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Corporate governance reforms and our regulatory future

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Abstract It is undeniable that the global financial crisis (GFC) has been a catalyst for regulatory change. Whether these policies and regulatory changes are good or bad, whether they will help or hinder growth, and whether they can effect proper balance between growth and effective risk management, the reality is that significant regulatory changes have been proposed and many have already been adopted and implemented. Business leaders may argue that the proposed policy and regulatory choices are both bad policy and bad economics, but the conclusions reached from the GFC is that the status quo was unworkable, and is certainly now politically unpalatable. Corporate governance reforms have arisen as a result of the global financial crisis. This article examines a slew of trends and changes in the wake of the GFC.

1. The global financial environment

Despite current global circumstances—including the gloom and pessimism of bear markets, stressed banks and strained societies, and politics and policies that seem unable to dislodge persistent economic malaise—our state of affairs will eventually change. Markets trend to extremes and overreaction. So too do we all, particularly when we are enduring turbulent and uncertain times. But the odds and history both tell us that things will improve. The pessimism will move aside to accommodate market and individual predisposition to optimism. The eurozone will almost certainly survive. Markets will see happier days and more bullish terrain. Political and policy changes will occur in ways that will alleviate, or at least postpone, some of the current ailments that have perched the global economy on the precipice.

This does not mean, however, that the events markets and societies are experiencing will soon be a distant, silent footnote for historians and scholars to reflect upon. While the dark cloud of gloom and pessimism may lighten, there are important changes stemming from the current crisis. These are creating a very different environment for business, and not only financial institutions. While it is far too early to conclude whether any of these changes will persist to form a trend or define a new reality or status quo, business leaders are watching closely, nonetheless—and rightfully so.

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It is undeniable that the global financial crisis (GFC) has been a catalyst for regulatory change. Whether these policies and regulatory changes are good or bad, whether they will help or hinder growth, and whether they can effect proper balance between growth and effective risk management, the reality is that significant regulatory changes have been proposed and many have already been adopted and implemented. Business leaders may argue that the proposed policy and regulatory choices are both bad policy and bad economics, but the conclusions reached from the GFC is that the status quo was unworkable, and is certainly now politically unpalatable.

2. Changes abound

As the financial crisis was the catalyst for a new environment of policy and regulatory change, it is financial institutions that have been targeted and that will undergo the most noticeable alterations. Some jurisdictions will experience relatively few changes, while others—where the impact of the crisis was most dramatic—will experience a very different landscape. The United States, for example, has passed far-reaching legislation in the form of the Dodd Frank Act (DFA) that outlines significant changes for financial institutions and their regulation. Regulators such as the Securities and Exchange Commission (SEC) have been tasked with developing comprehensive rules and guidelines to implement the provisions of the DFA. The United Kingdom and Europe have proposed and implemented far-reaching policies dealing with hedge funds, executive compensation, capital reserves and liquidity, over-the-counter derivatives and clearing-houses, ring-fencing, and ways to reduce risks inherent in systemically important financial institutions. There are also international initiatives such as Basel III that attempt to create rules beyond national jurisdictions to ensure the health and manage the risk of the international banking system. These objectives have resulted in numerous proposals for increasing capital reserves, increasing the amount of certain types of capital, and requiring certain types of systemically important financial institutions to hold even greater capital reserves.

While some of these new laws have been enacted, many more are still being debated and reviewed. As a result, the policy environment is very fluid and the regulatory future rather cloudy. Even in the United States, where the Dodd Frank Act has been passed, most of its associated specific rules are yet to be formulated by regulators following conclusions reached by the many studies the Act requires. However unpredictable, the new regulatory environment will likely include at least some of the following: new rules on capital reserves, with special rules for banks that are considered systemically important or 'too big to fail;' restrictions on proprietary trading; financial transaction taxes such as the Tobin tax; and ongoing stress tests and disclosure requirements to make the health of financial institutions more transparent to markets, regulators, and investors. Financial institutions will also adopt their own improved internal controls to limit or prevent inappropriate risk-taking, as well as the fraudulent activities of rogue traders. Many financial institutions have already taken aggressive steps to review how their boards deal with risk oversight, how risk oversight is institutionalized, and how risk-taking is encouraged and managed. Recent activities of the rogue trader at UBS, Kweku Adoboli—who racked up over $2 billion in losses—illustrates how difficult preventing fraud and rogue trading can be. Regardless of these challenges of controlling rather than stifling risk-taking, new internal policies at firms will also form an important part of the rules that financial institutions will be operating under.

While many of the new rules have focused on the specific problems and activities of banks and other financial entities, the scrutiny of how corporate institutions make decisions and govern themselves has reached far beyond the world of banks. New rules have already been proposed and implemented to improve how companies govern themselves. Corporate governance regulation through company and securities law is not new but the financial crisis has provided momentum for policy and regulatory change that will improve dimensions of corporate governance that aim to further improve how corporations make decisions, manage risk, elect boards, compensate senior management, and engage with shareholders. Among its various regulations and directives, the Dodd Frank Act will also require improvements in the way corporate boards identify and respond to various types of risk. Companies will be required to create special committees of their boards to deal with risk issues and oversight beyond the typical arrangements where overburdened audit committees are left to deal with these matters. Boards and senior management will be expected to create institutions and opportunities for risk oversight that currently do not always exist and which have been blamed—at least in part—for some of the mistakes that were made and that contributed to, or exacerbated, the recent financial crisis.

Beyond improving risk oversight, companies and their boards will increasingly be asked to reduce