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Developments in Financial Services Regulation: A Canadian Perspective

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In the years following the financial crisis, there has been increased scrutiny of financial institutions as economic and social actors. The crisis highlighted the dual issues of access to financial services and the structural and behavioural regulation of banks and countries have introduced various prudential, governance and access-based reforms. This article addresses eight specific issues spanning three main areas of reform. The three areas of reform are: the availability and provision of financial services; behavioural reforms designed to discourage excessive risk-taking and promote sound corporate governance practices in financial institutions; and prudential reforms designed to reduce risk in financial institutions. The eight specific issues are: (1) access to retail banking services in Canada; (2) access to short-term credit and payday lending; (3) the Equator Principles for project finance; (4) whistle-blower protection and self-regulation by audit committees; (5) corporate governance strategies for effective risk management; (6) executive compensation and say-on-pay; (7) the regulation of proprietary trading by insured depository institutions; and (8) central clearing of over-the-counter derivatives. Topics 1-3 relate to the first of the three broad areas of reform identified above; topics 4-6 relate to the second area of reform; and topics 7-8 relate to the third.

I. INTRODUCTION

An effective banking system is critical for the growth and development of a modern economy. Access to high quality and predictable financial services facilitates long-term economic planning and stability. However, leverage and credit risk also creates complex corporate governance and risk management challenges. Following the financial crisis regulators around the world introduced new prudential and governance standards designed to control risk within financial institutions and encourage sound management practices. Similarly, there has been increased scrutiny

of the role of bank and non-bank financial institutions serve as gatekeepers for accessing financial products and as social actors. Because of the prominent role of financial services in the modern economy, barriers to access can limit an individual's prosperity and ability to fully participate in society. However, the unscrupulous provision of high risk financial products can also have social and economic consequences, as seen in the United States subprime mortgage crisis.

Based on these principles of effective prudential regulation and access to financial services, this paper identifies eight contemporary issues affecting financial institutions, regulators, and consumers.

Parts II-IV of the paper focus on the availability and provision of financial services. Part II considers the access to retail banking services for low income Canadians and those in remote communities. Part III evaluates the availability and risks created by short-term consumer credit by examining the growth of payday lending institutions. Part IV assesses the reporting requirements of the Equator Principles for project finance in the developing world.

Parts V-VII address behavioural reforms designed to discourage excessive risk taking and promote sound corporate governance practices in financial institutions. Part V considers the United States' decision to award whistle-blowers a portion of any regulatory sanctions greater than $1 million and discusses its impact on the capacity of the audit committee. Part VI contrasts the corporate governance reforms developed under the United States' Dodd-Frank Act, [1] the Basel Committee on Banking Supervision's "Principles for Enhancing Corporate Governance", [2] and South Africa's King Code III [3] reforms. This comparison evaluates the strengths and weaknesses of reforms designed to enhance the capacity and autonomy of board committees and process-based reforms, which attempt to affect the means by which decisions are made and the manner in which issues are considered. Part VII examines say-on-pay legislation in the United States and United Kingdom to assess whether these votes help align the

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compensation structure of bank executives with the long-term interests of various stakeholder groups.

Parts VIII and IX examine prudential reforms designed to reduce risk in financial institutions. Part VIII considers whether the United States' "Volcker Rule", [4] banning short-term proprietary trading by insured financial institutions is an appropriate response to high-risk trading strategies and market manipulation. Part IX provides an update on the implementation of over-the-counter derivatives clearing through central clearing counterparties.

II. IMPROVING ACCESS TO RETAIL BANKING SERVICES

Access to consumer banking services is critical for sustainable economic growth and the reduction of poverty. [5] In particular, bank accounts are often pre-requisites for obtaining social security, long-term credit, accessing financial services such as mortgages, cashing cheques and paying bills without additional fees. [6] In both the developed world and developing nations, the capacity to acquire a retail bank account is widely regarded as a crucial divide in terms of social status and regional development. [7] To address this concern, Canadian law provides that consumers have the right to open a basic bank account. This section explores the issue of access to retail banking and basic credit services in Canada and throughout the developing world, by examining the effectiveness of Canada's right to open a basic bank account initiative and the availability of credit for low income individuals or individuals with limited financial history.

The consumer banking sector in Canada is dominated by the "Big-Five" banks who control over 85% of the assets in the Canadian financial system. [8] Although regional credit unions have

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been recognized for providing enhanced customer service and low-cost banking options to consumers, the high degree of concentration in the Canadian financial services market has resulted in limited price-based competition among the large banks for basic product offerings. [9] In 2003, the Government of Canada enacted the Access to Basic Banking Services Regulations, [10] which stipulate that, subject to certain identification requirements designed to prevent money laundering and terrorist financing, [11] individuals have the right to open a basic bank account irrespective of whether they are unemployed, are an undischarged bankrupt, or do not have funds to make an initial deposit. [12] Similar proposals have been explored in Europe, which is currently in the process of tabling legislation guaranteeing access to basic banking services [13] and in South Africa through its voluntary Code of Banking Practice. [14]

Despite the Access to Basic Banking Services Regulation, a significant number of low income Canadians -- many of whom are located in remote communities -- do not have access to, or choose not to access, basic banking services. [15] However, the effectiveness of measures designed to increase access to basic banking services is largely constrained by the extent to which consumers are aware of their rights. According to the former commissioner of the Financial Consumer Agency of Canada, William Knight, educat

ing marginalized Canadians about their right to open a basic deposit account is particularly challenging given the low literacy levels and language barriers that exist in these communities. [16] Since many low income Canadians do not possess the basic documentation required to open an account, the identification requirements may also create systemic barriers to access. [17] Consequently, it has proven difficult to overcome the existing divide between the banked and unbanked members of society.

