A New Milestone in Corporate Regulation: Procedural Legalisation, Standards of Transnational Corporate Behaviour and Lessons from Financial Regulation and Anti-Bribery Regulation

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Abstract and Introduction

Governing transnational corporate behaviour through traditional regulatory design is a challenging objective that has been canvassed in much academic literature. Difficulties arise as, *inter alia*, transnational corporations make extensive use of regulatory arbitrage and corporate structures in order to avoid or mitigate the reach of legal and regulatory governance. Moreover, international soft law standards that encourage multinational corporations to be more responsible are not always effective or enforceable. Against this context, we explore an emerging regulatory trend in corporate regulation that has the potential to overcome some of the perceived limitations in the modern regulatory governance of transnational corporate groups.

There is an intensifying trend in adopting procedural regulatory strategies for corporations. This involves prescribing various control systems and processes that corporations have to institute, such as compelling them to develop due diligence requirements within their commercial operations. This trend is not entirely new, and fits within the regulation theory framework of 'new governance',[1] such as 'management-based regulation'[2] or 'meta-regulation'.[3] However the changes we

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[1] See Cristie Ford, "New Governance, Compliance, and Principles-Based Securities Regulation" (2008) 45 American Business Law Journal 1; Robert F Weber, 'New Governance, Financial Regulation, and Challenges to Legitimacy: The Example of the Internal Models Approach to Capital Adequacy Regulation' (2010) 62 Administrative Law Review 783; Julia Black, 'Paradoxes and Failures:"New Governance" Techniques and the Financial Crisis' (2012) 75 Modern Law Review 1037.

[2] Cary Coglianese and David Lazer, 'Management-Based Regulation: Prescribing Private Management to Achieve Public Goals' (2003) 37 Law and Society Review 691.

[3] Sharon Gilad, "It Runs in the Family: Meta-regulation and its Siblings" (2010) 4 Regulation and Governance 485; Christine Parker, *The Open Corporation* (Cambridge: Cambridge University Press 2000). On meta-regulation within the context of the wider corporate social responsibility debate see: Christine Parker, 'Meta-Regulation: Legal Accountability for Corporate Social Responsibility,' in

observe are that: such procedural regulatory strategies are becoming more prescriptive, more widespread and targeted at individual and organisational behaviour. We suggest this is a new milestone in 'new governance' design that we call 'procedural legalisation'. Procedural legalisation is being adopted at an unprecedented level in financial sector and corporate regulation,[4] and offers a new promise in changing corporate culture and behaviour, potentially addressing longstanding limitations with the effective regulation of corporations. We present two case studies to explore how procedural legalisation is applied to regulate corporations in both the financial sector and with anti-bribery initiatives.

Procedural legalisation is a new trajectory in corporate regulation located at the intersection of regulation theory and the wider movement in law and behaviour[5]. Our account provides the theoretical anchors of this regulatory strategy, which integrates into regulation theory insights from organisational behaviour and corporate governance. Procedural legalisation advances 'new governance' theory by refining its scope and the dynamics of the relevant governance actors. However, we are critically mindful of the limitations suggested in organisational behaviour literature and of the need to support the early successes of procedural legalisation with effective enforcement, which is an area yet to be developed comprehensively.

A. Challenges in Regulating Transnational Corporate Behaviour

Corporations are separate legal personalities,[6] typically engaged in private wealth creation for their financial stakeholders.[7] However, where a business has expanded

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Doreen McBarnet, Aurora Voiculescu and Tom Campbell (eds), *New Corporate Accountability: Corporate Social Responsibility and the Law* (CUP, 2007), 207 – 240.

[4] With current proposals to extend this even further. See for example the proposed adoption of the 'failure to prevent' model to the facilitation of tax evasion (Criminal Finances Bill 2016-2017, ss 37-38) and economic crime (Ministry of Justice, *Corporate Liability for Economic Crime, Call for Evidence* (Cm 9370, 2017).

