees with a propensity to engage in illegal activities.142 Once a violation has been detected, the organization must take all reasonable steps to respond appropriately to the offense and to prevent similar offenses.143 Additionally, the code of conduct must have been consistently enforced.144

B. THE INCENTIVES AND THE DISINCENTIVES BEHIND THE NEED TO SET-UP AN “EFFECTIVE COMPLIANCE PROGRAM”

Companies may have various incentives and disincentives to implement compliance programs into their organizational structure. Some of the incentives and disincentives that companies face include the following:

Incentives:

• Incentives for corporations to shield themselves against criminal liability.
• Incentives to deter criminal activity within a corporation.
• Incentives to potentially save millions of dollars.
• Incentives to adopt sub-optimal programs.

143. Id. §§8B2.1(b)(7).
144. Id. §§8B2.1(b)(6).
• Incentives to invest in “low-cost, potentially ineffective internal policing measures that fail to reduce organizational misconduct, yet nonetheless reduce organizational liability” (what one commentator suggests is a cosmetic approach to organizational compliance).
• Incentives for the company to self-report.

Disincentives:
• Expenses to create a compliance program make it difficult for small-sized corporations.
• Weakness of the sentence downgrade, which “forces companies to choose between complying either with the spirit of the law or letter of the law.” The more detailed the design, the less effective a compliance program is to the differing industry-specific needs each company adheres to. This could lead to under-deterrence by the corporation to implement compliance structures, which in turn may enhance liability, a disincentive to self-police ex post and a difficult to credibly enforce internal compliance measures ex ante.
• Information generated by compliance programs may be used against the corporation—by the government or in civil suits. As such, the more effective the compliance program, the more likely the violations will become public.

Whether or not an organization implements a compliance program depends on how individual organizations see the effectiveness of their own compliance mechanisms and whether they ultimately want to invest in such programs at the risk of not being caught in an organizational misconduct.

C. Characteristics of an “Effective Compliance Program”

The central feature of an effective compliance program is that it must be adapted to fit legal standards and persuade the public of the program’s effectiveness. Some companies may continue their operations without a formal compliance structure, while others adopt four potential orientations for effective compliance programs.

• “Compliance-based” approach
• “Values-based” approach

145. Krawiec, Organizational Misconduct, supra note 1, at 577.
146. See Krawiec, Cosmetic Compliance, supra note 79, at 487 (“Cosmetic” compliance structures should be understood as those structures designed to create the illusion of compliance for purposes of avoiding legal liability, rather than for the purpose of deterring misconduct).
147. Krawiec, Organizational Misconduct, supra note 1, at n. 149.
149. Id. n. 53; see also Richard A. Bierschbach & Alex Stein, Overenforcement, 93 Geo. L.J. 1743, 1774 (2005).
150. Wellner, supra note 148, at 510-511; see discussion supra Section II.C.2.ii on data privacy and protection.
152. Id. at 513.
As previously mentioned, empirical studies do not demonstrate the effectiveness of compliance programs, so “courts and agencies lack sufficient information regarding the effectiveness of internal compliance structures” designed primarily to avoid liability rather than to deter misconduct. But a compliance program will generally be considered effective if it “promotes an organizational culture that encourages ethical conduct and a commitment to compliance with the law.”

Organizational culture, incentive and reward systems, and management commitment to ethical conduct all shape the organizational environment, which determines whether an internal compliance structure is effective or not.

Two cursory standards for understanding what constitutes an “effective” compliance program are the OECD standard and the U.S. Sentencing Guidelines Standard.

1. The OECD Standard

The OECD issued the “Good Practice Guidance on Internal Controls, Ethics and Compliance” in 2010, which provides guidance on combating bribery and setting standards for effective compliance programs.

The document notes that effective compliance programs require the following: (i) senior management personnel installed to support the compliance programs, (ii) a clear and publicly known corporate policy prohibiting bribery, (iii) the fact that all employees understand and abide by internal controls and compliance programs, (iv) effective supervision of the program, (v) adoption of provisions on any kind of payments, (vi) accounting to ensure accurate books and records, (vii) training for all employees and subsidiaries, (viii) measures for observation of conformity with the provisions of the compliance program, (ix) reporting and disciplinary proceedings if compliance fails, (x) an advice mechanism for employees facing potential violations, and (xi) periodic reviews for evaluation purposes.

2. The U.S. Sentencing Guidelines Standard

Regarded as the “gold standard” of compliance programs, the U.S. Sentencing Guidelines do not provide much detail on the standards of an effective compliance program, although they prescribe a multi-part test. Instead, they provide general guidance, not-
ing that an organization shall exercise due diligence to prevent and detect criminal conduct, promote an organizational culture that encourages ethical conduct, and commit to compliance with the law.160 “Such compliance and ethics program shall be reasonably designed, implemented, and enforced so that the program is generally effective in preventing and detecting criminal conduct.”161

“The failure to prevent or detect an offense does not necessarily indicate that the program is ineffective at preventing and detecting criminal conduct.”162 The guidelines furthermore note that (i) standards and procedures must be established to prevent and detect criminal conduct; (ii) employees in highly-ranked functions should ensure the effectiveness of the program and have responsibility for this purpose; (iii) daily operation should be executed by specifically selected individuals, which should be periodically informed about the standards and procedures; (iv) compliance with the program should be ensured, including monitoring and auditing to detect criminal conduct; (v) to have and publicize an advice and whistleblowing system for employees and agents, which may include mechanisms that allow for anonymity or confidentiality without fear of retaliation; (vi) compliance shall be promoted and enforced through incentives and disciplinary measures; and (vii) reasonable steps shall be taken to respond to criminal conduct.163 The commentary notes that effectiveness may also depend on the relevant industry practice, the standard required by government regulation, the size of the company, and similar misconducts by the company in the past.164 Furthermore, sector-specific standards and U.S. Department of Justice (DOJ) Guidance (memorandum for prosecutors and agreements of non-prosecution) provide additional indications of standards.165

3. Standards across Europe for an Effective Compliance Programs

Recently, the French Competition Authority (French Authority) provided rather extensive guidance on indications of an effective compliance program indicating two main objectives of compliance programs: “firstly, [to] prevent the risk of committing infringements and, secondly, [to] provide the means of detecting and handling misconducts that have not been avoided in the first place.”166 In addition to training the company’s supervising personnel, a culture of compliance must be created and maintained. The value of the compliance program depends on the combination of the preventive and corrective components. The French Authority notes that there is no “one-size-fits-all” program and that programs should be tailored to the characteristics of the company such as size, activity and markets, organization, governance, and culture.167 The French guidelines mirror the requirements of the OECD and U.S. Sentencing Guidelines.

160. Id. § 8B2.1(a)(1-2).
161. Id. § 8B2.1(a)(2).
162. Id.
164. Id. §8B2.1, Application Note 2(A).
165. See John S. Moot, Compliance Programs, Penalty Mitigation and The FERC, 29 ENERGY L.J. 547, 561-67 (2008).
167. Id. ¶ 19.
The British Office of Fair Trading (OFT) has also published guidance on competition law compliance. The OFT emphasizes that no specific compliance measures are obligatory; it suggests a “risk-based, four-step approach” that assists in tailoring the program to the risk faced by the company and is not mandatory.168 “The key point is that businesses should find an effective means of identifying, assessing, mitigating and reviewing their competition law risks in order to create and maintain a culture of compliance with competition law that works for their organizations.”169 The OFT approach is made up of the following ideas: (i) a commitment to compliance by management is considered the core of the program; (ii) aimed at identifying risks for the company; (iii) assessing the risk by indicating whether it is high, medium, or low risk; (iv) facilitating risk mitigation where policies, procedures, and training can be set up; and (v) reviewing the first three steps and the company’s commitment to compliance regularly.170

III. Conclusion

The multitudinous corporate compliance questions that companies face every day, including how to deter organizational misconduct and how to not fall under the radar of courts and agencies, may increasingly lend support to cross-over considerations among employment law, criminal law, and antitrust law matters. There are strong incentives for establishing internal compliance structures implemented at a sub-optimal level when corporations choose to adopt compliance programs to shield themselves from corporate liability. But this is not to say that a discouraging picture of the effectiveness of compliance programs is painted by such an approach.

Ultimately, internal company investigations into corporate misconduct can be effectively carried out by setting up an effective compliance program that neither fits into any prescribed stricture, nor follows a “one-size-fits-all” approach. The underlying rationale behind setting up effective compliance programs rests in fostering a culture of ethics and legal compliance within corporations.

Compliance programs should be encouraged and not prescribed in a manner that compromises their effectiveness. Corporations should be allowed the freedom to tailor their programs more effectively to their industries and business models and not be constricted to any legal or judicial mechanical approaches.171 As one commentator effectively describes, “law should not ask whether the corporation adopted a relatively rigid framework prescribed by the [agency]. It should ask whether the corporation’s actions were, in general, reasonable efforts to ensure compliance with the law.”172
THE INTERNATIONAL LAWYER
A QUARTERLY PUBLICATION OF THE ABA/SECTION OF INTERNATIONAL LAW

PUBLISHED IN COOPERATION WITH
SMU DEDMAN SCHOOL OF LAW
Implications of the *Interim Accord* Ruling of the International Court of Justice

HALIL RAHMAN BASARAN

Abstract

The *Interim Accord* ruling of the International Court of Justice is a renewed challenge from an international court to international organizations. The Court pierced the veil of NATO and disregarded NATO’s indispensable position. It implied that member-States could not avoid responsibility by hiding behind the corporate veil of an international organization. In the final analysis, this ruling constitutes a phase in the constructive process of international relations.

I. Introduction

The *Interim Accord* ruling of the International Court of Justice (ICJ) points to an important development in international law: the ICJ demonstrated that it was ready to pierce the corporate veil of international organizations (IOs) and remove their relevance in a legal dispute between a Member State of the IO and an outsider country.\(^1\)

IOs are founded to solve coordination problems between governments; they help create mutual understanding and cooperation. They offer a common venue for the representatives of governments in a variety of fields and help deal with global problems. Yet, IOs have one ultimate and not-openly-discussed function: the opportunity given to countries to avoid international responsibility. IOs assume and cover the individual responsibilities of States. Put in simpler terms, they become scapegoats for the individual faults, deficiencies, and actions of member countries on the international stage. An IO is an organization to refer to when governments do not want to challenge their counterparts head-on but want to provide a shelter for themselves. IOs give members leverage over non-members.

Nevertheless, the *Interim Accord* ruling of the ICJ runs contrary to that understanding. The ruling makes it clear that an IO cannot prevent the international community from

---

pinpointing the wrongdoing Member State. Member States cannot be covered under the corporate veil of an IO in order to avoid liability. The Interim Accord ruling makes it possible to hold a member country responsible notwithstanding the protection of the IO.

To put the Interim Accord ruling in context, this article examines the rulings of three courts: the ICJ, the European Court of Human Rights (ECtHR), and the European Court of Justice (ECJ). The ICJ is an organ of the United Nations (UN) and the universal court. The ECtHR is a very active court with a high level of prestige. It embodies the pro-active stance of international courts after the Second World War, with a focus on human rights. It has been dealing with governments and IOs for a very long time. As for the ECJ, it is an interesting court in that it has an active policy of forming the European Union as a community of law and represents the judicial dimension of a sui generis IO, which has intricate relationships with both its Member States and other IOs. In short, these three international courts implicate three IOs—the UN, the Council of Europe, and the European Union—and help concretize the relationship between international courts, governments, and IOs.

This paper puts forward the point that the position of IOs is determined by its interaction with international courts and governments. The paper proceeds as follows: first, it provides a summary of the Interim Accord ruling; second, it considers the piercing of the corporate veil; third, it discusses the concept of an indispensable third party; fourth, it delves into a theoretical view of the Interim Accord ruling; and lastly, it concludes that the Interim Accord ruling constitutes a phase of the constructive process of international relations.