Creating adequate economic and social incentives for financial institutions to provide services in remote and low income areas is one of the central challenges for overcoming these institutional barriers. This lack of incentives is compounded by Canada's geographic expanse. Thus, although Canada has one of the highest ratios of branch banks and automatic teller machines per capita in the world, it also has one of the lowest ratios per square kilometer. [18] Although expanded access to banking services in multiple languages, remote and online banking services and Aboriginal banking initiatives have started to address this concern, [19] financial literacy remains one of the most significant barriers to full participation. Given the low literacy levels in these communities, it is critical that financial institutions and regulators work with community organizations to develop long-term partnerships designed to promote enhanced financial engagement. [20] Communication strategies should be developed using plain language or alternative mediums which can be understood by persons with low literacy and those who are not fluent in one of Canada's official or First Nations' languages. [21]

Canadian financial institutions have been active in exploring methods for delivering financial services to remote communities and vulnerable segments of society. For instance, the Royal Bank of Canada has flown representatives into remote communities to assist residents in opening deposit accounts and implementing direct deposit services with employers. [22] As a result of this initiative, residents and merchants are now able to use electronic payment methods such as debit to cover day-to-day expenses, thereby reducing cash liquidity issues in this community. [23] Similarly, Scotiabank has developed an "Aboriginal Community Initiative", which partners with community leaders to promote enhanced financial literacy and develop social ties within the these communities. [24] For instance, through a partnership with the Martin Aboriginal Education Initiative and the Band Council of the Opaskwayak Cree Nation --- a remote Aboriginal community in northern Manitoba --- Scotiabank created an entrepreneurship program which assists high school students in developing the financial literacy and skills required for business ownership. [25] Through grassroots initiatives such as these, regulators, financial institutions, and community organizations can work to together to expand the overall financial literacy of the community and, over time, introduce more advanced financial products which can assist with economic development and entrepreneurship.

Basic deposit banking services are a cornerstone of a modern financial system. When individuals have access to basic banking services they are more likely and able to engage in long-term financial planning, develop enhanced financial literacy, and access more advanced financial products. Consequently, it is critical that regulators and institutions work together to ensure individuals have sufficient access to banking services. Access to basic bank services must extend beyond simply reducing legal barriers to

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access; it also requires the reduction of systemic and cultural barriers which may discourage individuals from accessing these services. Consequently, attaining these objectives will require co-operation from all segments of society including regulators, financial institutions and community organizations.

III. ACCESS TO SHORT-TERM CREDIT AND PAYDAY LENDING

Although household debt-to-income levels in the United States have decreased significantly from their high in 2008, Canadian household debt has increased substantially following the financial crisis. 26 As such, the availability and use of consumer credit and the risks associated with rising interest rates continue to pose significant challenges for the stability of Canada's financial system. 27 Tightening credit markets may force consumers to rely on alternative credit products to meet their needs. Short-term credit products such as payday loans, lines of credit, and credit cards frequently charge high interest rates. When these loans are not paid off in a timely manner, consumers can easily become trapped in mounting debt and unable to pay the increasing service costs associated with loans. 28 In response, there have been calls by consumer advocates for government to impose interest rate caps and increase the regulations surrounding these credit products. 29

The issue of consumer over-indebtedness and high-risk credit can be approached from two different perspectives. First, consumers may lack the financial literacy necessary to fully understand the risk associated with these products and as a result may be unable to manage their indebtedness. Thus, increases in consumer literacy and disclosure may represent a potential legislative solution. Secondly, because of the high interest rates charged on these loans, lenders can accept higher default rates and

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do not have a sufficient incentive to conduct a detailed assessment of the debtor's creditworthiness. Interest rate regulation would force lenders to impose more stringent lending requirements in order to ensure the profitability of these loans.

Although short-term consumer credit presents a high degree of risk for consumers who lack the education to appropriately manage these instruments, short-term credit serves a valuable role by smoothing income irregularities in income and expenditures thereby facilitating greater individual and macro-economic stability. 30 In addition, because credit cards and lines of credit often have lower lending requirements than higher value products they provide a mechanism for individuals to build their credit rating.

In many jurisdictions, payday lending has emerged as an alternative to the conventional banking system and it has quickly acquired a significant market presence. The Australian National Financial Service estimates that between 2008 and 2011, the principal value of payday loans provided each year has increased from approximately $500 million to $800 million. 31 This suggests there is significant market demand for short-term credit, which is not being met by the traditional banking system.

In Canada, payday lenders offer loans of up to half the applicant's biweekly salary to a maximum of $1,500. The principal and any accrued interest is payable in full at the end of the 14-day period. Payday lenders typically charge flat rates ranging from $17-$25 per $100 loaned. 32 Although some provinces have prohibited payday lenders from rolling over a maturing loan at the end of the period and thereby charging compound interest on the principal plus accrued interest, lenders may continue to charge interest on the principal loan following a default. 33

The high interest rates charged by payday lenders have attracted significant scrutiny and calls for regulatory reform. In 2006, the Government of Canada enacted legislation, which criminalized "usury" interest rates of 60% or more per annum. 34 However, as a
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result of an exception in the Criminal Code which permits higher interest rates when loans for less than $1,500 are provided by a provincially licensed lender and the repayment period is less than 62 days, payday lenders are able to continue to charge annual percentage rates higher than 60% on their 14-day contracts. 35

Proponents of payday lending maintain that high interest rates are necessary given the high risk of default and unsecured nature of payday loans. Assuming an average default rate of 5%, payday lenders are required to charge an annual percentage rate of 130% or $5 per $100 loaned in order to recover the principal value of a defaulting loan. Research by Mark Flannery and Katherine Samolyk into the business model for payday lending found that lenders' operating costs were approximately $8.33 per $100 loaned. Thus, under this model, to be economically viable, lenders must charge an interest rate of at least 346.6% per annum to cover the costs of default and overhead. 36 By contrast, conventional unsecured credit provided by financial institutions usually has more stringent eligibility requirements, longer periods, and higher principal amounts; thus the marginal rate of return on each loan tends to be greater and the interest rates lower. 37

However, advocates of stringent regulation of consumer credit, such as United States Senator Elizabeth Warren support direct government intervention including the creation of a financial products oversight body, which would establish standards and evaluate the "safety" of financial products marketed to a retail audience --- similar to the physical product safety review required for other consumer products. 38 Warren argues that the risks and terms of financial products should be disclosed in a manner that can be easily understood by the target audience. 39 Although complex and tightly worded contracts may be legally sound, they are of limited social utility if purchasers are unable to easily identify their rights, responsibilities, and liabilities under the contract. Despite the difficulties inherent in reading these contracts, lenders may be hesitant to use a less technical version
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given the emergence of payday lender class actions. 40 Consequently, a balance must be established between the need for legally complete agreements and readability for the average consumer.