[5] Cass Sunstein and Richard H Thaler, Nudge: Improving Decisions About Health, Wealth and Happiness (NY: Penguin 2009); Alberto Alemanno and Anne-Lise Sibony, Nudge and the Law: A European Perspective (Modern Studies in European Law) (Oxford: Hart Publishing 2015); Alberto Alemanno, 'A Behavioural Approach to Health Promotion: Informing the Global NCD Agenda with Behavioural Insights' (2014) at http://ssrn.com/abstract=2475805; Frederic St Martin, 'Measuring the Effectiveness of Canadian Whistleblowing Law' (2014) at http://ssrn.com/abstract=2635641. Our article however focuses on the issue of regulation and corporate compliance.

[6] *Salomon v A. Salomon & Co Ltd* [1897] A.C. 22.

[7] The shareholder centric view of the firm has become a dominant one, led by theories of organisational efficiency and the agency-based paradigm of the firm. Armen A Alchian and Harold Demsetz, "Production, Information Costs and Economic Organisation" (1972) 62 The American Economic Rev 777; Oliver Williamson, "Corporate Governance" (1984) 93 Yale Law Journal 1197; Eugene F Fama and Michael C Jensen, "Separation of Ownership and Control" (1983) 26 Journal of Law and Economics 301; Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 Journal of Financial

to acquire a global, multi-jurisdictional footprint, an anomaly arises between its legal characterisation and its social and political importance. The global business is usually structured as a collection of separate corporate legal personalities loosely called a 'corporate group' but, as a whole, it is strategically connected and could have important influence in a number of economies and societies.[8]

The transnational corporate group is able to exploit the comparative advantages of different jurisdictions offering different resources, primary materials and services. Further, it is also situated in the centre of a web of global business-relations with external entities including suppliers and distributors.[9] The transnational corporate group may indeed be described as an extensive and somewhat amorphous beast in terms of its power, influence and arguably, responsibility. However, the scope of its legal responsibility may be surprisingly limited for its global profile for three key reasons.[10]

First, each separate legal entity in the group bears its own legal responsibility.[11] This has given rise to a common corporate structuring strategy known as 'asset

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Economics 305; Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (1991). Many jurisdictions have now provided for exceptions to this shareholder-centric view of the firm. For example, the B-Corporation in the United States and the Community Interest Company in the United Kingdom. Moreover, there is, of course, a large body of literature that challenges the legitimacy of adopting such a narrow view of the objective of the firm. The literature is too vast to cite in full but key works in this field include: Edward Freeman, "A Stakeholder Theory of the Modern Corporation" reproduced in Max BE Clarkson ed, *The Corporation and Its Stakeholders* (Univ of Toronto Press 1998) at 125; Margaret M Blair & Lynn A Stout, "A Team Production Theory of Corporate Law" (1999) 85 Virginia. L. Rev. 247; Thomas Donaldson and Lee E Preston, 'The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications' (1995) 20 Academy of Management Review 65; John E Parkinson, *Corporate Power and Responsibility* (OUP 1993) at 402-423; Andrew Keay, *The Corporate Objective* (Cheltenham: Edward Elgar 2010); Colin Mayer, *Firm Commitment* (Oxford: OUP 2013).

[8] John Parkinson, *Corporate Power and Responsibility* (Oxford: Clarendon Press 1993), generally. Also see Janet Dine, 'Transnationals out of Control' in *Governance of Corporate Groups* (Cambridge University Press 2000, 2006), Joel Bakan, *The Corporation - The Pathological Pursuit of Profit and Power* (London: Penguin, 2003).

[9] For example: see chapter 1, Henry WC Yeung, *Transnational Corporations and Business Networks* (Oxford: Routledge 1998).

[10] Larry Cata Backer, 'The Autonomous Global Enterprise: On the Role of Organizational Law Beyond Asset Partitioning and Legal Personality' (2006) 41 Tulsa Law Journal at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=880730, expressing concern for the ability of transnational corporations to have such expansive reach and yet remain relatively autonomous from state-based regimes of law.

[11] That is, 'each company in a group of companies … is a separate legal entity possessed of separate legal rights and liabilities' *The Albazero* [1977] AC 774, 807 (Roskill LJ).

partitioning',[12] allowing transnational corporate groups to manage their risks and carry out regulatory arbitrage between the jurisdictions of their operations.[13] As corporate regulation is national in character, transnational corporate groups are able to use subsidiary structures or offshore incorporations[14] to avoid regulation. Although some regulations are capable of extra-territoriality, there remain concerns with regard to their legality and proportionality, as well as the efficacy of their enforcement.[15] Extra-territorial regulation can to an extent bring liability home to the parent corporation, such as under the US Alien Torts Act, but lessons from enforcement of that Act[16] indicate that there are difficulties in securing evidence and enforcement.