II. Summary of the Interim Accord Ruling

Greece and the Republic of Macedonia have been locked in a dispute concerning the name of the latter since Greece argued that the term “Macedonia” has irredentist connotations in respect of Greece and should be removed or qualified. The Republic of Macedonia objects, stating that no country has the right to interfere with its name choice; it is an identity issue and concerns Macedonia’s sovereign rights. This dispute started just after the Republic’s proclamation of independence in 1991 and was addressed by a 1995 Interim Accord—an international treaty—between the two countries. Under this accord, the “Republic of Macedonia” is provisionally to be referred to in all IOs as the “Former Yugoslav Republic of Macedonia” (FYRM), until the final settlement of the name issue, and Greece is not to object to the membership of the FYRM to IOs.

The deal represented a compromise between the two countries and worked well until the 2008 Bucharest Summit of North Atlantic Treaty Organization (NATO). At that summit, NATO declared that the FYRM could not join unless it solved its name problem with Greece. This was a blow to the membership aspirations of the FYRM and induced

2. Id. ¶¶ 124-26.
3. Id.
4. Id. ¶ 16.
5. Id. ¶ 15.
6. Id. ¶¶ 15, 20.
7. Id. ¶ 85.
the FYRM to initiate proceedings against Greece before the ICJ.9 The FYRM argued that Greece breached its commitment not to object to the entry of the FYRM to an IO.10 Indeed, the ICJ found that Greece had objected to the membership of the FYRM to NATO, and this was held to be in violation of the Interim Accord.11

Nevertheless, this ruling cannot be seen as a simple case of the *pacta sunt servanda* obligation of Greece. Rather, it implicates three significant questions. First, how can the ICJ pinpoint and blame Greece alone even though NATO’s decision not to invite Macedonia to the organization was taken by consensus? This is the question regarding *piercing the corporate veil*. Second, isn’t NATO an indispensable third party to the issue before the ICJ? Can the ICJ isolate the dispute between Greece and Macedonia and exclude NATO from the equation? Third, this paper considers whether a theory could be advanced to explain the *Interim Accord* ruling.

### III. Piercing the Corporate Veil

The ICJ stated in the *Interim Accord* ruling that it did not target NATO.12 The ruling was merely about the Greek objection to the Macedonian entry to NATO, not the NATO rejection of the FYRM as such.13 But it can be argued that NATO was subtly targeted. By sanctioning a NATO member country (Greece), NATO’s consensus decision to reject Macedonia’s membership was circumvented and indirectly questioned. In other words, the ICJ isolated Greece’s objection to Macedonia’s membership and declared it illegal. Regardless of the institutional framework provided by NATO, a NATO member State was held responsible.

Nonetheless, there have been cases of governments being held directly responsible regardless of the institutional cover provided by the IOs. Governments could be held liable even when they merely implement the decisions of the IOs of which they are members. For instance, the *Matthews* ruling of the ECtHR made it clear that the United Kingdom—notwithstanding the European Community (EC) Council Decision 76/787 and the 1976 Act laying out the procedure for the European Parliament elections—was liable for the breach of the right to vote for residents of Gibraltar (a province of the United King—

10. *Id.* ¶ 1.
11. *Id.* ¶ 164.
12. *Id.* ¶ 42.
13. *Id.* ¶ 43.
The residents of Gibraltar were prevented from voting at all in the European Parliament elections. This was in violation of the right to vote—a fundamental right. Although the UK argued that it was merely implementing the measures as established by the EC, it could not avoid its responsibility under the European Convention on Human Rights (ECHR). Human rights (fundamental rights) considerations prevailed over the obligations of the United Kingdom to the EC. Indeed, the ECtHR does not exclude the transfer of competences to IOs, provided that ECHR rights continue to be “secured”; member countries’ responsibility therefore subsists even after such a transfer.

This situation was all the more endorsed by the Bosphorus ruling of the ECtHR. In that case, Ireland seized a Yugoslav airliner, relying on an EC measure, which, in turn, was based on UN Security Council Resolution 820 (1993). The resolution provided that States should impound all aircraft in their territories “in which a majority or controlling interest is held by a person or undertaking in or operating” from the Former Republic of Yugoslavia. Ireland’s action seemed like an encroachment on the right to property, which is a human right. Against this, an application before the ECtHR was brought by the Bosphorus Airlines, an airline company registered in Turkey, which leased the impounded Boeing aircraft from Yugoslav Airlines. The ECtHR did not find that Ireland had breached human rights. Yet, it stated that the possibility of finding a violation of human rights and sanctioning Ireland was, theoretically, an open possibility:

the presumption will be that a State has not departed from the requirements of the Convention when it does no more than implement legal obligations flowing from its membership of the organisation. However, any such presumption can be rebutted if, in the circumstances of a particular case, it is considered that the protection of Convention rights was manifestly deficient. In such cases, the interest of international cooperation would be outweighed by the Convention’s role as a “constitutional instrument of European public order” in the field of human rights.

---

15. Id. ¶ 7.
16. Id. ¶¶ 61, 65.
17. Id. ¶ 26.
18. Id. ¶ 65.
19. “Human rights” and “fundamental rights” are synonymous and can be used interchangeably.
21. Id.
23. Id. ¶¶ 16, 23.
24. Council Regulation 990/93, Concerning Trade Between the European Economic Community and the Federal Republic of Yugoslavia (Serbia and Montenegro), art. 8, 1993 O.J. (L102) 14, 16.
25. Id. preamble.
26. Id. art. 1.2(b).
28. Id. ¶ 167.
29. Id. ¶ 156.
The ECtHR affirmed that if the EC system did not ensure an adequate human rights protection level, it could intervene. Both the Bosphorus and Matthews rulings indicate that the corporate veil of an IO (the EC) cannot be a bar to the human rights scrutiny of the acts of member countries. In doing this, the ECtHR has not directly targeted the EC measures. Actually, that was not possible because the EC was not a party to the ECtHR. The EC’s consent was not given before or during the examination of its measures by the ECtHR. But the ECtHR indirectly second guessed the EC measures through challenging their implementation in member countries, and this was a sufficient cause for inferring that fundamental rights do suffuse the international system.

Nevertheless, the context of the Interim Accord ruling is different: first of all, NATO is different from the EC. It is a security organization that presents itself to the outside world as monolithic and homogenous. The prime evidence for this is the lack of formal voting and veto procedures. The North Atlantic Council—NATO’s governing body—does not take a roll-call vote. This has significant implications. It demonstrates the solidarity among the NATO members. There is a complete unity of the members and the organization. They are strongly interwoven. It is impossible to identify the members from the institution. It is a compact community of legal destiny. Their liability is collective. This is all the more compatible with the motivation for creating IOs. If public international law were to create some form of residual liability for Member States, then international law would interfere with the internal activities of IOs and might even make it unattractive for States to establish or join IOs.

In this regard, it is impossible to determine definitively whether Greece objected to the membership of the FYRM. It is inconceivable to distinguish the Greek rejection from the NATO rejection. Therefore, there is no legitimate way to target a NATO member State for its role in NATO decisions. NATO assumes full responsibility for the decisions it takes. It is the only interlocutor for the complainants who are unhappy with its decisions.

The decision-making mechanism of NATO consists purely of a political process. NATO decides what is convenient for itself. In contrast to the EC, it is not a transparent and open organization with specific voting procedures for specific issues; it is a specialized and close organization with an informal voting procedure. Hence, outsiders cannot accuse it of being arbitrary. When countries coordinate with one another or cooperate, they need to establish a point of coordination. NATO is a point of coordination for its members. It is closed to the countries outside of the North Atlantic and European areas and maintains solidarity among its members through its informal and anonymous decision-making机制.

30. Id. ¶ 153.
33. Hüseyin Pazarci, International Law 187 (2011) (Turkish) (Pazarci makes a distinction between “closed” and “open” organizations. He argues that “open” international organizations adopt majority voting whereas “closed” organizations work on a unanimity basis).
making procedure. Likewise, there is no transparent legal criterion for being a member of NATO. One cannot legally accuse NATO of not accepting the membership application of a country. There is no legal requirement of taking in a new member. The criteria of accepting new members are not legal, but political. NATO has been, from the start, seen as a political club aiming at security and common defense of its members, not as a legalistic institution such as the EC. Thus, the veil of NATO is a strictly political and closed one.

Second, NATO is different from the other organizations of which the FYRM became a member thanks to the lifting of the veto by Greece. For instance, neither the Council of Europe nor the Organization for Security and Cooperation in Europe embodies the close relationship seen between the members of NATO. NATO is an organization that undertakes military interventions, and this requires a special relationship among its members. That is why the FYRM’s membership to those other organizations did not pose a problem, but it may pose one to NATO.

Third, the EC is more committed to human rights than NATO. There are provisions in EC treaties and ECJ jurisprudence in the field of human rights. Moreover, these provisions and jurisprudence make specific reference to the ECHR. Thus, when the ECtHR adjudged the implementation of EC measures in member countries, it was well aware that there was a parallel between the fundamental rights vision of the EC and the ECHR system.

Fourth, the identity of the courts plays an important role. The ECtHR is the court of Europe and claims to establish a “European Public Order.” The ICJ is the universal world court, which hands down rulings for the greater international community, unlike the ECtHR, which gives rulings for a closely-knit public order. The countries in Europe share a more or less similar worldview and embody a community of nations whereas the ICJ cannot claim to adjudicate for a similar community. Hence, on a theoretical level, the intervention of the ECtHR in the affairs of the EC should be easier than the ICJ’s intervention in the affairs of NATO.

Fifth, in the Interim Accord ruling of the ICJ, human rights are not an issue. The tension there is not between human rights concerns of individuals on the one hand and the implementation of an IO measure by the member country on the other. What concerns the ruling is the application for membership by the FYRM to NATO and whether Greece

---

36. Id.
37. Id.
objected to this membership in contravention of its obligation not to object under Article 11 of the Interim Accord between Greece and the FYRM. Indeed, being fully aware of this, the FYRM rested its case on Article 11 of the Interim Accord—a contractual right that provides that “[Greece] agrees not to object to the application by or the membership of the Party of [FYRM] in international, multilateral and regional organizations and institutions of which [Greece] is a member.”

But this provision is to be evaluated in light of Article 22 of the Interim Accord, which protects the other obligations of Greece under different international treaties and which states that “[t]his Interim Accord is not directed against any other State or entity and it does not infringe on the rights and duties resulting from bilateral or multilateral agreements already in force that the Parties have concluded with other States or international organizations.”

Under this approach, the North Atlantic Treaty—which established NATO—is to be considered under the constraint of Article 22. Thus, Article 11 is to be limited by Article 22, and the balance between these two provisions strengthens the position of Greece. The clash is between the two articles of the Interim Accord, not between fundamental rights and a country’s implementation measures. Human rights are inherent and natural rights for all individuals. But no country has the inherent and natural right to be a member of an IO. Be that as it may, the ICJ demonstrated judicial activism by pinpointing both Greece in the whole of NATO and Article 11 in the Interim Accord. In doing this, the ICJ behaved as if a “fundamental right” of Macedonia was breached by Greece—that is, the fundamental right to join IOs.

IV. Indispensable Third Parties

The Matthews and Bosphorus rulings demonstrate that governments cannot put forward IOs as scapegoats when those countries do not fulfill their human rights duties. The most important inference is that the organization is not seen as an indispensable party to cases brought against the countries concerned. In effect, a measure of the organization is challenged and questioned by the ICJ. But the ICJ avoids any direct confrontation whatsoever with IOs. Rather, the ICJ targets the governments’ implementation of measures in violation of human rights. It is not the source, but concrete measures taken by individual states that become the object of contention and the target of sanction before the ICJ.