Canada has been reluctant to aggressively regulate interest rates charged by payday lenders. Instead regulators introduced licensing requirements, enhanced disclosure standards and developed consumer education initiatives, which encourage individuals to consider other credit products with lower annual percentage rates, such as credit cards, lines of credit, and bank account overdrafts where available. 41 These educational programs utilize a combination of print and video media, which highlight how payday loans differ from other credit products and outline the debtor's rights on default. 42 However, in order for these education initiatives to be effective, it is critical that they are presented to consumers in a manner and in locations where it may influence their decision to apply for a payday loan. 43 In addition, payday lenders must be licensed by the province in which they operate and are liable for regulatory sanctions if they are found not to have complied with the governing legislation. 44

Where properly regulated, payday lending can fill a market void for individuals with poor or insufficient credit history. Although some of the larger financial institutions have experimented with various small principal lending programs such as microcredit in the developing world, similar lending initiatives have not been introduced domestically. 45 This may suggest that there are not

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adequate returns in this lending market to justify intervention by the larger financial institutions. As a result, the provision of microcredit and other non-conventional credit products continue to be confined to smaller credit unions and community organizations. 46

Similar to retail banking service, access to credit is important for individuals to fully participate in modern society. However, as financial institutions become more conservative in their lending practices, low income consumers are increasingly forced to rely on payday lenders for short-term, small-value credit. Because of the high default rates and low margins on payday loans, increased regulation of interest rates may limit the viability of payday lending as a business. Consequently, any decision on whether to regulate the interest rates charged by payday lenders will depend on society's opinion on the appropriate balance between the right of high-risk debtors to access credit, the short-term liquidity appropriate for their default risk and the appropriate role for consumer protection standards designed to prevent these individuals from becoming entrapped in debt. 47

IV. THE EQUATOR PRINCIPLES FOR PROJECT FINANCE

As society has become increasingly attentive to the impact of the extractive industries on the communities in which they operate, there has been greater focus on the relationship between project finance and sustainable development. In response, a consortium of nine of the world's largest financial institutions developed the Equator Principles. The Equator Principles are a set of 10 corporate governance and project finance due diligence guidelines, designed to improve and harmonize the environmental and social risk management practices of these institutions. 48

As of May, 2012, the number of Equator Principles financial institutions has grown to 77 around the world. 49 In addition, the

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Equator Principles financial institutions recently released a draft of the third edition of the Equator Principles, which covers a broader range of financing agreements and introduces new requirements relating to climate change and the United Nations' "Protect, Respect and Remedy" Framework for Business and Human Rights. 50

The cornerstone of the Equator Principles framework is Principle 10 --- Reporting. Requiring financial institutions to disclose details of their project finance initiatives will assist outside actors in monitoring compliance and making recommendations for future reform. However, the lack of consistency in the reporting practices of the Equator Principles Financial Institutions significantly limits the utility of this information.

The Equator Principles require member institutions to assess and categorize all loans greater than $10 million based on the magnitude and likelihood of adverse social impacts and develop an action plan to mitigate the impacts of the project with significant or demonstrable environmental or social costs. When a project with significant or demonstrable environmental or social costs is conducted in a non-high income Organisation for Economic Co-operation and Development (OECD) country or non-OECD country, the financier is required to disclose details of the project and consult with affected communities in a structured and culturally appropriate manner. Equator

Principles financial institutions are then required to retain independent experts to review their project finance assessments, include covenants in their finance agreements obligating borrowers to comply with the financier's social and environmental risk-mitigation strategy, and retain independent experts to monitor their compliance.

Critics suggest the Equator Principles may constitute "green-washing" by member institutions and have had a limited impact on sustainable development. 51 Rather, the principles simply require institutions to disclose pre-existing due diligence. In particular, banks have traditionally conducted detailed analysis of the

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solvency, political, social and environmental risks associated with project finance subject to the Equator Principles because these projects are structured through operating companies, which provide creditors with limited recourse against the parent corporation. Thus, critics suggest the Equator Principles have not had the effect of forcing the member institutions to modify their behaviour. 52 However, proponents contend that, despite the voluntary character of the Equator Principles and the shortcomings in current reporting practices, these requirements have increased the accountability and transparency of project finance. 53 Moreover, as a universal set of project finance guidelines, the Equator Principles have the potential to prevent a race to the bottom and will lessen the regulatory burden for the host state. 54

Ultimately the efficacy of the Equator Principles will be contingent on the ability of outside actors to monitor compliance, compare the lending practices of various institutions, and use this information to encourage institutions to introduce substantive changes to their lending practices. However, this potential is impaired by the inconsistent reporting practices of member institutions. Thus it would be useful for the Equator Principles financial institutions to standardize their reporting practices. In addition, although many banks voluntarily disclose aggregate data on sector, location and value of projects financed, 55 it would be useful for comparative purposes to receive this information on a country-by-country and sectoral basis. This information would facilitate more detailed analysis of how financial institutions are allocating their high-, medium- and low-risk projects and the overlap of this data.

In sum, the introduction of the reporting requirements to the Equator Principles has the potential to significantly improve the

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transparency and accountability of international project finance. However, greater standardization and more detailed reporting requirements are necessary to fully realize this potential.

