Risk Management, Company Law and Procedures

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The Issue

Lessons for
- **company law?**
- **regulators?**
- **corporate governance codes?**

Formalization & Legalization of Procedures

→

Corporate Governance

More and more procedures …. (Compliance, internal controls, risk management, internal audit ….)

Banking / Financial industry heavily proceduralized for more than a decade.

Liability vis-a-vis shareholders, creditors, customers, tort claimants? ⇔ discussion in MS

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Overview

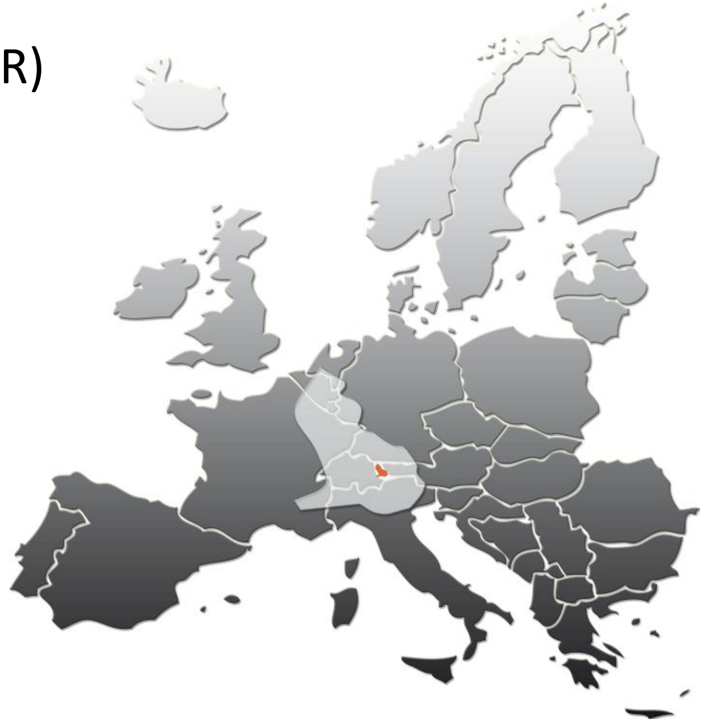
I. Defining Risk-Oriented Procedural Rules (ROPR)

II. The Legislature‘s Expectations

III. The Case against ROPR

IV. Policy Considerations

V. Theses



I. Defining Risk-Oriented Procedural Rules

Defining Risk-Oriented Procedural Rules (ROPR)