42. Application of the Interim Accord, supra note 1, art. 11.
43. Id. art. 22.
46. Id.
47. Id.
48. Id.
49. Id.
Nevertheless, international law functions through consent. This is all the more true of the ICJ; it cannot deal with the legal dispute of a country without its consent. To be sure, a ruling by the ICJ may touch upon the legal interests of a third party. The problem is to determine the threshold where the participation of the third party in the dispute becomes indispensable. The ICJ’s Monetary Gold judgment emphasized this point; if the legal interest of a third party, which does not have to consent to the jurisdiction of the ICJ, constitutes the very object of the dispute, it is not judicially proper to decide the dispute. On this rationale, the 2008 NATO decision not to invite the FYRM for membership constituted the basis of the dispute—the very object of the dispute. Nevertheless, NATO was not a party to the dispute before the ICJ. To be sure, the ICJ is an interstate court. IOs—such as NATO—cannot be a party to the proceedings. Still, this obstacle could be circumvented through instituting proceedings against all the NATO member countries.

The concept of an indispensable third party needs further clarification. For instance, the Nauru v. Australia ruling of the ICJ affirmed that the dispute between Nauru and Australia did not require the participation of New Zealand and the UK for its resolution. The determination of the responsibility of New Zealand and the UK was not necessary to determine the responsibility of Australia. Although these three governments altogether constituted an Administrative Authority for Nauru, the ICJ found Australia alone eligible to come before the ICJ for its actions as regards the administration of the national resources of Nauru. The interests of New Zealand and the UK did not constitute the very subject matter of the decision to be rendered by the ICJ. An explanation to this rationale would be that the Administrative Authority, as established under the 1947 Trusteeship Agreement on Nauru, did not have a legal personality. There was a loose cooperation between the three administrator governments, and it was easy to get at one of them. But NATO has a legal personality, and it is not possible to render Greece alone responsible.

The Congo v. Uganda ruling by the ICJ is similar to the Nauru v. Australia ruling. Uganda argued that Congo could not bring it before the ICJ without, at the same time, having Rwanda in the proceedings. Rwanda occupied the Congolese territory at the

---

53. See generally NATO Bucharest Summit Declaration, supra note 8.
54. Application of Interim Accord, supra note 1, ¶ 1.
56. Id.
58. Id.
59. Id. ¶¶ 11, 55-57.
60. Id. ¶¶ 55-57.
61. Id. ¶ 47; MALCOLM N. SHAW, INTERNATIONAL LAW 1297 (6th ed. 2008).
63. Id. ¶¶ 197-98.
same time as Uganda and thus, so argued Uganda, holding only Uganda responsible for
the events in Congo was not possible. On this approach, the ICJ should have found the
claim relating to Uganda’s responsibility for these events inadmissible. But the Court
responded that the interests of Rwanda did not constitute the “very subject-matter” of the
decision to be rendered by it and that it was not necessary for Rwanda to be a party to the
case. As in the Nauru v. Australia case, in the Congo v. Uganda case, there was no IO
with a legal personality to which the acts of the respondent country could be attributed.
Thus, it was not difficult for the ICJ to dismiss the arguments based on the collective
responsibility of the third country. The loose relationship between the respondent and
the third country gave the opening to the ICJ to dismiss the indispensable role of the third
country.

The state of affairs changes when there is an IO (an entity with a legal personality).
The joined Behrami and Saramati ruling of the ECtHR was the harbinger of such defer-
ce to IOs and the importance of the indispensable third party. The Behrami case
concerned the demining of Kosovo. After being exposed to undetonated cluster bomb
units (CBUs), Gadaf Behrami died while his brother Bekim was disfigured and lost his
sight. The father of the two children, Agim Behrami, instituted proceedings against
France at the ECtHR. He argued that the incident took place because of the failure of
the French Kosovo Force troops (KFOR) to mark and/or defuse the undetonated CBUs,
which those troops knew to be present on that site. As for the Saramati case, the issue
was the pre-trial detention of Mr. Saramati. He directed his complaint against Norway
and France whose contingents in the KFOR detained him.

At the time, Kosovo was being administered by the KFOR and the United Nations
Interim Administration Mission in Kosovo (UNMIK), as authorized by Security Council
Resolution 1244. Both were functioning under the authority of the United Nations.
The ECtHR held that the applicants’ complaints were incompatible ratione personae with
the provisions of the ECHR Convention; the ECtHR dismissed the application as inad-
misible on the grounds that the actions complained against were “directly attributable
to the UN.” It affirmed that the impugned acts—the lack of de-mining and the arbitrary
pre-trial detention—were not attributable to Norway and France. Having reached this
conclusion, the ECtHR stated, with regards to applying the ECHR provisions to the UN,
that to subject the acts of UNMIK and KFOR to the scrutiny of the ECtHR would be “to

---

64. Id. ¶¶ 174, 176-78.
65. Id. ¶¶ 196-204.
   http://hudoc.echr.coe.int/sites/eng/pages/search.aspx?i=001-80830#“itemid”:“001-80830”}.
67. Id. ¶ 51-60.
68. Id. ¶ 5.
69. Id. ¶ 1.
70. Id. ¶ 61.
71. Id. ¶ 8.
72. Id. ¶ 63.
73. Id. ¶ 4.
74. Id. ¶¶ 151-52.
75. Id. ¶ 151.
interfere with the fulfillment of the United Nation’s key mission in this field including. . .
with the effective conduct of its operations.76

Hence, the UN was seen as the indispensable party—a distinction between France and
Norway on the one hand and the UN on the other hand was not made. As additional
support, the ECtHR distinguished the Behrami and Saramati case by underlining that the
impugned acts did not take place in the territories of France or Norway whereas the im-
pugned act in the Bosphorus ruling (the Irish seizure of the aircraft) took place in the terri-
tory of Ireland.77 Moreover, the ECtHR argued that there was a close hierarchy between
the UN authorities and the French and Norwegian agents on the ground in Kosovo
whereas Ireland had certain autonomy in regard to the impugned act it took with regard
to the applicant.78 Thus, there was a possibility for Ireland to be individually liable in the
Bosphorus ruling, but the French and Norwegian authorities could not be individually lia-
ble in the Behrami and Saramati ruling.79

But this justification puts the Interim Accord ruling of the ICJ in an awkward position.
First, the objection of Greece to the FYRM’s application to NATO cannot be confined to
the Greek territory—to the Greek jurisdiction. Second, the decision to reject the FYRM’s
membership application was taken by NATO’s North Atlantic Council, through consen-
sus. That is to say, Greece did not have the autonomy to determine the fate of the
FYRM’s application. On this reading, NATO is the indispensable third party in the dis-
pute between Greece and the FYRM. There is a complete overlap between the distinct
will of NATO, as an IO, and the will of a Member State, like Greece. NATO maintains
an informal system of voting. There is no specific or formal procedure for casting a veto
in NATO. Thus, the individual responsibilities of Member States for the acts of NATO
disappear. Thereby, the institutional effectiveness of NATO as a monolithic organization
is assured and allocating responsibility to individual countries is rendered impossible.

Nevertheless, the Interim Accord ruling can find some support in the Kadi judgment of
the European Court of Justice—the judicial organ of the European Union (EU).80 It is
similar in that it demonstrates no deference to an IO—the United Nations. In this case,
the anti-terrorism measures as established by the UN Security Council resolution were at
issue.81 The EU transposed the Security Council measures in the shape of a Council
regulation.82 Under this legislation, the assets of Mr. Kadi were seized by the EU, and
this constituted an encroachment on the right to property—a fundamental right.83 But
the source of the problem was that this was done without due process and in violation of
Mr. Kadi’s right to information and right to defense.84

The ECJ declared that, notwithstanding the Security Council resolution and its annex
indicating Mr. Kadi as one of the individuals whose assets were to be frozen, the right to
due procedure and human rights considerations (as established in the EU legal order)

76. Id. ¶ 149.
77. Id. ¶ 106.
78. Id. ¶ 151.
79. Id.
84. Id. ¶ 257.
were to be safeguarded as well.\textsuperscript{85} The ECJ stated that it did not judge the validity of the Security Council resolution\textsuperscript{86} (just as the ICJ argued that it did not judge the validity of the NATO rejection of the FYRM’s membership bid). Rather, the ECJ solely affirmed that the EU legal order, comprising fundamental rights,\textsuperscript{87} is to be complied with in the EU jurisdiction area, whatever the ultimate source of the measures.\textsuperscript{88} The ECJ annulled the EU Council Regulation, breaching the EU legal order.\textsuperscript{89} The UN—the universal IO—was not deferred to, and the autonomy of the EU legal order was emphasized. In like vein, the \textit{Interim Accord} ruling gave the impression that Article 11 of the Interim Accord between the FYRM and Greece had certain autonomy. The right to participate in IOs was raised to the level of a fundamental right, and the ICJ acted as if it were protecting the autonomy of a value, which favored the participation of countries in IOs. But the ICJ is not the court of NATO and, most importantly, there is no such value requiring the participation of the FYRM in NATO.

\section{A Theoretical View of the Interim Accord Ruling}

At this point, a constructivist interpretation of the \textit{Interim Accord} ruling can be made. Constructivism in international relations asserts that the interaction between countries and IOs changes both sets of players in the game;\textsuperscript{90} the rules change as the governments and IOs invoke and interpret them in particular cases, and the attitude of the IOs and governments change as their decisions and, indeed, their sovereignty are redefined by the international rules.\textsuperscript{91} The actors on the international stage consider the reactions to their previous actions and act accordingly later on.

In that regard, the constructivist theory would argue that there are no unmovable international parameters where the positions and attitudes are fixed.\textsuperscript{92} The international system is not based on strictly defined material conditions and nature, but on ideas and interactions between actors. Interests and identities are formed by the process comprising actions and reactions of international actors—governments, IOs, international courts, etc. Human associations (a prime example of which are IOs) are determined by shared ideas, and these shared ideas are liable to change. “Structure” is not “given,” but influenced and modified by social practice—that is, signals of international actors to each other.

Arguably, there is a specific motivation for the judicial activism of an international court, which is the willingness to remain relevant on the international stage. The ICJ, in the \textit{Interim Accord} case, was stuck between a rock and a hard place. On the one hand, it was risking handing down a ruling without effective and practical results. There was no guarantee that Greece would comply with the ICJ’s ruling in the future. Besides, the ICJ risked seeming too interventionist into the affairs of IOs. On the other hand, the ICJ wanted to make its voice heard and did not want to leave the issue wholly to the political
process. The ICJ once made a mistake of dismissing a case because of its political nature and lack of legal interest of the applicants; this was the *South West Africa* ruling. In that case, Ethiopia and Liberia instituted proceedings against South Africa for the improper treatment of South West Africa (Namibia), which was, at the time, under the Trusteeship administration of South Africa. The two governments relied on Article 7 of the Mandate of 17 December 1920 for South West Africa, which implied *erga omnes* obligations of South Africa vis-à-vis the international community. Still, this was not enough to establish their *locus standi* before the ICJ, and the ICJ rejected the status of Ethiopia and Liberia as applicants. Article 22 of the League of Covenant, which established the mandate system as a system of “sacred trust of civilization,” and the UN Trusteeship Agreement, which made trusteeships the interest of the whole international community under the UN Charter, did not suffice. The ICJ found that there was no legal interest of those two countries, but merely their moral, humanitarian, and political interests. It indicated that the issue would be better decided by the UN Security Council (an IO). The IO was favored over governments and the Court. The judicial path was closed.