V. WHISTLE-BLOWER PROTECTION AND SELF-REGULATION BY AUDIT COMMITTEES

Whistle-blower protection and financial rewards for whistle-blowers serve an important role in ensuring companies comply with the heightened behaviour and risk management standards imposed following the financial crisis. This legislation can be designed to either protect whistle-blowers from retaliation by their employer or provide incentives for employees to disclose wrongdoing. The balance between these two models has resulted in debate on whether whistle-blowers should be required to first disclose the wrongdoing within their firm and exhaust all internal avenues or whether whistle-blowers should be permitted to disclose the wrongdoing to outside authorities. This section contrasts the internal disclosure model developed under the

Sarbanes Oxley Act [56] with the Dodd-Frank Act's approach of providing awards to whistle-blowers who provide information which leads to a successful enforcement action. [57]

The United States was one of the first countries to enact whistle-blower legislation. Under the False Claims Act of 1863, individuals were permitted to bring a qui tam claim as a "relator" on behalf of the United States government against individuals and government contractors for defrauding the state. [58] If successful, the claimant was entitled to retain up to 50% of the proceeds of the action. [59] In addition, whistle-blowers were entitled to bring a claim against their employer for any retaliation by their employer resulting from the decision to bring a qui tam claim. [60] Over the next century, a series of legislative amendments and judicial decisions significantly narrowed the scope of the False Claims Act to focus primarily on fraud within government and in government contracts. [61]

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Following the collapses of Enron and WorldCom, whistle-blower protection laws were significantly expanded to provide enhanced protection for whistle-blowers in publicly listed companies and establish internal structures to assist employees in reporting wrongdoing to the company's audit committee. Under the Sarbanes Oxley Act, any employee who is retaliated against for providing information that assists public officials or management in the investigation of fraud or violation of Securities Exchange Commission (SEC) rules is entitled to any financial or equitable relief necessary to make them whole. [62] Severe criminal penalties of up to 10 years in prison were also introduced for retaliation against whistle-blowers. [63] In addition, the Sarbanes Oxley Act also requires corporate audit committees to play a more active role in identifying and investigating fraud and violations of SEC rules by developing an internal action plan for reporting, tracking, and managing internal disclosures of wrongdoing. [64]

Despite these supports, entrenched institutional cultures may create social and institutional barriers for whistle-blowers wanting to disclose wrongdoing. Although fraud and misconduct in financial institutions represent an avoidable business loss and liability, which management has an incentive to eliminate, there are high social costs associated with whistle-blowing, irrespective of whether any direct retaliation occurs. In particular, when an individual is sufficiently proximate to the wrongdoing so as be able to provide sufficient details to the audit committee, they are likely to face significant upheaval in their work environment, potentially be stigmatized by affected colleagues, and suffer long-term career repercussions as a result of management's efforts to address the wrongdoing. [65] Although whistle-blowers are entitled bring a claim for monetary compensation and reinstatement following retaliation by their employer, only 10% of whistle-blowers who brought claims against their former employer were successful in obtaining compensation or reinstatement and 55% failed to establish a cause

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of action. [66] Consequently, there may be strong disincentives for employees to report fraud to the audit committee.

The ability of regulators to offer monetary awards may help in overcoming the social and professional repercussions faced by whistle-blowers and may help increase regulatory intensity. Under the Dodd-Frank Act, whistle-blowers are entitled to receive a financial award of 10-30% of any judicial or monetary settlement between the SEC and the reported firm. [67] A recent study by the Association of Certified Fraud Examiners found that more than three times as many frauds are uncovered by tipsters within the impugned firm than by any other means. [68] As such, whistle-blowing incentives present a powerful regulatory instrument, which has the capacity to promote greater compliance within affected firms. By providing an incentive for employees to disclose wrongdoing within their organization, regulators are able to devolve a portion of the costs of uncovering fraud to the individual level and increase the capacity of regulators to investigate and prosecute a wider range of offences.

Whistle-blowing awards create a financial incentive for whistle-blowers to assert their claim outside of the accountability framework established by the audit committee. The presence of this incentive may encourage whistle-blowers to act in an opportunistic and self-serving manner, rather than disclosing wrongdoing out of a sense of moral imperative. 69 Thus, the benefits of enhanced disclosure of corporate wrongdoing must be weighed against the potential corporate governance costs. In particular, providing incentives for employees to disclose corporate wrongdoing and fraud to outside actors may inhibit the ability of the audit committee to identify and address behavioural issues within the organization on a proactive basis. Incentivizing employees to disclose wrongdoing outside the institutional frame

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work may foster a culture that does not support those who disclose wrongdoing. Therefore, although these incentives may be effective from an enforcement perspective, they may not support long-term behaviour modification. In order to offset these concerns, it is important that audit committees develop adequate internal structures to support employees in disclosing potential wrongdoing internally.

Providing monetary incentives for whistle-blowers to report wrongdoing to regulators has the potential to reduce the costs associated of identifying fraud, increase regulatory intensity, and mitigate the professional costs associated with whistle-blowing. However, these incentives may also reduce the capacity of the audit committee to address these concerns internally. Therefore, it is critical that institutions develop an effective internal whistle-blower program that is strongly supported by management and enables employees to make disclosures without fear of reprisal. 70

VI. CORPORATE GOVERNANCE STRATEGIES FOR EFFECTIVE RISK-MANAGEMENT

As leaders in the capital markets, banks serve an important role in promoting market confidence and macro-economic stability. Because of the large number of stakeholders who are directly and indirectly affected by the conduct of financial institutions, banks are, in many respects, distinct from non-financial institutions. Effective corporate governance in financial institutions requires boards of directors and senior management to develop substantive strategies designed to effectively identify and manage the unique risk exposures inherent with financial institutions, rather than engaging in a series of generic procedural formalities. This section explores the role of corporate governance in financial institutions and contrasts the reforms made under South Africa's King Code III with those proposed by the Basel Committee on Banking Supervision, and United States' Dodd-Frank Act.

The asymmetry between a financial institution's notional risk exposure and the capacity of leverage to serve as a multiplier on returns creates significant corporate governance challenges for financial institutions and may exacerbate agency conflicts between

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equity and non-equity stakeholders. In financial institutions, the vast majority of assets are provided by depositors. For instance, Canadian financial institutions have an average ratio of liabilities to equity of 17.6:1, 71 whereas corporate debt to equity in Canada is approximately 0.55:1. 72 Although this discrepancy is partially reflective of the nature of the banking relationship, it also suggests that traditional models of corporate governance, shareholder involvement, and risk management may not be directly transferable to financial institutions. Because, equity holders have a fixed potential loss and unlimited potential gains they rationally favour using the institution's leverage to generate high yields. By contrast, depositors and bond-holders have a fixed claim vis-a-vis the institution and rationally support stronger risk management policies designed to ensure the security of their claims. Therefore, corporate governance standards should be designed to ensure directors consider and appropriately balance the interests of these various stakeholders.