Secondly, prevailing regulatory strategies for corporations face certain challenges in controlling corporate behaviour due to their design limitations. Commentators point out that regulation is often designed in terms of 'outcomes' or 'technologies'.[17] Outcomes-based regulation prescribes certain ends that corporations need to achieve or avoid. Technologies-based regulation prescribes that corporations must adopt a certain methodology, which proxies for the achievement of certain outcomes. An outcomes-based regulation for example could prescribe standards in product safety or occupier's liability. A technologies-based regulation could be found in the mandatory requirement for companies to appoint qualified external auditors to assure their financial statements, in order to achieve the outcome of accurate financial reporting to the markets.

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[12] On which see: Henry Hansmann and Reinier Kraakman, Organizational Law as Asset Partitioning, (2000) 44 European Economic Review 807, 810-812.

[13] Often transnational corporations use thinly capitalised subsidiaries to undertake risky overseas operations so that the other corporate members of the group will be immune from the losses suffered by that subsidiary. The shifting of liability onto the parent company, a process called 'lifting of the corporate veil' is highly difficult to achieve in UK civil litigation, see *Adams v Cape Industries* [1990] Ch 433; 2 WLR 657; [1991] 1 All ER, 929; *Prest v Petrodel Resources Ltd* [2013] UKSC 34. There is no doctrine of 'enterprise liability' in the UK for corporate groups as a whole although some extent of such liability is recognised in the US and Germany. See Meredith Dearborn, 'Enterprise Liability: Reviewing and Revitalizing Liability for Corporate Groups' (2009) 97 California Law Review 195.

[14] Although tax and regulatory avoidance is increasingly being pared down by international and extra-territorial initiatives, see Iris H-Y Chiu, 'From Multilateral to Unilateral Lines of Attack: The Sustainability of Offshore Tax Havens and Financial Centres in the International Legal Order', Connecticut Journal of International Law (2016), forthcoming.

[15] See for example, Joanne Scott, 'The New EU Extraterritoriality' (2014) 51 Common Market Law Review 1343.

[16] For example: see C Forcece, 'ATCA's Achilles Heel: Corporate Complicity, International Law and the Alien Tort Claims Act' (2001) 26 Yale Journal of International Law 487.

[17] See for example: Stephen Breyer, *Regulation and Its Reform* (Cambridge: Harvard University Press, 1982).

Regulatory design limitations are arguably augmented where transnational corporate groups are concerned. 'Outcomes-based' regulation may not adequately control corporate behaviour where some outcomes cannot be directly attributed to distinct legal personalities in the group, or are broad-based and difficult to define as specific legal duties. For example, whilst certain corporations can be made liable for outputs or conduct that can be directly attributed to them such as unsafe products or breaches of consumer data protection, it is more challenging to establish liability for remote associations such as the human rights standards of its suppliers, even if highly influential and close associations with suppliers is established.[18] Indeed, transnational corporate groups are able to design structures in such a way as to make certain responsibilities difficult to pin down. In terms of prescribing the mandatory adoption of certain technologies, such technologies may not be appropriate across the board for the corporate sector. Technologies-based regulation also needs to be proportionate to the cost of compliance for corporations, or regulatory arbitrage would be explored by them. The mandatory adoption of certain regulatory technologies need not achieve a high correlation with desirable outcomes.

At a higher level, legal and regulatory regimes for corporations are designed to change corporate behaviour in order to align with certain public interests and social outcomes. But transnational corporations could become inured to litigation and regulatory fines, which are regarded as a cost for doing business.[19] Thus, legal and regulatory regimes may continue to be peripheral to corporate culture and the incentives of individuals managing and working in the transnational corporate group.

Finally, the limitations of legal and regulatory regimes are also to a large extent attributable to how corporate law theory frames the nature of the corporation, which we explore in Section C. In general, Pendras argues that the corporation has been able to manipulate the definition of its legal nature as a *political development* and not as an outworking of normative conceptions in theory or law.[20] In doing so, the corporation has been able to determine politically the extent of its rights and shape the scope and objectives of corporate regulation.