The Court suffered a loss of prestige after that ruling because colonial issues were crucial, especially for African states in the 1960s. In this respect, the Court was, at first, seen by them as an important venue to frame the issue in legal terms and the language of rights. But the ICJ missed this opportunity and disappointed the international community. It was so damaging to the ICJ that, in order to compensate for its decision, the ICJ went on to establish the principle of *erga omnes* in a later case. It thereby signaled that it was interested in the most challenging problems of humanity and that it would not play the same passive role that it played in the *South West African* case. Besides, later on, the ICJ handed down an advisory opinion on South West Africa and tried to fill the legal vacuum on the issue. This time, the interwoven nature of the political and legal aspects of the dispute did not prevent the ICJ from looking at it through a legal lens. Put differently, the political dimension of the dispute did not prevent the ICJ from qualifying the dispute as a legal one and adjudicating it. Rather than leaving the matter totally to governments and IOs, the ICJ assumed responsibility. This evolution of the ICJ is a typical example of the constructive process in international relations.

Similarly, although NATO’s rejection of the FYRM’s membership application was the political decision of NATO, the ICJ still found a legal dimension to it and adjudged the

---

94. *Id.* at 10-11.
95. *Id.*
96. *Id.* ¶¶ 99, 100.
97. U.N. Charter art. 88. (“[t]he Trusteeship Council shall formulate a questionnaire on the political, economic, social, and educational advancement of the inhabitants of each trust territory, and the administering authority for each trust territory within the competence of the General Assembly shall make an annual report to the General Assembly upon the basis of such questionnaire”).
99. *Id.* ¶¶ 99-100.
100. *Id.* ¶ 93.
103. *Id.*
dispute. That is because this could make the ICJ irrelevant as regards its position on the world stage when it comes to relations between IOs and non-member countries. The number of IOs has grown immensely, and the ICJ does not want to be a mere spectator to the developments and disputes in this dynamic field. Nevertheless, it did not want to interfere in the affairs of an IO (NATO) either. It avoided dictating a certain conduct to NATO. Therefore, the ICJ limited itself to declaring that Greece acted illegally in view of the interim accord’s prohibition of objection to the membership of the FYRM to IOs. The ICJ did not order Greece or NATO to adjust their behaviors or practices in a certain way in the future but just determined the existence of this past illegality. The ICJ made its voice heard and entered the constructivist process in international relations; it did not repeat its mistake from the South West Africa ruling. Now, the ball is in the court of NATO. NATO’s practice will influence the development of international law and international politics as regards the relationship between IOs, governments, and international courts.

VI. Conclusion

There is no fixed nature to the international legal order. It is not a “given,” but a social construct. There is a constructive process; it is continually being built, modified, and re-built by actors—governments, international courts, and IOs. They send and receive signals as regards their positions. The knowledge and reality of IOs is constructed through the interaction between IOs, member and non-member countries, and international courts. Indeed, the international system is what the actors on the international stage make it out to be.

In that regard, on the one hand, the Behrami and Saramati ruling is the epitome of a court’s deference to IOs. The South West Africa case demonstrated deference to the IOs (the Security Council and the Trusteeship Council) as well, but, later on, the ICJ became active by giving an Advisory Opinion on the issue. On the other hand, the Matthews, Bosphorus, and Kadi rulings demonstrate assertive actions on the part of courts vis-à-vis IOs, and the Interim Accord judgment is a renewed challenge from an international court to IOs. The Interim Accord ruling of the ICJ constitutes a phase in this constructive process. The ICJ pierced the veil of NATO and disregarded its indispensable position. This ruling is a signal from the ICJ that a newly independent country ought not to be excluded from IOs and the international community. In case it is excluded, the ICJ is ready to engage in the constructive process of attempting to secure its membership.
The Rules of the Game for Eurozone Debtors: Will the 21st Century See Effective Reform or Financial Calamity?

CODY T. PERLMETER

Abstract

The ongoing sovereign debt crisis in the European Union threatens a global financial meltdown. An instance of default by one such country could trigger contagion with striking parallels to the economic turmoil of 2008–2009, or perhaps worse. Many EU countries simply cannot pay their bills, and so they dig deeper into debt to pay obligations that come due. Legal efforts to solve this problem have not, to this point, produced a lasting remedy. Current and prospective reforms, limited as they are by political realities, may indeed be insufficient to avoid an instance of default in the long-run. If so, how can policymakers minimize the turbulence ahead?

I. Introduction

The economic situation in Europe is a shambles. The strained finances of numerous Member States of the European Union (EU or Union) represent at best a serious problem for the continent, at worst an inexorable crisis to the global economy and an existential threat to the Union itself. Many of these countries have borrowed to the hilt and fend off the prospect of default only by borrowing yet more. If insolvency is indeed unavoidable, these states need a legal mechanism through which they can resolve their untenable finan-

* The author expresses his appreciation to Phillip Spinella, Scott Ferebee, and Jim Campbell for advising; above all else, to those around the world working tirelessly to remedy the sovereign debt crisis—it would be impossible to overstate the importance and challenge of their task.

** This attribution is accepted, though the primary source is unavailable. See http://www.themoneymast ers.com/the-money-masters/famous-quotations-on-banking/.


2. See Eurozone Crisis Explained, BBC NEWS (June 19, 2012), http://www.bbc.co.uk/news/business-16290598 (depicting in bar graphs the growing debt burdens of various EU member states over time).
cial position while minimizing collateral damage to the broader economy. Yet many contend that the currently planned legal structure is inadequate to meet the challenges at hand.3 Whether the timing and substance of such recent and near-term reforms yield a solution remains to be seen. For instance, the recent Treaty on Stability, Coordination, and Governance in the European Monetary Union (TSCG or Fiscal Compact)—entered into force at the beginning of 2013 and representing part of the latest efforts to solve this crisis—could be part of a bold, effective plan to right the ship, or in the alternative, nothing more than wishful thinking by politicians and bureaucrats who have repeatedly proven themselves to be a step behind this unfolding crisis.4

Unfortunately, the question of what constitutes optimal legal reform for the European Union is not the sole concern. There has been litigation to vie over the predicate question, who gets to decide what reforms will be implemented?5 With legal regimes that overlap yet remain far from seamless, the Member States of the Union have a sovereign debt crisis that is unique in its challenges and that will thus require a unique legal solution.

To evaluate the viability of prospective legal reform, context is key. That which is palatable legally may be untenable in the marketplace. The court cannot enjoin financial panic or contagion. And the financial dynamics are just one constraint on viable legal reform. Reform instituted to solve the EU sovereign debt problem may take effect on current legal terms, only then to fail in the face of subsequent political opposition. A political backdrop increasingly hostile to recent reform—in creditor and debtor countries alike—represents, then, a second limiting force upon any sort of legal reform and it must be taken into account in crafting any realistic solution.6

A. TYING THE GORDIAN KNOT

Years before the worldwide financial crisis of 2008-2009 (Credit Crisis), the default or near-default of various third-world nations on their sovereign debt obligations brought to the fore the extraordinary danger posed by a resolution process so unruly and fraught with uncertainty.7 These seemingly isolated events in faraway lands brought quick and severe punishment to major markets, demonstrating the risks of contagion in an increasingly interconnected global marketplace. Very rapidly, a sovereign default in Russia could threaten the existence of a hedge fund in Connecticut, which could in turn threaten the entire banking system and world economy.8 In turn, the centuries-old question of how countries could work together to best resolve instances of sovereign insolvency again be-

8. Id.
came a topic of focus for academics. As with many collective action problems, however, the theorizing flowed easily while the policy-making lagged. Following the Argentinian debt crisis, several years passed while loose monetary policy, primarily out of the United States, flooded the world market with borrowed cash, bidding up the value of assets across the globe from home prices to stock markets to pensions. The need for action on the issue of sovereign debt restructuring was again obscured, as times were good and budget projections were rosy.

The Credit Crisis that swept across the world several years ago has many theorized causes and many documented effects that this paper will not undertake to analyze. One relevant effect, however, was to crystallize the woeful financial state of many of the world’s developed economies, particularly in the Eurozone. As job losses and asset devaluation led to less-than-anticipated tax receipts for government coffers, sovereigns from Greece to the United Kingdom faced yawning budget deficits and the concomitant need to finance this divide between tax collections and expenditures. Some countries gambited, taking on even more debt to fund stimulative fiscal policies intended to fuel their economies and, in turn, tax revenue. Other countries hunkered down, taking an austere fiscal track to bring budget projections in order by reinsing in future spending. Meanwhile, private demand in the financial markets soaked up the bonds issued to finance sovereign deficits; many investors, recently burned in the market downturn, sought a safer play than traditional corporate investments and thought they had found it in sovereign debt investing. In exchange for a periodic payment of interest on the bonds and a promise to repay the borrowings in full at a later date—perhaps a year or a decade later—these troubled economies secured what they desperately needed: more borrowed money and, thus, time to let their economies heal and their budgets snap back into order. But as the first decade of the millennium drew to a close and a new one began, this hope proved unrealistic; many sovereign budget projections within the Eurozone not only failed to improve, but instead deteriorated further. In response, the private sector that had just so recently warmed to the perceived protection of sovereign credit began to look upon nations such as Ireland, Greece, and others as having dubious financial prospects of their own. The notion that the budget deficits facing these countries were actually structural rather than temporary gained traction, and investors in turn demanded a higher rate of interest in return for


11. Eurozone Crisis Explained, supra note 2.

12. See id.


14. See id.


16. See Thompson, supra note 6.
providing the same quantity of lending.⁷ This increase in projected interest service cost (the aggregate cost paid by an entity to fulfill payment obligations arising from interest owed on its debts) made the budgetary picture darker still for these countries, further scaring away potential lenders, and the vicious cyclicity of a debt spiral began to appear a real threat.⁸ But where the Credit Crisis saw industry leap into the arms of government, where could these very governments now find safe harbor?

B. THE CENTRAL BANK DISTINCTION

Countries struggling to borrow in the private market have either one or two options available to them. First, intergovernmental financial entities—principally the International Monetary Fund (IMF)—exist to affect lending programs to a target country from a consortium of contributing countries.⁹ With these loans, however, come terms set forth by the IMF regime meant to right the borrowing country’s troubled financial path.¹⁰ The release of each tranche of IMF lending is often conditioned upon a tightening of fiscal policy within the borrowing country and the attainment by that country of certain fiscal and monetary benchmarks.¹¹ Crucially, this requires that the constituents of a borrowing country will accede to the reforms put upon them from bureaucrats abroad.¹² Intransigence on the part of the borrowing country to comply with the terms of IMF lending may compel a decision from the organization to withhold additional funding, almost assuredly bringing about default.¹³ For countries without control of their monetary policy, such forms of intergovernmental lending are the only meaningful option available.