The United States Dodd-Frank Act promotes increased shareholder involvement in the governance of financial institutions through the use of say-on-pay votes and, enhanced proxy requirements, and it builds upon the New York Stock Exchange's (NYSE) existing restrictions on the ability of brokers to beneficially vote their clients' shares for director elections and other significant matters. 73 In addition, banks and bank-holding companies with more than $10 billion in assets are required to establish a risk management committee. 74 It is presumed that the creation of a board-level risk management committee will result in greater risk-specific oversight and accountability to external stakeholders for the institution's risk management policies. Moreover, the independent directors who serve on this committee will provide a degree of separation from the institutional conflicts which may promote excessive risk-taking. 75 Thus, these measures represent a primarily
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structural approach to corporate governance reform, which attempts to facilitate enhanced oversight by independent directors and shareholders. 76 Although structural reforms may assist institutions by establishing the infrastructure necessary to address complex corporate governance challenges, these reforms should also be accompanied by substantive changes in the governance practices of the institution.

Following the financial crisis, the Basel Committee on Banking Supervision released its "Principles for Enhancing Corporate Governance." 77 These principles outline the duty of directors and executives to establish internal risk management protocols which are reflective of the institution's risk tolerance and long-term growth strategy. In doing so, financial institutions are encouraged to develop policies which enable directors to become actively involved in the governance and risk management of the institution, rather than adopting an oversight role. For instance, the Basel Committee emphasized the importance of ensuring that risk management officers and board members are actively involved in identifying risks on an institutional basis and ensuring the internal risk management infrastructure is responsive to changes in the institution's macro-systemic and sector-specific risk exposures. 78 These proposals emanate from the failure of many of the largest institutions to develop policies and designate officers to oversee risk at a firm wide level. 79 Thus the Basel Committee's framework is predominately focused on promoting greater transparency by identifying and managing an institution's risk exposure though increased board involvement rather than limiting the institution's business activities.

The South African King Code III on corporate governance provides a third regulatory model. The changes introduced in the King Code III emphasize the analytical process by which board members should consider issues when evaluating a business decision and attempts to create an integrated decision making framework which emphasizes how the various factors affect each
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other. In particular, the King Code III encourages boards to consider issues such as sustainability as an intrinsic element of any decision rather than a separate category which may be considered independently. 80 By combining these factors into a single integrated analysis rather than

employing a touchstone approach, boards may be more able to appreciate how each of these factors contributes to the institution's long-term viability. 81

The difficulties presented by a touchstone approach to decision making are particularly pronounced in Canadian corporate governance. In *BCE Inc. v. 1976 Debentureholders* , the Supreme Court of Canada held that boards have a duty to consider the impact of their decision on non-equity stakeholders. In doing so, boards are permitted to adopt a touchstone approach, which evaluates how a decision will affect each stakeholder group. 82 However, this approach may downplay the interaction of the various interests and may result in compartmentalized decision-making. Thus, the King Code III's approach of requiring directors to consider the interaction of these issues and stakeholder groups as part of a unitary analysis may be conducive to superior governance results.

Achieving effective corporate governance outcomes requires a combination of structural reforms, which ensure that boards and committees have sufficient autonomy and capacity, procedural requirements that encourage management and directors to assume an active role in overseeing the operations of the financial institution, and analytical structures which promote a global decision making framework. The Dodd-Frank Act, the Basel Committee's "Principles for Enhancing Corporate Governance", and King Code III each incorporate elements of these requirements and have the potential to enhance corporate governance. However, attaining superior governance outcomes is a product of legislative and policy reforms as well as the development of an institutional culture which is supportive of these governance objectives. Thus, regulators should work closely with institutions to foster enhanced awareness of the unique risk and agency challenge that result from the use of leveraged financial products. Similarly, senior management should be actively involved in communicating these goals, objectives and values to employees at all levels of the organization.

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VII. EXECUTIVE COMPENSATION AND SAY-ON-PAY

Securities regulators have traditionally required publicly listed companies in Canada, the United States, and United Kingdom to disclose the amount and forms of compensation provided to senior executives and directors as part of their annual financial statements. 83 Following the collapses of Enron and WorldCom and the financial crisis there has been public criticism of the magnitude and character of the compensation provided to senior executives at those institutions hardest hit. 84 In particular, performance-based compensation and stock options have been criticized for creating a disconnect between the short-term performance of the company's stock and shareholders' interests in long-run growth and stability. 85

Regulators have responded by developing mechanisms to give shareholders greater input on executive compensation policies, ensure compensation packages are aligned with the interests of the corporation, and prioritize long-term stability rather than short-term profitability. Although these reforms attempt to provide greater transparency and accountability for executive compensation, they do not directly address the correlation between the character of the compensation and risk taking in financial institutions.

Over the past decade, the United Kingdom has been among the most progressive jurisdictions in providing shareholders with increased opportunities to review a corporation's executive compensation policies. In 2002, the United Kingdom became the first country to require public corporations to hold an advisory

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say-on-pay vote as part of their annual general meeting. Recently the United Kingdom passed legislation, which will make executive compensation policies subject to a binding resolution by shareholders and the shareholders will have the right to make executive compensation contingent upon a shareholder vote. 86 These executive compensation reports must disclose the nature and amount of compensation provided, the consultation process undertaken to develop the compensation policy, the existence of any claw-back provisions, details of the severance package available to executives, and how the nature of the departure would affect the executive's severance package. 87 Finally if a company fails to secure at least 75% support for its executive compensation report, the board is required to issue a statement discussing the principal grievances of shareholders and the steps taken to address these concerns. 88