RM Procedures

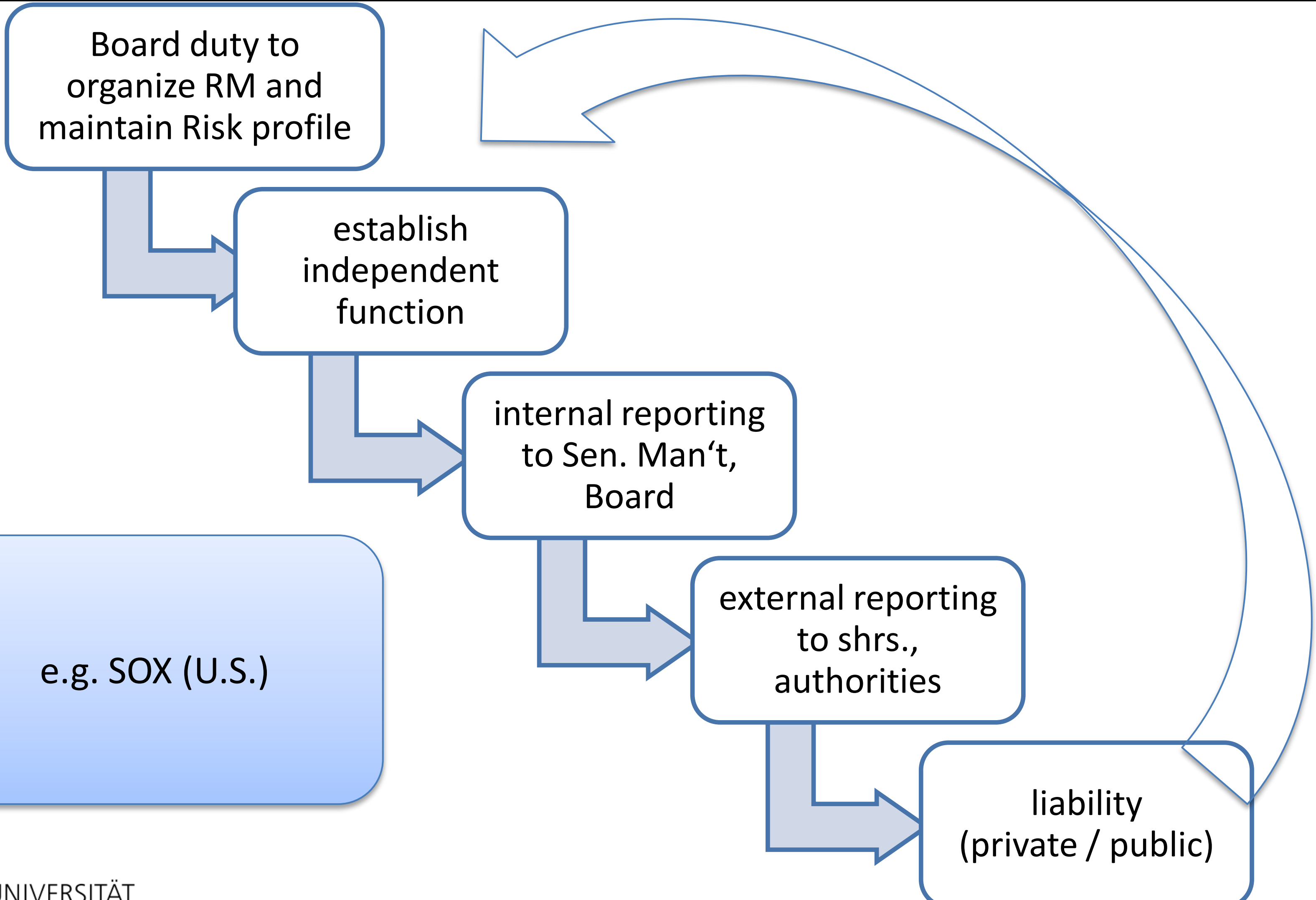
- Feature of any organisation
- Formal / informal
- The larger the organization, the more formal procedures we expect

ROPR

- **Legally relevant** procedures
- Private enforcement (liability)
- Public enforcement

ROPR: an instrument of financial law

A typical ROPR ...



e.g. SOX (U.S.)

Focus: EC's Green Paper on Corporate Governance

Proposal for a board duty to

„ensure a proper oversight of the risk management processes, [...] the board of directors [having to] bear[] primary responsibility for defining the risk profile of a given organisation according to the strategy followed and monitoring it adequately to ensure it works effectively."

Focus: Legal Relevance?

Legal relevance:
Legal consequences to the presence/absence of such procedures, and/or to their quality (adequateness).

e.g.

- director liability
- enterprise liability to third parties

(liability = private or public enforcement)

II. Expectations

Expectations

- Enhance Accountability of the Board of Directors / Senior Management
  - ‚furthering corporate honesty‘
  - enhance investor protection
  - better enforcement
- Reduce Systemic Risk

III. The Case against ROPR

The Case against ROPR

1. Enhancing Accountability?
2. Reducing Systemic Risk?

1. Enhancing the Board‘s Accountability?

Enhancing Accountability?

- formalization of procedures
- petrification of procedures
- enhancement of firm-internal agency conflicts
- Reducing front people’s responsibility
- box ticking behavior inside the firms

‚formal‘ ⇔ substantive accountability

Sound business judgement?

Enhancing Accountability? – lack of substantive guidance

- vague quality expectations (‘efficiency’, ‘effectiveness’, ‘adequateness’ etc.) ⇔ uncertainty
- a lack of guidance as ROPR result in many cases in procedures without clear objectives and / or substantive guidance

Accountability –
as to what?

Enhancing Accountability? – Interference effect

- ROPR
  - interfere with board competence to organize the firm
  - provide easy excuse in difficult times

Reduced accountability

2. Reducing Systemic Risk?

Reducing Systemic Risk?

advanced risk management → Firm-internal diversification, netting → greater access to leverage → **higher systemic risks**

Evidence from the financial sector

Reducing Systemic Risk?

- Creating a 'risk culture' by regulation?
- Empirical studies by sociologists (e.g. Parker & Gilad, 2011, on compliance): unlikely

ROPR add something to risk (compliance, governance) awareness, but that is not a significant factor and it cannot stand alone. More important is the mindset of senior management that you cannot impose by law.

ROPR = pro-concentration effects

- ROPR => “good” is measured formally rather than substantial.
  - High level of fixed costs for procedures
  - barrier to entry
  - reduced price competition
  - enhanced firm size

‚Big is beautiful.‘

vs.