Countries that maintain autonomous central banking authority, however, can draw upon an entirely different resource. Traditionally, a central bank could cheapen the cost of borrowing money during a recession in order to stimulate its domestic economy.¹⁴ This outcome is generally achieved through a central bank’s manipulation of important

---

⁷ See Eurozone Crisis Explained, supra note 2 (depicting, in line graph form, rising interest rates on various EU member states over the period of time in question).
⁸ See Michael Schuman, Spain’s Death Spiral and the Hypocrisy of the Euro, TIME (Apr. 5, 2012), http://business.time.com/2012/04/05/spains-death-spiral-and-the-hypocrisy-of-the-euro/  (describing this cyclical-ity—generally known as a debt spiral or death spiral—in the case of Spain’s sovereign debt crisis). The informal name “death spiral” speaks to the consequence for an entity that is increasingly weakened by growing interest service costs from growing debt and an attendant diminishment of investor confidence. Skepticism from the investing community translates into higher interest rates demanded by them to effect subsequent lending. The cycle perpetuates until the entity collapses (or is saved by some extrinsic circumstance).
¹⁰ Id.
¹¹ Id.
¹² In effect, the terms of IMF lending must be accepted at three levels. The IMF and the borrowing country are directly involved, and the borrowing country’s citizenry has a derivative power over the approval by way of changing the mandate of its democratic representation.
¹³ See Peter Spiegel, Alan Beattie & Joshua Chaffin, IMF Threatens to Withhold Greek Loan, FIN. TIMES (Sept. 15, 2011, 8:46 PM), http://www.ft.com/intl/cms/s/0/b6ded476-dfb2-11e0-8e15-00144feabdce0.html#axzz2KVSRo19d.
short-term interest rates.\textsuperscript{25} But through a newer process known as “Quantitative Easing,” a country could potentially rely upon its own central bank to purchase that country’s bonds.\textsuperscript{26} Though many experts regard this method of financing tantamount to simply printing money\textsuperscript{27} (and warn of its dire long-term inflationary consequences), the near-term benefits to the capital markets are undeniable.\textsuperscript{28} Where IMF lending requires harmonious execution of an agreed-upon fiscal plan between bureaucrats and politicians across countries, central bank lending is conditional upon only the compliance of a country’s own central bank. With a more direct alignment of interests, central bank funding can reasonably be viewed as a more assured source of financing than IMF funding. Investors, emboldened by the belief that a central bank will support the asset class into which they are investing, are naturally encouraged to re-enter the market for that country’s bonds.\textsuperscript{29} By these direct and indirect means, Quantitative Easing bids up bond prices and drives down yields for sovereign debt, thereby reducing interest payments owed by the debtor nation and lowering overall interest service cost.\textsuperscript{30} This has the opposite cyclical effect of a debt spiral; brightening the budgetary outlook brings yet more investors who sense financial viability (at least over some finite period) in the borrowing country.

Quantitative Easing is controversial monetary policy.\textsuperscript{31} Opponents of Quantitative Easing typically contend that a nation willing to print money in an ad hoc manner will inevitably undermine the integrity of that nation’s currency.\textsuperscript{32} Further, many believe that central bank purchases of bonds only hide the inevitable, unavoidable problem of growing sovereign debt by allowing politicians to defer taking action to balance the budget.\textsuperscript{33} This...

\textsuperscript{25} See id. A central bank may announce a new target interest rate and then, through its own actions in the financial markets, affect the supply-demand dynamics of money such that the bank achieves its desired influence over the price (i.e. interest rate) of borrowed money in the marketplace. Thus, the interest rate is better understood as being manipulated, rather than set.

\textsuperscript{26} See BoE Stops Quantitative Easing as Inflation Worries Weigh, REUTERS (May 10, 2012, 7:10 AM), http://www.reuters.com/article/2012/05/10/britain-boe-rates-idUSL5E8GA65320120510 [hereinafter BoE Stops QE].


\textsuperscript{30} There is an inverse relationship between the price of a bond and the overall return an investor can expect from purchasing that bond. Because a given bond may have a fixed amount of interest to be paid on it, acquiring that bond at a price above or below its issuance price will change the expectations for interest earned on the money invested in that bond. A quick example: If X is a ten-year bond issued to a first purchaser at 100 Euros, paying 10 percent interest each year, and X quickly is traded to a second purchaser in the financial markets for 10 Euros (i.e. a 90 percent decrease), then the second purchaser will have an economic expectation of a 100 percent effective interest rate in that first year—10 Euros invested to earn 10 Euros in one year—rather than a 10 percent return, which was the rate established at issuance. The repayment of principal at the bond’s maturity date adds additional complexity, but does not alter this inverse dynamic.


\textsuperscript{32} See Id.

\textsuperscript{33} See Warner, supra note 27.
skeptical view of Quantitative Easing has meaningful political backing internationally. Therefore, while Quantitative Easing does not have legal limitations, per se, there is enough suspicion of the practice that its scope seems practically limited. For instance, England, an EU Member State with an autonomous central bank, employed Quantitative Easing in response to the domestic recession that followed the Credit Crisis, yet the Bank of England stopped the program short of its desired stimulative goal. Opposition, both inside and outside the bank, expressed skepticism of the bond-buying program. Many criticized the uneven benefits conferred by Quantitative Easing; while the practice does much to support prices in the capital markets, boosting the wealth of those who are substantially invested therein (that is to say, very wealthy individuals and institutions), its effect of lowering interest rates poses a problem for those who planned to survive upon the limited income generated by their savings (for instance, middle-class retirees). This divergence of benefit amongst economic classes is a key political challenge of Quantitative Easing wherever it occurs around the globe; in a democracy, will the majority tolerate monetary policy that putatively strengthens the economy, but patently helps the wealthiest at the expense of certain others? This conflict inherent in a monetary policy that bids up asset prices and drives down yields is perhaps at its worst in the European Union, where the tug-of-war extends not just across socio-economic classes, but also national boundaries.

II. The Curious Case of the Eurozone

The Eurozone bears the awkward combination of a unified monetary policy yet largely independent fiscal policies amongst its constituent states (Euro States). While the European Central Bank (ECB) singularly dictates monetary policy for Euro States—controlling the money supply, fixing interest rates, and, of late, purchasing government bonds—each of these sovereigns was essentially independent in its domestic decisions regarding how and how much to tax and spend. Logically, this was a necessary step along the path to closer integration; at the outset of the Euro, it would have been unreasonable for a more productive, surplus nation to make choices on spending and taxation that were uniform with a less productive, debtor nation. Beyond just cultural and economic asymmetry, this monetary-fiscal compromise reflected a discomfort many expressed in unnecessarily ceding localized authority to a central entity. The goal, it seems, was for Euro States to enjoy the financial benefits of uniformity and efficiency while protecting

35. See, e.g., BoE Stops QE, supra note 26.
36. Id.
38. To wit, the ECB may undertake bond purchases of a given country’s sovereign debt, but such a decision by the ECB would leave other countries of the European Union on the hook for prospective losses associated with such purchasing.
40. See Id.
41. BAGUS, supra note 3, at 1-10.
important aspects of state sovereignty. In the beginning decade of the Eurozone, this goal seemed satisfied, by and large; Euro States essentially managed their own fiscal affairs while the Euro—commonly used among them and managed by the ECB—saw a meaningful long-run appreciation against the U.S. Dollar.42

A. There is No Such Thing as a Free Lunch

The Credit Crisis rendered many Euro States unhappy partners. The outsized debts accrued by many of these countries during the recession made painfully evident that which they had traded away in exchange for common-currency efficiency, the right to control their own currency.43 Whereas almost every country on the planet retained this control through a central bank44—from some of the poorest to the richest—Euro States had effectively abdicated this role to the ECB.45 Thus, as clouds darkened overhead in the market for sovereign debt, these troubled Euro states had a relatively constrained set of policy options: dramatically slash the budget, or seek intergovernmental funding. Initially, the IMF did come to the rescue.46 But when the IMF’s lending criteria were chronically left unfulfilled, the prospect of the IMF’s withholding future loans and subsequent default by the borrowing nation loomed large. The market price of outstanding debts of these Euro States plummeted, causing interest rates to skyrocket, and circumstances grew worse still. On the other side of the table, the healthier economies of Europe found themselves stuck; they had no legal authority to impose fiscal controls on their fellow members, and yet the prospect of default and disassociation of an insolvent nation from the Euro would entail panic in the market and potentially catastrophic financial losses that could plunge the world back into chaos.47 In sum, the strong and the weak of Europe were locked in a sort of unworkable marriage. The healthier states could not effectively disassociate from the disastrous economic circumstances of their partners, while the weak could not simply print money (without the consent of the ECB) to pay down or simply inflate away their debts.

This quagmire cast new attention on the need for legal reform in the sovereign debt market. Searching for a solution to a crisis that was quickly gathering steam, policymakers and bureaucrats from across the world turned their attention to the issue that had long been languishing in academia. The relevant parties, representing wildly different constituent interests, undertook to find a permanent, unified legal reformation to solve the sovereign debt problem, while at the same time warding off the imminent threat of financial collapse.48

43. Soft Centre, supra note 39.
45. See Soft Centre, supra note 39.
47. See Thompson, supra note 6.
B. The Legal Landscape

Bankruptcy and related legal structures differ widely between nations. An individual debtor in arrears may find himself subject to relatively harsh or lenient treatment, depending on the country in which he finds himself. In some countries, for instance the United Arab Emirates, a non-paying debtor is potentially subject to criminal charges and a prison sentence. On the other hand, a debtor in the United States may potentially default and yet maintain millions of dollars of assets. Despite this large variance in treatment, developed nations are consistent insofar as they each have some pre-established manner of dealing with instances of domestic bankruptcy. These legal mechanisms diminish uncertainty and bring about greater economic efficiency; lenders, armed with this information, are better able to assess risk and in turn lend at lower rates to borrowers in need of financing. Lenders will either receive interest payments and an eventual repayment of principal or they will seek out legal redress for that which is owed to them through bankruptcy or a related process. Either way, there is some manner of clear path ahead. Intuitively, what underpins these systems of law for debtors is a state’s monopoly of power and authority over its own citizens.

The international network of debtor and creditor nations operates in stark contrast to the above. Rather than disputes being governed under consistent rule of law, each of the many sovereign defaults in history seems to have its own unique story. Such examples have shown that at times the more pertinent matter is not the size of debts and credits but rather the size of armies. It is the victor in war who may coerce reparations. It is the larger country that may compel repayment of debts owed by a smaller country. Because there is no monopoly of power between states, there is no reliable structure to sovereign insolvency. In a way, it is quite similar to the Wild West; the existence of legal rights and protections does not by any means imply their enforcement. This is less the case in recent history than in the time of empires, and sovereign defaults today are quite unlikely to end in war. But through debt repudiation or hyperinflation, countries can still exercise their intrinsic rights of sovereignty, much to the displeasure of creditors. Despite this chaotic history of international financial affairs, the Euro States set out in 1993 to bind themselves


51. It is intuitive that investor uncertainty diminishes investment activity; investors deploy capital in order to earn a profit from expected future activity. Uncertainty (from an unstable legal regime, for example) will cloud the expected outcome, making investors less likely to take such action.


53. _Id._

54. _Id._
together with a series of treaties and amendments that, for better or worse, would place them under one common currency.55

C. A Superficial Discipline

The Treaty on European Union (TEU or Maastricht Treaty) was the seminal document in creating the Euro currency and the Eurozone.56 It is the foundation for subsequent reform and provides the context in which they must be analyzed.

On its face, the TEU holds out terms that require serious fiscal discipline; criteria for admission to the Eurozone, known as the Euro Convergence Criteria, ostensibly place conservative fiscal benchmarks upon applicant countries.57 Limits were set on an applicant country’s allowable deficits, debt, and other key economic metrics.58 As a complement to these admission criteria, the Stability and Growth Pact (SGP) was signed in 1997.59 These additional terms stipulated that a country, once admitted into the Eurozone, must either demonstrate ongoing compliance with these fiscal criteria or face the prospect of economic sanctions.60 One may rightly wonder about the logic of a legal structure set to impose fines upon a country struggling to regain its financial footing.

From the terms of the Euro Convergence Criteria, it is reasonable to infer that the drafters sensed the danger of a single fiscal renegade within their monetary union. Any implacable insolvency of one Euro State would require either some manner of indefinite sovereign welfare or otherwise a disassociation from the Euro by that country. Neither option appeals.