Prior to the enactment of the Dodd-Frank Act, the United States favoured the use of corporate governance structures to promote accountability in executive compensation. Under the NYSE and National Association of Securities Dealers Automated Quotations (NASDAQ) listing rules, companies are either required or tax incentives make it highly desirable to establish independent compensation committees. 89 In order to shelter the board from potential liability, compensation committees frequently retained independent consultants to advise on the compensation provided to executives. 90 Consequently, shareholders had limited capacity to challenge a compensation committee's decisions through a derivative action. The only mechanism available to shareholders was to withhold their vote for those directors who were on the

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compensation committee. Under the Dodd-Frank Act, all publicly listed companies are now required to establish independent compensation committees, disclose the role of compensation consultants who advise these committees, and allow shareholders to cast an advisory vote on the compensation policy. 91

Given the intense public scrutiny of the compensation provided to Wall Street executives during the financial crisis, American regulators have moved to allow shareholders greater opportunity to contribute to institutions' compensation policies. In 2008, the United States required all recipients of Troubled Assets Relief Program (TARP) funding to hold advisory votes on executive compensation and provide comments on how the results of these resolutions have influenced the compensation packages. 92 Under the Dodd-Frank Act, shareholders of publicly listed corporations are entitled to cast an advisory vote on the institution's compensation policy and any golden parachutes offered to senior executives, and decide whether these advisory votes should be held every two or three years. In addition, corporations are required to hold a separate advisory vote in relation to any performance-based compensation accruing as a result of a transaction which shareholders are required to ratify. 93 To assist shareholders in evaluating the say-on-pay resolution, the Dodd-Frank Act also expands the disclosure requirements relating to the structure of the compensation provided to executives and includes the median salary paid to non-executive employees in the general compensation disclosure. 94

When corporations voluntarily adopted say-on-pay votes, shareholders were, in general, highly supportive of the corporation's compensation policies. 95 However, the Dodd-Frank Act's restrictions on broker proxy voting appears to have made these votes far more contentious and resulted in shareholders opposing 37 executive compensation packages in 2011 and 57 in 2012. Most notably, in April, 2012 Citigroup became the first bulge-bracket bank to have shareholders reject its executive compensation

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package. This adverse say-on-pay vote followed a year where, despite Citigroup's share price dropping by more than half, from a high of $51.50 in January to a low of $21.40 in October, 2011, C.E.O. Vikram Pandit was awarded $11 million in salary and a multi-year retention package, which was reportedly worth approximately $40 million. 96 Shortly after the failed say-on-pay vote, Vikram Pandit resigned as the C.E.O. of Citigroup and Citigroup announced a restructuring of its executive compensation policies following meetings with "nearly 20 shareholders representing more than 30% of Citigroup stock". 97

In a survey by the Council of Institutional Investors of the shareholders of firms who rejected their say-on-pay resolutions, 92% of shareholders cited an apparent disconnect between the firm's compensation practices over a one-to-five-year time horizon as a reason for opposing the say-on-pay resolution and poor pay practices were cited by 57% of shareholders. These pay practices included the choice of performance measures, excessive use of incentives such as stock options that are not tied to a more specific performance measure, retention awards, severance packages, and tax gross-ups for income in kind. 98

Investors have made ready use of the Dodd-Frank Act say-on-pay votes to oppose executive compensation in small- and middle-market companies. However, there has been less opposition to executive compensation in financial institutions. Of the 37 companies listed in the United States who failed say-on-pay resolutions in 2011, 32% had less than $500 million in revenue and only 27% had more than $3 billion in revenue --- the largest being Hewlett Packard Corp. with $126 billion in revenue, followed by FreeportMcMoRan Copper and Gold with $18.9 billion, and Constellation Energy Group with $14.3 billion in revenue. The only financial services sector firm to fail a say-on-pay resolution in 2011 was PICO Holdings with annual revenue of $32 million. 99

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In 2012 the number of firms who failed their say-on-pay resolution increased to 57 and there was slightly greater opposition within high revenue companies. The largest institution to fail its say-on-pay vote and the only financial services institution was Citigroup with $102 billion in revenue, followed by Best Buy with $51 billion and Oracle Corp. with $37 billion in revenue. 100 This may suggest that dissident shareholders and proxy firms are developing greater capacity to oppose say-on-pay resolutions; however it is still too early to make a robust observation. It is also noteworthy that the majority of companies who failed a say-on-pay vote in 2011 received on average 39% more support in 2012. 101

In January, 2011, securities regulators in Ontario, Canada presented a staff notice and request for comments on the possibility of introducing mandatory advisory say-on-pay votes for Canadian corporations. However, regulators have not taken steps towards mandating a say-on-pay vote. 102 Although submissions were in general supportive of the premise of enhancing shareholder democracy, promoting shareholder involvement in the governance of the corporation, and increased board accountability on compensation matters, 103 many expressed concerns that mandatory say-on-pay votes are a "blunt instrument" which is ill-suited to addressing intricate corporate governance and compensation matters across a variety of issuers. 104 Thus the binary outcome provided by a say-on-pay vote is regarded by critics as providing limited utility for boards when evaluating shareholders' particular grievances with an executive compensation package. 105 In addition, the use of a separate say-on-pay

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resolution has the potential to deflect criticism away from the directors on the compensation committee and onto the executives receiving the criticism. Consequently, shareholders may be less likely to withhold support for the board, when they are able to express their disapproval through a separate say-on-pay resolution. 106 However, proponents suggest that, notwithstanding the potential shortcomings of say-on-pay votes, these resolutions represent a step towards greater accountability on corporate boards. 107

Mandatory say-on-pay votes increase the role of shareholders in the governance of financial institutions. Because executives are often compensated using performance-based bonuses and stock options, allowing shareholders to vote on executive compensation packages can serve as a check against gross misalignment. However, since shareholders are only given the opportunity to accept or reject the compensation policy, there is limited opportunity for shareholders to directly influence the structure of the compensation in order to better align the interests of directors with those of shareholders. Thus, because say-on-pay votes only permit shareholders to approve or reject the resolution and the vote provides directors with limited feedback on the reasons why shareholders opposed the compensation package, mandating say-on-pay votes will not necessarily result in superior governance outcomes.