In this light, international norms have been developed to encourage transnational corporations to behave responsibly not only within their corporate structure but also more widely within their network of global business-centred relations.[21] Further, there

[18] As causation for harm may not be established in law.

[19] See: Cynthia A. Williams, 'Corporate Compliance With the Law in the Era of Efficiency,' (1997) 76 North Carolina Law Review 1265.

[20] Mark Pendras, 'Law and the Political Geography of US Corporate Regulation' (2011) 15 Regulation, Space and Polity 1.

[21] For example: UN Norms on the Responsibilities of Transnational Corporations (2003) superseded by the UN Guiding Principles on Business and Human Rights (2011) at

have been nascent discussions of making transnational corporations legal persons within the meaning of international law for standard-setting and enforcement purposes.[22] The pros and cons of soft law approaches in the international governance of business is a well-trodden area - there are optimists who see potential in the soft law of international governance as constituting a quasi-legal or even constitutional order for transnational corporations, and there are those more sceptical of the effectiveness of such regimes in changing corporate culture and behaviour.[23] After all, international norms are not enforceable unless adopted in state-based regulation. Further, corporations could even use associations with international norms as part of their branding appeal while adhering superficially to their spirit.[24]

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http://www.ohchr.org/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf. It is arguable that the latter may be subject to greater legalisation than its soft law predecessor and the following soft law examples. Also see the UN Global Compact, at https://www.unglobalcompact.org/ and the OECD Guidelines for Multinational Enterprises (2011) at http://mneguidelines.oecd.org/text/.

[22] See for example: Nicola Jägers, 'The Legal Status of the Multinational Corporation Under International Law', in Michael K. Addo ed., *Human Rights Standards and the Responsibility of Transnational Corporations* 259, 262 (1999); Fleur E Johns, 'The Invisibility of the Transnational Corporation: An Analysis of International Law and Legal Theory' (1994) 19 Melbourne University Law Review 893.

[23] We do not embark on a comprehensive literature review here, but see for example those who view more optimistically the governance of transnational corporations by international norms or soft law, see Larry Catá Backer, 'Rights and Accountability in Development (Raid) V Das Air and Global Witness V Afrimex: Small Steps Toward an Autonomous Transnational Legal System for the Regulation of Multinational Corporations' (2009) 10 Melbourne Journal of International Law 258; 'From Moral Obligation to International Law: Disclosure Systems, Markets and the Regulation of Multinational Corporations' (2008) 39 Georgetown Journal of International Law 591, 'Governance Without Government: An Overview and Application of Interactions Between Law-State and Governance-Corporate Systems' (2010) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1568934; Peer Zumbansen, 'Defining the Space of Transnational Law: Legal Theory, Global Governance & Legal Pluralism' (2011) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1934044; Grahame F Thompson, *Constitutionalisation of the Global Corporate Sphere* (Oxford: OUP 2014). For a sceptical opinion see Alice de Jonge, *Transnational Corporations and International Law* (Cheltenham; Edward Elgar 2011); Giovanni Distefano, 'The Regulation of Transnational Corporations: Some Observations from the Standpoint from Public International Law, The Mirage of a New International Economic Order' (2011) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1889274. (Supporters of 'harder' law governance include Ben Bowling and JWE Sheptycki, 'Global Policing and Transnational Rule with Law' (2015) 6 Transnational Legal Theory 141; John Braithwaite and Peter Drahos, *Global Business Regulation* (Cambridge: Cambridge University Press 2008) generally; David Levi-Faur, 'The Global Diffusion of Regulatory Capitalism' (2005) 598 ANNALS of the Academy of Political Science 12; John Braithwaite, *Regulatory Capitalism* (Cheltenham: Edward Elgar, 2008).

[24] On the use of 'symbolic' structures to signify compliance, without meaningfully observing the spirit of legislation see: Laruen B. Edelman, 'Legal Ambiguity and Symbolic Structures: Organizational Mediation of Civil Rights Law,' (1992) 97(6) American Journal of Sociology 1531.

In light of the difficulties in suing or regulating the distinct legal personalities of the transnational corporate group, we critically explore what can be achieved by procedural legalisation as a new form of corporate regulation. Procedural legalisation targets the incentives and behaviour of micro-constituents within an organisation in a procedural but prescriptive manner. This is for the purposes of changing corporate behaviour or culture more widely.