Unfortunately, the fiscal reality among the Euro States wasted no time in betraying the conservatism “mandated” in the Convergence Criteria and the SGP terms, setting the Eurozone upon its troubled course from the very beginning.61 Numerous Euro States failed to meet the Convergence Criteria upon admission, and yet more failed to live up to the terms of the SGP after entry into the Eurozone.62 Even Germany, considered a financial exemplar within the Eurozone, failed to adhere to the terms to which it had assented in writing.63 The frequent breach of treaty terms evinced the obvious flaw of the SGP legal structure. The countries were basically designed to punish themselves in order to maintain financial discipline.64 It is therefore less than shocking that corners were cut. Further still, the balance of power between larger, more politically influential Euro States and smaller Euro States rendered the measures of the SGP essentially meaningless. The powerful states would not sanction themselves, nor would the weak seek to punish the powerful, and perhaps for fear of hypocrisy, the most discipline ever meted out under the

56. Id.
57. See Bagus, supra note 3, at 30-33.
58. Id.
59. Id.
60. Id.
61. Id.
63. See Bagus, supra note 3, at 30-33.
64. Id.
SGP—even to the smaller states—culminated in nothing more than saber rattling. In parallel, countries seeking admission to the Eurozone skirted the Convergence Criteria by obscuring their financial position with accounting tricks. Italy was allowed to adopt the Euro despite clear evidence, known by the relevant parties at the time of admission, that the country was not within the bounds of acceptable debt-to-GDP as required by the Convergence Criteria. Subsequent investigation suggests that political considerations, rather than economic diligence, cleared Italy’s path to the Eurozone. These first exceptions begat yet bigger ones, as newcomers could argue precedence as a waiver for their own financial disorder. By the time of Greece’s admission to the Eurozone, the superficiality of the SGP’s written fiscal constraints on the Euro States was plainly obvious. And even though crises often succeed recklessness, the absence of any legal mechanism within the European Union to triage such a problem seemed to persist without much protest.

For a time, the capital market’s appetite for sovereign debt gave Euro States the only pretense needed to ignore one another’s fiscal disorder. Because there was no prayer from debtor nations for intergovernmental relief, there was no imposition upon the strong from the weak. Hence, there was no meaningful catalyst to convert the latent problem of snowballing sovereign debt into the headline-grabbing emergency it would soon become. As late as 2005, the Eurozone, led by Germany and France, undertook to liberalize the SGP criteria so that the terms would better accommodate the looser economic reality. But when the Credit Crisis set in across the globe, it exposed the tenuous nature of obtaining financing in the private market. Weaker Euro States—typified by Greece—rang the alarm bell. This time, the whole world took notice. In short order, it was not just Greece, but Ireland, Portugal, Italy, Spain, and others that began to see rising interest service costs and threatened solvency, as private lenders tightened the financing spigot.

III. A Bailout to Save the Eurozone

The European Union acted quickly in order to stem the danger of Greek default and the contagious effect that this prospect bore on similarly situated Euro States. In tandem with the IMF, the Eurozone agreed in 2010 to provide emergency lending to Greece in the form of a three-year, 110 billion Euro loan in order to stave the prospect of the country’s default. In return, Greece promised to reform its fiscal policy, imposing measures of austerity intended to improve its budget projections. Within days, massive anti-austerity protests shook Greece. Greeks took to the streets in thousands. Several Greek citi-
zens were killed in the riots, and buildings were set on fire. This rioting was a harbinger of sorts, not just for Greece, but for any debtor nation subject to such imposed austerity. The looming threat was (and remains) that an otherwise viable course of reform could suddenly be voided from the inside out, should a democratic country’s constituents decide to elect new government with a mandate of noncompliance. Interestingly, while the riots in Greece evinced great outrage over the terms of austerity, there were seemingly no riots in the street about the possible illegality of such a bailout under the governing EU treaties.

The treaty language that served as the purported legal basis for this initial Greek bailout exposes the chasm between the problem at hand and any potential legal solution. Originally, the 1957 Treaty Establishing the European Community (EEC or Rome Treaty) did not even contain the term “financial assistance” under any of its articles. Only after the Euro had been launched amidst the dubious fiscal circumstances of its constituents did the EEC (as amended by the Treaty of Nice in 2001) adopt the following language: “where a Member State is in difficulties . . . caused by natural disasters or exceptional occurrences beyond its control, the Council, acting by a qualified majority on a proposal from the Commission, may grant, under certain conditions, Community financial assistance to the Member State concerned” (emphasis added). In yet another display of the growing political constraints to reform, the unanimous assent required to ratify the terms of the Treaty of Nice was not initially attained. Ireland rejected the treaty by referendum, a procedure required by the Irish Constitution. Only after additional political wrangling was unanimity within the Eurozone secured. Later, the European Union again revised the terms, removing the “qualified majority” requirement as a condition for providing such “financial assistance.” Instead, such authority was left solely to “the Council, on a proposal from the Commission” to determine whether financial assistance would be provided. But critically, the language stipulating that the cause of such “difficulty” must be “beyond [the assisted country’s] control” remained in the body of what was at that time Article 100 of the EEC. Many supporters of the bailout indicated that there was enough ambiguity in the legal terms of this article to survive a legal challenge. Others argued that the plain meaning of the language precluded such an action. While little doubt existed that

74. Id.  
75. Id.  
80. Twenty-sixth Amendment of the Constitution Act 2002 (Irl.).  
82. Id.  
83. Id.  
85. Id.
Greece was indeed in a difficult spot, many expressed skepticism that the problem was derived from “exceptional occurrences beyond its control.”86 To the contrary, many believed that Greece had sealed its own fate with a feckless, corrupt tax regime and anti-competitive policies that expanded the welfare state at the expense of the country’s own financial health87—policy choices that were all directed by the Greek government. Under this thinking, it would be quite a stretch to contend that this Greek bailout complied with the foregoing terms of the presently named Treaty on the Functioning of the European Union (TFEU) (previously the EEC and renamed as part of the highly controversial Lisbon Treaty).88

The TFEU contained the following provision in Article 125, informally dubbed the “No Bailout” provision, that seemed to clarify further the notion that treaty law prohibited the sort of bailout provided to Greece: “the Union shall not be liable for or assume the commitments . . . or public undertakings of any Member State. . . . A Member State shall not be liable for or assume the commitments . . . or public undertakings of another Member State.”89 Again, supporters of the bailout could point to the fact that, under the terms of the bailout, the European Union was not technically liable for Greece’s debt, nor was it assuming any of Greece’s obligations; the Union was, technically speaking, making an investment in Greece.

Eventually, the principal legal challenge to the bailout—taken up by several prominent German academics—failed in Germany’s Federal Constitutional Court.90 In essence, the treaty language seemed to be toothless—not unenforceable, but simply unenforced. Willingness on the part of the relevant Eurozone authorities to side-step this legal concern arguably signaled a preference toward expediency over the law that could be portrayed in parallel to the Euro States’ failure to adhere to the Convergence Criteria and SGP terms—the same sort of avoidance of the law that permitted the fiscal misbehavior within the Eurozone that brought about this very crisis.

Immediately after the bailout, it seemed possible that neither legal restraints under the EU treaties nor upheaval from domestic political backlash would stop the bailout plan designed to alleviate the sovereign debt crisis in the Eurozone. If the EU-IMF loan were to be successful in its goal of helping Greece attain a sustainable fiscal path, then the problem would be solved. Unfortunately, though Greece had the legal and political necessities in hand, its economic reality continued to slip away from the fiscal benchmarks that could predicate a deal for reform.91
A. Extend and Pretend

Even after the aid package provided to Greece in 2010, the country’s financial health continued to deteriorate. Even by 2011, the budget assumptions that underpinned the path to Greece’s economic viability (and therefore renewed ability to access the capital markets) were eviscerated. Austerity remained deeply unpopular politically, and further fiscal tightening on the part of the borrower threatened two dangerous prospects: (1) that the contraction in government spending would fuel the borrowing country’s recession and further depress tax revenue; and (2) that the citizens of that country—sufficiently discontented with austerity—would take the aforementioned political action to reject the terms, forcing a default and painful disassociation from the Euro. Many began to consider the possibility that any future decision to lend to Greece might ultimately amount to nothing more than throwing good money after bad. After all, these Euro loans are obliged to be repaid by Greece in Euros. If Greece could not close its budget deficit, no surplus could ever exist from which the country could repay the debt.

Important voices within the European Union—including British officials—expressed disapproval and hesitance to extend additional credit to Greece on nothing more than a hollow notion of long-run solvency (a cleverly nicknamed practice by the financial community: “extend and pretend”). Political pressure continued to build within Greece, as well, and new anti-austerity political forces began to take shape. Neither the creditors nor the debtor seemed content with a bailout package that wasn’t solving the problem. But still few key parties viewed the alternative—Greece’s default and disassociation—as a viable option.

B. A Bailout to Save the Bailout

While a solution to the long-term problem remained elusive, Greece’s immediate failure to meet budget projections forced a response to the near-term exigency. Greece was again running short of money and time—failure to take immediate, effective action implied default. In response, the Troika (the informal name given to the committee consisting of the IMF, the ECB, and the European Commission) organized a second bailout package to be delivered in 2012. This time, in addition to more money, extended dura-

92. Id.
93. Id.
99. See Neuger & Sterns, supra note 94.
100. Id.
tion for repayment, and a lowering of interest rates attached to much of the debt, the Troika coordinated a large, one-time debt-reduction by convincing many institutional holders of Greek debt— principally various European banks—to accept a “write down,” a reduction in the principal owed on Greece’s sovereign bonds held by the banks.\footnote{101} This was the first meaningful step in the direction of an orderly restructuring of Greek debt in total—a procedure fraught with legal and political difficulty, yet championed by many experts as the only means to resolve the Eurozone sovereign debt crisis.\footnote{102} In return for all of the assistance from abroad, Greece agreed to implement further austerity by tightening its fiscal policy, both in the near-term and in the form of long-term obligations previously taken on by the state.\footnote{103} Tens of thousands of Greeks again filled the streets in protest.\footnote{104} The riots could be seen as an emotional manifestation of the growing political intent within Greece to cast off the terms of austerity. In parallel, the Greek Parliament faced some political opposition in the austerity vote tied to this second bailout, and the measure passed with 199 votes to 74.\footnote{105} Again required to take legislative action on austerity in late 2012, the parliament found its pro-bailout coalition dwindling, with only 153 votes to 128 affirming implementation of the austerity conditions necessary to hold everything together.\footnote{106} Thus the Troika and Greece faced not just legal questions of their present and past actions, but also an eroding political landscape foreshadowing new, reactive legal impediments to future steps forward in this unpopular bailout-for-austerity program.

Opponents were again quick to criticize the second bailout package as simply throwing good money after bad.\footnote{107} To be sure, Greece’s projected budget under the bailout, while better than without the bailout, was still a long-term mess without a clear manner of resolution.\footnote{108} Yet the second bailout package— particularly in its consummation of the largest sovereign debt write-down in history, eliminating more than 100 billion Euros off of the total debt owed by Greece—shined hope on a situation many considered lost.\footnote{109} Officials grappling with the problem of Greece’s debt load demonstrated that this powerful measure—viewed by many as critical in solving the long-term crisis—could, in fact, be achieved. Given its importance, the legal underpinnings of this principal write-down, how

\footnote{103. See Ben Rooney, Greek Parliament Approves Austerity Package, CNN MONEY (Feb. 12, 2012, 8:13 PM), http://money.cnn.com/2012/02/10/markets/greece_vote/index.htm.}
\footnote{104. Id.}
\footnote{108. Id.}
\footnote{109. See Stevis, supra note 101.}
it was achieved, and whether it may be useful in the future, merit analysis in light of the massive problem that still remains.