When an institution has its executive compensation policy rejected in a non-binding vote, it may be expedient for management to shift the scrutiny onto the performance of management per se or the quantum of compensation received rather than accept direct responsibility for the nature of the compensation package. By contrast, binding shareholder votes require the compensation committee to restructure the compensation package and re-table it

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with shareholders for approval. Consequently a binding vote may result in a more equitable balance of accountability between both management and the board. However, since corporations have been responsive to the results of advisory votes there does not appear to be a significant impetus for moving towards a more coercive binding shareholder vote. Rather regulators and boards should work to identify compensation systems which encourage employees and management to act in the long-term best interests of the corporation and appropriately manage risk. Thus, although compensation policies and shareholder democracy play a role in responsible governance, these requirements must be accompanied by other policies and regulations designed to align the interests of executives with stakeholders.

VIII. THE REGULATION OF PROPRIETARY TRADING BY INSURED DEPOSITORY INSTITUTIONS

Following the 2008 financial crisis there has been substantial debate on the extent to which financial institutions should be permitted to engage in proprietary trading. Proprietary trading occurs when financial institutions engage in short-term, speculative trading on their own accounts rather than providing advice, brokering commissioned trades for clients, or assuming longer-term investments. Proprietary trading has been criticized because institutional traders may engage in trades that conflict with the interests of their clients, such as assuming a short position on a security which has been recommended to a client, front running client orders, or selling stocks from a proprietary portfolio to retail clients. However, proprietary trading by large institutions also serves an important market making and liquidity role in capital markets.

Following the recommendation of former Federal Reserve Chairman, Paul Volcker, the United States has forged ahead with a ban on proprietary trading based on "short-term price movements" by insured deposit taking institutions other than for certain approved risk mitigation activities. 108 Secondly, U.S. institutions are barred from acquiring or retaining greater than 3% equity ownership or a management interest in a hedge fund or private equity fund. 109 Finally, insured

financial institutions are prohibited under the "Lincoln Amendment" from operating as swap entities
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or dealers of derivatives contracts, unless these contracts are structured through an independent affiliate. 110

By contrast, Canada has vigorously opposed restrictions on the ability of financial institutions to engage in proprietary trading. Instead, Canadian regulators have favoured the use of prudential and behavioural regulation to promote responsible risk-management policies and conflict-of-interest rules within these institutions. 111 Other jurisdictions such as the European Union have sought a middle ground, which allows financial institutions to continue to engage in proprietary trading provided that these operations occur within a legally separate entity. 112 Ultimately, these differing approaches reflect the ongoing debate on what constitutes the proper use of bank capital and the amount of risk financial institutions should be permitted to assume.

The impetus for separating a bank's proprietary trading operation from its retail banking and investment advisory services arose after the Black Friday bank crash of October, 1929. Following the crash, the United States' Pecora Commission determined that the incentives associated with a bank's proprietary trading operations created serious conflicts of interest, caused market instability and undermined the interests of depositors. 113 Consequently, the United States enacted the Glass-Steagall Act, 114 which severely limited the ability of retail and commercial banks to trade securities on their own accounts. Other jurisdictions quickly followed the United States' lead and adopted similar reforms. In order to facilitate the growth of global capital markets in the 1980s and 1990s these restrictions were gradually relaxed with Canada allowing retail banks to acquire securities brokerages and investment banking firms in 1992 and in the United States in 1999. 115
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Following the financial crisis there has been significant criticism of the role of proprietary trading in increasing market risk and creating conflicts of interests within financial services firms. 116 In particular, scholars such as Paul Krugman have noted that the ability of proprietary trading desks to use liquidity from the Federal Reserve to backstop trading losses can significantly increase moral hazard in the financial system. 117 However, the acquisition of distressed investment banking firms such as Bank of America's acquisition of Merrill Lynch and J.P. Morgan's acquisition of Bear Stearns following the financial crisis has resulted in proprietary trading being integrated into the operations of large retail banks. Thus it may difficult to unwind these amalgamated firms without significant market repercussions.

Prior to the financial crisis, proprietary trading occupied a major role in many investment banks and enabled these firms to diversify their portfolios, boost profitability, and provide enhanced market liquidity. Although the United States Office of the Comptroller of the Currency estimates that, once assets previously engaged in property trading are reassigned, the compliance and capital costs of the Volcker Rule will amount to less than $1 billion per year, 118 a recent report by economic and management consultants Oliver Wyman suggests that a ban on proprietary trading in the United States would result in an annual increase in the cost of capital of $12-43 billion and a $90-315 billion loss of liquidity in U.S. bond markets. 119 As such, there appears to be no clear consensus on the market impact of proprietary trading.

When developing a regulatory response to proprietary trading, it is critical to identify an appropriate balance between the legitimate role of financial institutions in serving as market makers, the efficient allocation of capital, and the social and economic costs of undesirable conduct such as front running trades

and excessive risk-taking. Imposing a ban on proprietary trading appears designed to address undesirable conduct from a purely structural perspective. However, limiting the ability of banks to engage in short-term speculative trading does not eliminate the potential for conflicts of interest to emerge between a bank's long-term proprietary investments and the securities being sold to clients, engage in abusive practices, or assume risky investment positions. As such, it may be more appropriate to consider specific behavioural reforms which target the impugned conduct of proprietary traders rather than imposing a structural remedy which may affect the market making capacity, risk management and profitability of financial institutions. These reforms could include enhanced regulation and reporting of communications between an institution's investment banking, proprietary trading and brokerage services to help regulators identify and manage potential conflicts of interest or enhanced client due diligence requirements that must be satisfied before a firm can implement a proprietary investment strategy. In addition, regulators could develop enhanced regulations concerning the ability of brokers to advertise securities to their clients when these securities are or have recently been held in the institution's proprietary trading portfolio.

Proprietary trading raises important issues about the potential for conflicts of interests to emerge within the services and business activities of a financial institution and as a result of the institution's portfolio risk. The Volcker Rule attempts to remedy these concerns through structural changes, which limit an institution's ability to engage in certain trading activities. However, the use of a structural remedy does not adequately address the behavioural issues giving rise to these conflicts or respond to the impugned behaviours. Therefore, given the potentially disruptive consequences of forcing financial institutions to divest their proprietary trading operations, it may be more effective to target the impugned behaviour directly through strengthened corporate governance, internal monitoring of trading activity, and regulatory oversight.