In Section B, we explain 'procedural legalisation' and refer to two case studies, the regulation of financial sector firms and anti-bribery regulation in the UK respectively, to show how procedural legalisation has been deployed. In Section C, we argue that procedural legalisation, which introduces regulatory intervention *within the order of the corporation* is not defeated by theories of the corporate personhood, and is consistent with corporate law. We argue in Section D that procedural legalisation is founded upon 'new governance' approaches in modern regulation theory but is poised to overcome the latter's weaknesses. In Section E, we highlight the importance of integrating organisational behaviour research into procedural legalisation and discuss its achievements and limitations. In Section F, we conclude by identifying the future research directions for procedural legalisation, in particular its '*ex post'* or output legitimacy.

B. Trending: Procedural Legalisation by National Regulators

We observe that regulators are increasingly introducing regulatory duties with respect to how corporations may be organised, structured or governed. This means that regulation prescribes certain aspects of organisational or governance order *within* corporations or introduces incentives or personal responsibility for certain persons or office-holders. Such regulation is aimed at changing behaviour on the part of micro-constituents within the corporation, whether individuals or particular groupings. It is anticipated that such behavioural changes at micro level may facilitate changes in corporate behaviour as a whole.

The direct regulation of internal order within the corporation is not an entirely new approach. An early semblance of this regulatory approach is found in the unpopular US Sarbanes-Oxley Act 2002[25] where prescriptive regulation, including reposing specific responsibility on the Chief Financial Officer of listed companies to sign off financial statements,[26] is designed to make the CFO responsible for improving the integrity in financial reporting. Further, procedure-based regulation has been used in health and safety regulation, such as the institution of health and safety officers. In doing so, regulation has been used in areas of responsibility that are at risk of being

[25] Roberta Romano, 'The Sarbanes-Oxley Act and the Making of Quack Corporate Governance' (2005) 114 Yale Law Journal 1521.

[26] Section 302, Sarbanes-Oxley Act, (Pub.L. 107–204, 116 Stat. 745, enacted July 30, 2002), also known as the "Public Company Accounting Reform and Investor Protection Act".

externalised or neglected by corporations, were it not for the imposition of regulatory obligations.[27]

Procedure-based regulation is different from outcomes-based or technologies-based regulation, which are two prevailing regulatory techniques. Technologies-based regulation compels the adoption of certain methodologies by corporations such as standards of measurement for recycling, for example. In contrast, procedure-based regulation focuses on certain qualities of organisational or decision-making frameworks, such as independence and accountability. Outcomes-based regulation focuses on the achievement of certain ends, whereas procedure-based regulation focuses on the means, usually as a proxy for a range of ends, possibly because outcomes are hard to measure, for example, a healthy corporate culture. Procedural obligations provide regulators with relatively clear indicators for determining non-compliance (and criteria for enforcement).[28] Enforcement on the basis of such non-compliance may be more easily justified than for alleged breaches of substantive obligations which require proof of failure of care, proof of harm and causation, matters not always easy to establish. Breaches of procedural requirements are often clearer-cut and can be susceptible to being framed as matters for strict liability.

One question that may immediately arise is whether procedural legalisation would be effective in securing corporate behaviour that achieves substantive objectives such as being environmentally sustainable. There is some empirical evidence from the US[29] on how procedure-based regulation targeted at micro-constituents beneath the corporate veil has changed corporate behaviour and reduced regulatory breaches. We are of the view that this approach presents great promise in some difficult and complex areas for corporate regulation. Nevertheless, we acknowledge that there is a key weakness in regulatory design and empirical research that examines the *ex post* or *output* legitimacy of procedural legalisation is important.

(i) Procedural Legalisation in Regulating Financial Sector Firms

The background to procedural legalisation in financial regulation is the need to achieve the regulatory objective of financial stability.[30] Financial stability is a

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[27] Cary Coglianese and David Lazer, 'Management-Based Regulation: Prescribing Private Management to Achieve Public Goals' (2003) 37 Law and Society Review 691.