C. GETTING TO THE WRITE-DOWN

The debtor-creditor relationships created in the sovereign debt market are quite complex. Consider, for comparison, a local bank issuing a mortgage to a home purchaser. If the borrower fails to pay under the terms of the mortgage, the lender will seize the home—there is a straightforward relationship not just between the single debtor and the single creditor in this instance, but also between the borrowed money and the financed asset. On the other hand, sovereigns typically execute bonds, one ad hoc issuance after another, each having its own terms and covenants. Though ownership of these debts may begin in the hands of a limited number of large multinational banks, they ultimately may find themselves held in varied increments by those who acquire such a stake in the secondary market. Where a mortgagee can negotiate across the table from a homeowner in arrears, it is a logistical impossibility to suppose that a sovereign such as Greece, in its complex democratic representation, would be able to negotiate with each of the countless holders of its debt, including individuals and entities from all over the world, in order to find unanimity in reforming the terms of the bonds for all parties involved in an organized debt restructuring. A sovereign may come to mutually agreeable terms with even a majority of holders of its extant debt, yet intransigence on the part of residual bondholders representing the minority (i.e. those who do not accede to the terms of the contract reformation) may block any change to the bond terms whatsoever. For an entity under severe financial strain and loaded with debt, creditors have at least some logical incentive to accede to reformation; if the burden of interest service costs is so high as to suggest that the entity will eventually be forced into default, a creditor will perhaps seek to renegotiate terms on the bonds in order to extract all possible value from the debtor without the legal costs and delays associated with a default and bankruptcy (or related) proceedings. But in the instance of an acceding majority and a refusing minority, the majority will be far less likely to reform its own terms, knowing that the resultant incremental benefit from debt forgiveness will flow to the minority (that still stands to be paid in full on the unrevised terms of the bonds) at the sake of the write-down taken by the majority.

D. THE CAC PROVISION

With this dynamic in mind, it is critical to the goal of achieving a write-down that there be included in a bond’s contractual terms a specific provision allowing a qualifying plurality of bondholders to enforce the renegotiated terms of the bond upon all holders of the entire extant bond issue. This would create a sort of legal fiction: unanimity where none exists. This legal mechanism, referred to as a Collective Action Clause (CAC), can force the hand of an intransient group of bondholders, thereby circumventing the aforementioned problems.

tioned majority-minority problem that can stall efforts toward such reform. Interestingly, at the time of Greece’s 2012 debt restructuring, the bonds subject to the write-down contained no such CAC provisions in their original indentures, yet the eventually negotiated write-down did not achieve unanimous consent amongst the bondholders. A further irony, Greece’s bonds that actually included a CAC provision (a small fraction of Greece’s debt) were not ultimately subjected to a principal write-down in the large restructuring coincident with the second bailout. This baffling contradiction in the case of Greece’s debt restructuring is explained by the extraordinary influence that a sovereign bond’s legal jurisdiction can have on the financial outcome for creditors, perhaps even more weighty than the contractual terms printed on the face of the bond indenture.

E. The Choice of Law Distinction

Historically, issuers of sovereign debt in less developed countries often issued their bonds under foreign law, principally that of England or the United States, as a means to entice the private markets to purchase the debt. The rationale for this was intuitive; bonds governed by the law of less developed countries—typically with less stable political environments—would fail to inspire as much investor confidence that the terms as written in the bond indenture would actually be enforced, as compared to bond terms subject to enforcement under the laws of a more developed, stable nation. These latter bonds are called foreign-law bonds, as opposed to domestic-law bonds (i.e. those bonds that are subject to the judicial authority of the country from which they’re issued). Thus, a business entity or a government that borrows by issuing bonds with foreign choice-of-law may theoretically be subject to an adverse judgment from a foreign court for actions that, as adjudged by a domestic court, are without fault. In contrast, the domestic judiciary would have sole authority to mete out the resolution to disputes involving domestic-law bonds. There is no reason for an investor to expect, ex ante, a breach of a bond contract, let alone a breach that would result in two drastically different legal outcomes in two sovereign jurisdictions. As such, domestic and foreign-law bonds have a recent history (in the years prior to the Credit Crisis) of only a “small . . . but discernible” distinction in investor demand, as reflected by closely mirroring prices and yields between the two.

---

113. Id.
After all, an insolvent business entity or individual would expect no Deus Ex Machina in the form of legislative action absolving that entity of its debt obligations, irrespective of whether disputes over that entity’s bonds were justiciable at home or abroad. But where there may be little or no alignment of interests between a sovereign government’s legislature and a constituent business entity or individual, a sovereign nation possesses an enticing means of solving its own financial problems through legislative action on its own behalf. Herein lies the key distinction in an instance of sovereign insolvency; if a bankrupt country owes debts governed by its own law, what’s to stop that country from simply changing the law in order to manufacture a legal solution to its financial problems? It is not entirely clear, but the answer, it seems, is probably not much. In the case of Greece’s record-setting debt restructuring, this dynamic was no less than integral in achieving a more favorable outcome for Greece than would have otherwise been possible.

As mentioned above, the vast majority of Greece’s extant debt at the time of the restructuring existed in the form of domestic-law bonds, while approximately one-tenth of the extant debt was governed by foreign law, principally that of England. Moreover, this domestic-law majority—totaling at the time of restructuring in excess of 200 billion Euros—was subject to contract terms that contained no CAC provision at all. Therefore, under the terms of these bonds, Greece would have had to secure consent from every such bondholder in order to affect the complete restructuring in the manner it was eventually achieved. Any holdouts to the write-down of these domestic law bonds would not only directly diminish the overall quantity of debt reduction, but also (and perhaps more importantly) indirectly threaten the accession of other bondholders by way of the aforementioned majority-minority dilemma.

**F. Rewriting the Rules**

On February 23, 2012, the Greek Parliament built a legal bridge to reach a broad-based write-down when the legislature passed a law that became known as the Greek Bondholder Act. Among other provisions, one key feature of this law was to install a statutory CAC mechanism on Greece’s domestic-law bonds. Somewhat controversially, these terms were also retrofitted to bonds issued before the law was drafted, in essence changing the terms of the deal with investors after the deal was made. The question has been raised whether such a retroactive application of a CAC provision to force the hand of a withholding creditor minority into a restructuring may amount to some manner of ex-

---

120. See id. at 3.
121. See generally Boudreau, supra note 112.
124. Greek Government’s Official Terms, supra note 122.
125. See id.
126. See id.
127. See id.
propriation, and if so, whether it could predicate a successful cause of action brought in a foreign jurisdiction against Greece.\textsuperscript{128} To date, however, the question seems mainly academic, and Greece appears the beneficiary of the conventional wisdom that it is easier to obtain forgiveness than permission. The CAC alteration was quite material, indeed. Where, before the Greek Bondholder Act, even an acute minority consisting of one bondholder could hold out to a proposed restructuring, the terms of the Act turned this dynamic on its head; now as few as roughly one-third of bondholders were theoretically required to approve restructuring terms that would then bind the remaining bondholders.\textsuperscript{129} With a wave of the legislative wand, Greece not only changed the rules of the financial negotiations, but also showed its creditors that it could punish any future inflexibility with unpleasant legislative reform. By March 2012 an excess of the requisite portion of domestic-law bondholders (including only private entities) had approved the restructuring terms, and the largest sovereign debt restructuring in history became one of the many provisions of the second bailout.\textsuperscript{130}

IV. Barely Treading Water

Though the second bailout did forestall an immediate unraveling in Greece and the Eurozone, it did not achieve a solution to the intractable issue of sovereign insolvency.\textsuperscript{131} Experts expressed skepticism that the additional lending conferred no benefit, save time, with one bank executive bluntly noting that the bailout “doesn’t do anything to put Greece on a sustainable path.”\textsuperscript{132} The private markets reflected this same sentiment, as within weeks of the bailout Greece’s debt again tumbled in price to such a discount as to imply the expectation of yet another (i.e. third) bailout at some point in the future.\textsuperscript{133} Many financial experts felt that the write-down had not been substantial enough.\textsuperscript{134} To wit, the bailout with the largest write-down in history still left Greece with a projected debt burden well in excess of its annual Gross Domestic Product (GDP), even as far out as a decade into the future.\textsuperscript{135} A ratio of total debt to annual GDP in excess of one is often cited as the breaking point for insolvency, wherein a lack of investor confidence from the

\begin{footnotesize}
\begin{enumerate}[\textsuperscript{128}]
\item Among the various hurdles for such a legal claim would be not just satisfaction of the standard of expropriation, but also potentially defense related to sovereign immunity. See generally Boudreau, supra note 112.
\item This is measured by voting based upon face value of the holders’ total debt, where only half is needed to form a quorum, and only two-thirds of that quorum is needed to approve the restructuring terms. See Greek Government’s Official Terms, supra note 122.
\item See Glover & Chassany, supra note 118.
\item Id.
\item Id.
\item Id. (noting the words of Anders Aslund, a senior fellow at the Peterson Institute for International Economics: “[I]f you do a default, make it big enough”).
\item Id.
\end{enumerate}
\end{footnotesize}
private markets requires some manner of bailout from public entities (i.e. official entities) to avert default.\textsuperscript{136}

A. THE ECONOMIC PICTURE, DARKER STILL

Ironically, total Greek sovereign debt actually increased during 2012, the same year in which approximately 120 billion Euros worth of such debt was forgiven.\textsuperscript{137} There were many contributing factors to this increase in debt, but one notable feature of the restructuring certainly didn’t help; only private creditors were subjected to the write-down, even though much of Greece’s public debts were and are today held by public entities, including other sovereign governments and intergovernmental organizations (principally those of the Troika).\textsuperscript{138} The lack of participation from such public creditors was no mere oversight; while political opposition to austerity was slowly building within Greece, political opposition to these bailouts was also gathering steam abroad.\textsuperscript{139} With Greece showing no clear path to financial self-sufficiency, the notion that these other nations would then start forgiving loans to Greece—in effect creating an international mechanism for wealth transfer—would be deeply unpopular politically and likely untenable in the long term.\textsuperscript{140} Evidence suggests that such an act of debt forgiveness may simply be impossible because it would be deemed to violate EU treaty terms or sovereign law within Eurozone countries.\textsuperscript{141} In essence, the parties attempting to engineer a solution to this crisis were made powerless, stuck between the required enormity of any successful financial intervention and the constraints, both legal and political, to achieving such an intervention.\textsuperscript{142} The problem writ large was captured well in the following excerpt from an editorial from the Financial Times: “by agreeing [to] an aid package that they know [isn’t] sufficient, the [E]urozone. . . is true to form. . . its approach has been a halfway house of resisting a sovereign default but not doing enough to remove the risk altogether. . . core governments find it politically impossible to put up more money.”\textsuperscript{143}

B. LOSING FLEXIBILITY

On paper, the second bailout included mechanisms that increased flexibility for Greece and the international parties seeking to stem the crisis. But in reality, these reforms

\textsuperscript{137} See id. at 3, 14.
\textsuperscript{140} See, e.g., Taylor, supra note 138.
\textsuperscript{141} A German court opinion, issued at the bequest of the German government, intimated that credit losses stemming from Greek loans would be a violation of Article 125 of the TFEU, as well as German budgetary law. See id.
\textsuperscript{142} See Editorial, Greek Rescue is Still a Halfway House, FIN. TIMES (Feb. 21, 2012, 7:32 PM), http://www.ft.com/cms/s/0/2f16a2b2-5e8a-11e1-9116-00144feabdc0.html#axzz2LkbWoE8Z.
\textsuperscript{143} Id.
brought about a certain unfortunate irony. During 2012, holdings of Greece’s sovereign debt by private entities decreased, as many of these obligations were diminished through the restructuring write-down, but debt held by other sovereign governments and international organizations increased in light of the new bailout lending along with zero offsetting write-downs of outstanding debt held by these same public entities.\textsuperscript{144} Though Greece had passed the Greek Bondholder Act in order to achieve a write-down of its untenable sovereign debt load, the entities that were increasingly Greece’s creditors after the write-down were the very entities that could not (or perhaps would not) participate in such a write-down.\textsuperscript{145} In essence, public creditors had replaced private creditors, and the CAC provisions—the principal tool developed in the struggle to this point—were applicable only to privately-held debts.\textsuperscript{146} The legal maneuvers available were yet again a step behind the financial and political turmoil, both of which continued to pick up steam through 2012.