IX. CENTRAL CLEARING OF OVER-THE-COUNTER DERIVATIVES

Following the financial crisis members of the G-20 agreed to develop infrastructure to facilitate the standardization and mandatory central clearing of a large portion of over-the-counter

derivatives by the end of 2012. Any derivatives which cannot be centrally cleared will subject to increased regulatory capital requirements and registration with a trade repository. [120] The central clearing of derivatives is designed to transfer the counterparty risk in derivatives contracts onto a clearinghouse and thereby mitigate the systemic risk associated with the default of a large number of derivatives contracts. Although progress has been made towards central clearing, there continues to be uncertainty on the margining requirements for counterparties.

The central clearing of derivatives represents a major reconfiguration of the exempt securities market. Because over-the-counter derivatives transactions occur between sophisticated institutional entities with significant assets, these products have traditionally been exempt from securities disclosure rules and trading requirements. However, under traditional prudential regulatory models, regulators focused on the financial institution's leverage and sectoral risk exposures rather than the contagion and systemic risk exposure created by the derivatives market per se . Thus the regulation and clearing of over-the-counter derivatives transactions represents a major shift in the regulation of capital markets.

The regulation of over-the-counter derivatives is designed to reduce the systemic risk that can accrue unchecked when these products are traded anonymously in exempt markets. At its peak in 2010, the global derivatives market had a notional value in excess of $700 trillion. [121] Consequently, even minor unanticipated changes to an underlying reference entity can have a significant impact on a protection seller's settlement costs and create significant systemic risk if a seller is unable to satisfy its payment obligations. This will in turn result in a reduction in market liquidity and an increase in systemic risk. Thus, although the hedging of an institution's naked derivatives exposures may result in their overall risk appearing reasonable from a balance-sheet perspective, the fractioning of credit risk has the tendency to increase risk at the systemic level. [122] These systemic counterparty

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default risks are exacerbated by the fact that counterparties lack full disclosure of a contracting party's total derivatives exposure from other sources. [123]

Central clearing of derivatives is designed to aggregate systemic risk within a central counterparty, provide enhanced disclosure about the location of systemic risk and facilitate more effective prudential regulation and internal risk management. [124] This model assumes that, when properly structured and funded, a central clearing counterparty will have sufficient reserves to indemnify protection buyers for the value of their defaulting contracts during a systemic market event. However, the assumption that a central clearing counterparty will have sufficient reserves to support the system during a liquidity crisis places a tremendous burden on prudential regulators to effectively identify risks, and set maintenance margins for specific contracts and issuers. [125]

Although substantial progress has been made towards central clearing, regulatory uncertainty continues to hinder the scaling-up of central clearing and limits the ability of market participants to structure their future operations to comply with these new requirements. [126] In particular, there continues to be a lack of consensus on the margin and collateral requirements for centrally cleared and non-centrally cleared over-the-counter derivatives. [127] This lack of consensus has been accentuated by the debate on whether derivatives clearing should occur on a global or domestic level. For instance, emerging markets such as Brazil, China, and India have indicated that they will require central clearing through

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an entirely domestic counterparty. [128] By contrast, some jurisdictions such as Canada have elected to allow their financial institutions to clear through global central-clearing counterparties rather than create a separate domestic central clearinghouse. This decision was primarily based on the international character of the over-the-counter derivatives market, the desire to promote greater efficiency in central clearing and the Bank of Canada's position that co-operative oversight of Canadian market transactions in a global central clearing counterparty will satisfy Canada's macro-prudential regulatory needs. [129] However, because large jurisdictions such as the United States and the European Union have not yet settled on the registration requirements for trading through a central clearing counterparty, it is too early to fully assess the impact of these different approaches on derivatives clearing. [130]

The protracted time-line for implementing the central clearing of over-the-counter derivatives has created significant uncertainty in structured finance markets. As the regulations governing central clearing take shape in the coming years, it will be interesting to observe how the patchwork system of domestic and international clearing houses affect the development of global structured finance markets. However, during this period, it will be critical that regulators and clearinghouses work together to promote harmonization, avoid undue regulatory competition in the structured finance markets, and ensure collaborative monitoring of systemic risk factors.

X. CONCLUSION

As a result of continued global economic uncertainty, it remains critical that regulators develop pragmatic solutions which are conducive to long-term economic stability and planning. An effective and efficient banking system is a cornerstone for

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sustainable growth, economic development and individual prosperity. In order to preserve the health of this system, regulators introduced new prudential regulatory standards designed to control risk and promote sound management practices within financial institutions in response to the weaknesses exposed by the financial crisis. In addition, there has been increased focus on the role of financial institutions as gatekeepers for retail financial services and conduits for sustainable project finance.

Based on these principles of effective prudential regulation and access to financial services, this paper identified eight recent developments affecting regulators, financial institutions and consumers. In particular, the provision of financial services was examined through a discussion of access to basic banking services and regulation of the lending practices of bank and non-bank financial institutions. Next, strategies for enhancing corporate governance were presented, through a comparative assessment of the United States', Basel Committee's and King Code III's proposals, an evaluation of the role of whistle-blowers in uncovering wrongdoing in financial institutions and devolving the investigation of misconduct from regulators to individuals within the institution, and providing shareholders with increased input on issues such as executive compensation. Finally, the regulation of risk within financial institutions was evaluated through an assessment of the Volcker Rule's prohibition of proprietary trading within insured financial institutions and the implementation of central clearing of over-the-counter derivatives.

As evidenced by the preceding discussion, financial institutions around the world are presently in a state of regulatory change and uncertainty. Therefore, it is critical that regulators adopt a pragmatic and measured approach, which carefully evaluates the impact and interaction of these changes on the affected institutions, vulnerable segments of society, and overall market confidence.

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ENDNOTES

* An earlier draft of this paper was presented at the Annual Banking Law Update conference on April 17, 2013 in Johannesburg, South Africa.

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