[28] In a way procedural legalisation can achieve enforcement in areas where securing compliance with substantive outcomes may be difficult and hence procedural enforcement results in an achievement of proxy justice or deterrence, see analogous reasoning in Leora Bilsky and Natalie R Davidson, 'A Process-Oriented Approach to Corporate Liability for Human Rights Violations' (2013) at http://ssrn.com/abstract=2302240.

[29] Lori Snyder Bennear, 'Are Management-Based Regulations Effective? Evidence from State Pollution Prevention Programs' (2007) 26 Journal of Policy Analysis and Management 327.

[30] See chapter 1, Mads Andenas and Iris H-Y Chiu, *Foundations and Future of Financial Regulation* (Oxford: Routledge 2014) and cites within.

collective goal which is perceived to be achieved if all firms are subject to common standards in microprudential regulation.[31] However, as post-crisis diagnoses after the global financial crisis 2007-9 have revealed, individual firms indulged in perverse incentives, flawed governance structures and weak organisation in order to undermine the spirit of microprudential regulation, ultimately contributing to firms' failure[32] and bringing about the collective financial crisis. Individual firms do not have incentives to act in a manner that promotes collective good[33] at the expense of their self-interest. Hence, regulators now consider it vital to govern the behaviour of micro-constituents micro-constituents in financial firms.[34] EU legislation and the UK regulators, the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) have introduced procedural legalisation to govern an expansive range of organisational structures from specialist departments to the Board, and incentives that affect individual behaviour such as remuneration. These are to be viewed as essential pieces of the larger matrix of regulation that is aimed at achieving financial stability.[35]

Regulating Internal Control in Financial Firms

All financial institutions, in fact all corporations, install systems of internal control. These systems comprise of self-checking procedures in order to deal with compliance with external regulations and internal rules, detecting wrongdoing or misconduct and protecting corporate assets from being misused or misappropriated.[36] Internal control in a financial institution is led and overseen by the compliance, risk management and internal audit departments.

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[31] Microprudential regulation is extensively discussed in other literature, for example, see Simon Gleeson, *International Regulation of Banking: Capital and Risk Requirements* (2nd ed, Oxford: OUP 2012).

[32] D Walker, 'A Review of Corporate Governance in UK Banks and other Financial Industry Entities: Final Recommendations' (26 November 2009) at http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf; Financial Services Authority, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009) http://www.fsa.gov.uk/pubs/other/turner_review.pdf; Howard Davies, *The Financial Crisis: Who is to Blame?* (Cambridge: Polity Press 2010).

[33] SL Schwarcz, 'Systemic Risk' (2008) 97 Georgetown Law Journal 193.

[34] Surveyed comprehensively in Iris H-Y Chiu, *Regulating (from) the Inside: The Legal Framework for Internal Control at Banks and Financial Institutions* (Oxford: Hart 2015).

[35] For an overview of the post-crisis reforms aimed at enhancing financial stability, see Mads Andenas and Iris H-Y Chiu, *The Foundations and Future of Financial Regulation* (Oxford; Routledge 2014).

[36] KPMG, Internal Control: A Practical Guide (1999) at http://www.ecgi.org/codes/documents/kpmg_internal_control_practical_guide.pdf.

In the wake of the global financial crisis, a number of financial institutions were found to have put their risk management departments under extreme pressure to condone excessive risk-taking, in order to push the boundaries of microprudential regulation.[37] Further, financial institutions have been found to be liable for strings of market misconduct and consumer mis-selling. [38] Market misconduct such as the foreign exchange manipulation scandals also involved collusive behaviour between individuals across different financial institutions.[39] Poor compliance culture and weak internal control are not isolated problems in firms but systemic problems in sectoral culture.

Regulators have now taken the step of directly prescribing how the internal control functions of banks and financial institutions, ie how the Compliance, Risk Management and Internal Audit departments should be structured, responsibilised and governed.[40] First, the three functions are to be protected in their independence so that they may be able to objectively gatekeep the financial institution from wrong-doing. The tenure, accountability and career progression of personnel should be separate from business interests. The accountability of the three functions lies