‚Good is beautiful.‘

More small firms ⇔ lesser systemic risk ⇔ more crisis resilience

Reducing Systemic Risk? – Greater overall stability?

- banks subject to RM-ROPR for years ⇔ financial crisis!
- Enhancing systemic risk through risk management

1) Regulated models ≠ economic discussion ≠ new regulation
2) Over-complexity: Assumptions little understood; If assumptions fail so do the firms
3) Concentration the market for risk management services
4) Concentration in the market for data provision.

Reducing Systemic Risk? - Costs

- Standardized ⇔ firm-specific risk approaches
  - Unnecessary costs => lesser profits &
  - Inaccurate measures for some firms

De-stabilization through ROPR

Reducing Systemic Risk? – Formalism - Flexibility

- Petrification through ROPR leads to lesser flexibility in times of crisis where it is needed most.
- Best governed firms (formally) were hit worst by the crisis (e.g. Adams, R.B., Governance and the Financial Crisis, 2012).

Enhancement of Systemic Risk

Intermediate results

$\Rightarrow$ ROPR do not enhance accountability. By contrast it reduces the board‘s accountability.

$\Rightarrow$ ROPR do not reduce systemic risk. By contrast ROPR create systemic risk.

$\Rightarrow$ ROPR is inadequate for achieving the policy objectives the legislature and regulators asssociate with it.

IV. Towards a better world (Policy Recommendation)

Towards a better world (Policy Recommendation)

1. Revealing the Core Issues
2. Prohibiting statutory ROPR
3. Empowering Shareholders

1. Core Issues

Why do we see ROPR? – Inefficiency of the political process

- ‚Something needs to be done.'
- Complexity ⇔ new understanding of risk
- Substantive guidance ⇔ costs, lack of expertise at regulator
- Procedure and transparency ⇔ easy solutions

⇒ ‚Quick and dirty'.

Core Issues

- Statutory ROPR ⇔ 'one-size-fits-all'
- Liability ⇔ Firm Governance

2. Prohibiting Statutory ROPR

Preliminary Considerations - Removing liability?

- Reduce negative impact on governance

- ROPR ~ guidance.

- Inspiring reckless behavior?

Prohibiting Statutory ROPR

- Default state: a world without statutory ROPR.
- Regulators should be required to set clear substantive standards rather than procedural requirements.

Prohibiting Statutory ROPR – BJR?

- Judge-made procedural tests such as the BJR shall prevail, however these are case-by-case rather than general reviews abstract from the details of the corporation.

3. Empowering Shareholders

Empowering Shareholders

- Let shareholders (rather than regulators and legislatures). decide on liability
  - Accountability concerns residual claimants most
  - Firm-specific adjustment

Empowering Shareholders

- Let shareholders define in the firm's articles of association. the extent and features of
  - D&O liability towards the corporation, and
  - the firm's liability vis-à-vis third parties (such as customers)

While the development of efficient sets of rules may take a while the firm-specific solution is likely to result in a firm-specific optimum while avoiding the perverse incentives of a no-liability regime.

Informal industry standards may assist this process.

Empowering Shareholders – Including tort claims?

- Including tort claims in the contractual solution may create perverse incentives. But please note that we only deal with ROPR, not with other types of torts.
- Excluding tort claims may inspire judges to frame violations of procedures as torts.

$\Rightarrow$ Work in progress …

V. Theses

Theses

The legislature expects ROPR to enhance accountability of the directors and to reduce systemic risk. Both expectations are likely to fail.

The formalization and legalization of procedures has detrimental effects on the firm-internal governance. ROPR enhance rather than reduce systemic risks. Non-economic reasons do not justify ROPR and their detrimental effects.

We reveal the one-size-fits-all approach of ROPR paired with private or public enforcement (‚liability‘) as the key driver for the negative effects of ROPR.

We deem a world without any statutory ROPR a desirable state of law. Any statutory liability from violating ROPR should be removed. As a default rule ROPR should be legally irrelevant.
Instead, shareholders should be empowered to define the extent and features of D&O liability towards the corporation and the corporation’s liability vis-à-vis third parties (such as customers, tort claimants) in the firm’s articles of association.

This results in a world without *statutory* ROPRs but with *contractual* ROPR:

- as a consequence of damages paid to third parties as enterprise liability, and
- as a consequence of other damages stemming from failure to adopt ROPR.

Thank you!

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