As anticipated by the private markets and many experts, Greece’s economic condition continued to deteriorate after the second bailout.\textsuperscript{147} Austerity programs implemented in rapid succession drove Greece into a deeper and longer recession than had been “anticipated” in budgetary projections that were clearly unrealistic in hindsight.\textsuperscript{148} The Greek economy was estimated to shrink meaningfully in 2012 and again in 2013.\textsuperscript{149} The multi-year recession cumulatively diminished Greece’s GDP by one-fifth, and thus Greece’s debt-to-GDP ratios appeared again to be entirely unsustainable.\textsuperscript{150} The bailout-for-austerity mechanism was not only failing to drive this critical debt-to-GDP ratio to a level that would imply sustainability for Greece, it was also motivating political developments that threatened to reject the mechanism outright.\textsuperscript{151}

C. POLITICAL UPRISING

By mid to late 2012, the bailout-for-austerity program, which had survived as the primary tool in the debt crisis despite its questionable legal footing, faced a formidable legal threat in the form of the democratic processes within the participating countries of the lenders and debtors alike.\textsuperscript{152} In advance of the May 2012 parliamentary elections in Greece, for example, the two leading parties in the polls, New Democracy (ND) and Coalition of the Radical Left – Unitary Social Movement (SYRIZA), had diametrically
opposing views on the management of the sovereign debt crisis. Where ND was, in essence, a pro-bailout party that could be relied upon to cram through legislation on austerity that was needed in exchange for the release of additional international financing, SYRIZA adamantly rejected the bailout-for-austerity process and promised to “tear up” Greece’s existing bailout agreements. It was unclear by May which of the two parties would command a plurality in Greek Parliament, and the world watched in fear as Greeks went to the polls to determine, in part, the fate of the Euro. A second election in June—required due to the inconclusive nature of the preceding month’s election—gave ND a thin margin over its rival SYRIZA, 29.7 percent to 26.9 percent. Critically, Greek law provides that the party commanding a winning plurality be allotted fifty bonus seats in the 300-seat Parliament. ND was therefore allotted 129 seats to SYRIZA’s 71 seats, despite the closeness of the popular vote between the two parties. Global financial markets reacted positively to the news, seemingly ignoring the growing popularity of the anti-austerity movement and the long-run implications it may have. As mentioned previously, the austerity vote in Greek Parliament in November 2012 demonstrated a far narrower approval of the bailout program. In light of this measure’s margin of approval—just twenty-five votes—the crucial role of the fifty bonus seats, allocated in accordance with Greek law, in saving the bailout program in 2012 is clear. Despite the success in passing these austerity measures, the ruling coalition in Greece has, since that time, essentially watched the political floor collapse underneath them. More recently, SYRIZA holds a lead over ND of 4.5 percent, as reflected in polling conducted near year-end 2012. In a frightening side note, Golden Dawn, a party that aligns with SYRIZA on the issue of rejecting the bailout program but also has a virulently anti-immigrant platform, has gained immensely in popularity. Much as ND formed a coalition to reach a pro-bailout majority, an anti-bailout majority could exist in SYRIZA and Golden Dawn, should current political momentum continue. In a sense, then, Greece is a ticking time bomb; though the current government can perpetuate the bailout process, it is only a matter of time before the democratic process affirms or rejects this methodology. And if current projections hold, the prospect of an outright rejection of the bailout methodology, and thus a rapid and catastrophic disassociation from the Eurozone, is very real indeed.

153. See id.
154. See id.
155. See id.
157. See Brown, supra note 151.
158. See Greece to Hold New Elections on 17 June, supra note 156 (footnoted in the diagram of Greek Parliament at bottom).
159. See Brown, supra note 151.
160. See id.
161. See Labropoulou & Smith-Spark, supra note 106.
162. See id.
164. Id.
165. See id.
D. Contagion

The political drama in Greece in the summer of 2012 not only jolted financial markets, but also instilled a new, awakened sense of danger and urgency within the intergovernmental pro-bailout affiliates, principally the Troika. While Greece was perhaps the most immediate and advanced problem, threats existed all over the Eurozone from other countries that were drowning in their unsustainable sovereign debt obligations. Most notably, Spain and Italy were experiencing tremendous challenges in financing their debts in the private markets, and these two countries combined were roughly ten times larger than Greece, as measured by each country’s GDP. While it could be argued that the impact to the international community, especially the Eurozone, of a Greek default alone may be containable, the disassociation of larger economies such as Italy and Spain from the Eurozone would create a problem that many policymakers feared would have a catastrophic, immitigable impact. Lending in exchange for austerity, irrespective of the details, simply failed to derive the results necessary to bring the Eurozone to long-run sustainability, and nothing evidenced the acceptance of this bitter conclusion more than the controversial decision of Mario Draghi, President of the European Central Bank, to institute a conditional but indefinite bond-buying program—an international course of Quantitative Easing.

E. A Bailout By Any Other Name

In September 2012, the ECB revealed its plan to stabilize the Eurozone through an indefinite program of purchasing Eurozone countries’ sovereign debt in the secondary markets. In exchange for this support, a Eurozone country would, as a precondition, need to submit to and implement an internationally agreed-upon austerity framework and bailout package. These strict conditions could be seen as a manner of compromise meant to assuage the concerns of many within the Eurozone who viewed this financial practice as dangerous or simply wrong. One such disapproving party was Germany. Through its Bundesbank, Germany cast the sole vote against the bond-buying program amongst the ECB’s Governing Council of twenty-three members. Many officials within Germany remain quite skeptical of a monetary policy that is arguably the

167. See id.
170. See Traynor, supra note 166.
171. See id. This action would directly—and by means of investor confidence—drive down yields on the debt of the country whose bonds are being purchased, thereby lowering their financing costs and prevent a debt spiral. See Shuman, supra note 18; see also supra note 10.
172. See Traynor, supra note 166.
173. See id.
174. See id.
equivalent of money printing.\footnote{175} This is true not only because Germany, as a lender, would naturally scrutinize the financial prospects of any borrowing country as to avoid prospective losses from a non-paying debtor nation. Perhaps more importantly, Germany’s history with loose monetary policy still weighs heavily on its citizens and policymakers. In the early twentieth century, German monetary policy brought on catastrophic hyperinflation that crippled the economy and attended such social havoc as would later afford the Nazi Party its foothold.\footnote{176} (It may serve well to consider now the recent ascension of the Golden Dawn in Greece, the party symbol of which looks quite like a Swastika). Thus, the fear articulated by German officials of the ECB’s proposed bond-buying plan was that such a program would not only risk taking the Eurozone down a slippery slope toward inflationary havoc and real financial losses,\footnote{177} but also the related consequences—social, political, et cetera—could be quite unpleasant, as well.\footnote{178} Despite these legitimate long-term concerns, the plan was put into place in the second half of 2012, and financial markets immediately embraced the idea.\footnote{179} This expressed willingness of the ECB to step in as a buyer of last resort buoyed investor confidence in sovereign debt across the Eurozone.\footnote{180} Interest rates demanded in the financial markets for new borrowing across these countries dropped, and the volatility of these rates likewise diminished.\footnote{181} Without actually having to employ the new mechanism, the ECB brought a several-month period of relative calm to the debt markets through merely its announcement and creation.\footnote{182} All of this, of course, did nothing to resolve the underlying issue; a multitude of Eurozone nations went into 2013 with roughly the same quality of (or perhaps worse) economic data that brought on insolvency fears and the sovereign debt crisis in the Eurozone in the first place.\footnote{183}

V. Conclusion

Coming full circle to assess the state of the current law—the recent Fiscal Compact—and whether it is suited or potentially will be suited to the immense challenges outlined in the foregoing, these words of T.S. Eliot ring true, “and the end of our exploring will be to


\footnote{176. See id.}

\footnote{177. “Real,” as used here, is in the economic sense; a real loss can occur when inflation exceeds financial return. For example, the ECB could print money to pay off all troubled Eurozone debts, but creditors would suffer meaningful real losses as a result of the drastic increase in the money supply leading to higher inflation (i.e. depreciation of the Euro).}

\footnote{178. See id.}


\footnote{180. Id.}

\footnote{181. See id.}

\footnote{182. See id.}

arrive where we started and know the place for the first time.”

At a glance, the terms of the Compact are strict indeed. Eurozone nations must adhere to certain benchmarks of fiscal conservatism or otherwise be subject to automatic remediation measures. If the signatory nations simply were to follow the terms of the TSCG as written and ratified, the treaty would perhaps be nothing less than a “revolution... ending more than 30 years of steadily rising public debt.” But history betrays this outlandish prospect.

A monetary union consummated upon deceit, omission, and outright flaunting of treaty terms now seeks to overlay another, stricter benchmark-based fiscal union between its Member States. One may rightly wonder, haven’t I heard this tune before? The economic and political realities facing Germany and Greece (as well as important debtor nations including Italy and Spain) are entirely inconsonant with the strictures of the Fiscal Compact; at present, these debtor nations seem bent to their maximum under austerity and debt burdens. It strains credulity to imagine that implementation of the Fiscal Compact will inspire debtor nations to adhere to its terms, at least not in the foreseeable future—no more so than talking about nice weather would quicker stop the rain.

It is convenient to imagine that debt refinancing can occur indefinitely, thereby obviating the need for real reform that would bring financial sustainability to these debtor states. But that which cannot go on forever must eventually stop. And no country can expect to grow its debt at an unbounded pace for an unbounded time, even if supported by an indefinite program of Quantitative Easing. Consider the following all-too-possible scenario: what would happen if a sovereign had debt grow to be so large that the interest costs on that debt exceeded that country’s entire tax revenue? No longer would the value of collected taxes be returned to constituents in the form of government services and goods—instead, all of that value would be transferred around the world to holders of that nation’s debt. How long might constituents in a representative democracy tolerate such punishment for past mistakes?

A puttering wait-and-see agenda that leans on the ECB for indefinite bond purchases is the long road to ruin. Hope is not a strategy, and especially not when the desired outcome runs contrary to observable data trending in the opposite direction. The reality is that in Greece, and now notably in Italy, the political window for meaningful legal reform is small and shrinking fast. In many parts of Europe the recession continues to new

186. See id.
187. Id.
188. See BAGUS, supra note 3, at 30-33.
189. See Roubini, supra note 183.
190. See Eurozone Crisis Explained, supra note 147.
Effective reform, if it occurs, will likely establish an unprecedented legal standard, perhaps including colossal write-downs by public creditors, but more likely an overhaul of the administration of the Euro. Indeed, at this late hour it seems likely that the composition of Eurozone countries will have to change, one way or another. From the top down, public officials could choose to get ahead of the crisis by coordinating for a given country a timely and financially-backstopped withdrawal from the Euro—perhaps even removing one of the stronger Euro States first—to demonstrate control to the markets, build confidence, and minimize the risk of contagion and panic. Or instead, those same politicians could choose to stay the course with the Compact—hoping despite the evidence that the conventional path will turn Europe’s fate—until such time as the Eurozone may rend itself apart by the democratic processes of its Member States. It may at last be wise for policymakers to befriend the devil that they know is coming. Such reformation of the Eurozone would indeed be unprecedented. But unprecedented, as well, will be the global cataclysm if such reform fails to materialize.

---

193. See Ewing, supra note 191.
194. If, for instance, Germany’s judiciary yields to accept the view that losses on publicly held debt do not per se violate the law. But see FXTOP.COM, supra note 42.