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[37] Gabriele Sabato, "Financial Crisis: Where Did Risk Management Fall?" (2009) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1460762; Annette Mikes, "Risk Management at Crunch Time: Are Chief Risk Officers Compliance Champions or Business Partners?" (2008) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1138615; Hans J Blommestein, Lex Hoogduin and JJW Peeters, "Uncertainty and Risk Management after the Great Moderation: The Role of Risk (Mis)Management by Financial Institutions" (2009) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1489826; Michel Crouhy, "Risk Management Failures During the Financial Crisis" in Robert W Kolb (ed), Lessons from the Financial Crisis (New Jersey: John Wiley, 2010) at 283; Elizabeth Sheedy, "The Future of Risk Modelling" in Robert W Kolb (ed), Lessons from the Financial Crisis (New Jersey: John Wiley, 2010) at 301; Frank Partnoy, "On Rogues, Risk-taking and Restoring Trust in Banks", *The Financial Times* (23 Sep 2011).

[38] The misselling of Payment Protection Insurance (PPI) to retail customers, see FSA, 'The Assessment and Redress of Payment Protection Insurance Complaints: Feedback on the Further Consultation in CP10/6 and Final Handbook Text' (August 2010) PS10/12 http://www.fsa.gov.uk/pubs/policy/ps10_12.pdf; FSA Handbook DISP 3; Eilis Ferran, 'Regulatory Lessons from the Payment Protection Insurance Mis-Selling Scandal in the UK' (2012) *European* Business Organisation Law Review 248. On the misselling of interest rate swaps to small businesses, see FSA, 'FSA Confirms Full Review of Interest Rate Swap Misselling' (31 January 2013) at http://www.fsa.gov.uk/library/other_publications/interest-rate-swaps. On the manipulation of the London Inter-bank Offered Rate, see 'UBS Fined £1.5bn for LIBOR Rigging', *BBC News* (19 December 2012); 'LIBOR Scandal: RBS Fined £390m', *BBC News* (6 February 2013); 'Foreign Exchange: The Big Fix', *Financial Times* (12 Nov 2013) discussing 15 banks including JP Morgan in potential enforcement action against foreign exchange fixing; 'Big Banks Slapped With £2.6bn FX 'Rate Rigging' Fines But Will They Ever Learn?', *Forbes.com* (15 Nov 2014); Martin DD Evans, 'Forex Trading and the WMR Fix' (2014) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2487991.

[39] See 'Forex scandal: How to rig the market', *BBC News* (20 May 2015).

[40] Argued in Iris H-Y Chiu, *Regulating from the Inside: The Legal Framework for Internal Control at Banks and Financial Institutions* (Oxford: Hart 2015).

directly to the Board of directors and not to the Chief Executive Officers so that their independence may not be compromised. Next, the three functions are to be headed by sufficiently senior officers in order not to be intimidated by senior executives who represent business interests. In particular, the institution of the Chief Risk Officer[41] was recommended after the Walker Review of Corporate Governance in Banks and Financial Institutions in 2009.[42] The three functions are assured adequate resources and empowerment such as access to firm-wide information in order to carry out their roles, some of which are now explicitly prescribed so that financial institutions cannot marginalise the three functions from key business decisions. For example the risk management function must be consulted on for marketing of new products,[43] and the compliance function must have oversight of activities in firms such as benchmarks submission.[44]

Procedural legalisation now intervenes directly into organisational design in order to change the behaviour of internal governance functions, influencing firm behaviour overall to be consistent with regulatory goals.

Although the direct regulation of internal control functions in a financial institution goes 'beneath the corporate veil' and is intended to affect corporate behaviour, such targeted regulation at micro-constituents can also achieve effects beyond the corporation. This is because internal control policies and systems are not always confined narrowly to distinct corporate entities and may encompass the entire group structure. Inter-dependencies and links in group-wide systems are not uncommon as a matter of strategic and operational efficiency.[45] Further, as financial institutions keenly affect and mimic each other[46] due to interconnections in transactions, changes in the behaviour of micro-constituents in individual corporations can influence the behaviour of those who interact with them. Such cascading and

[41] PRA Rulebook Risk Control, FCA Handbook, SYSC 21.

[42] D Walker, 'A Review of Corporate Governance in UK Banks and other Financial Industry Entities: Final Recommendations' (26 November 2009) at http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf.

[43] EBA Guidelines 2011.

[44] FCA Handbook MAR 8.2.

[45] For example see *Chandler v Cape* [2012] EWCA Civ 525. It may be argued that in response policy and systems 'segregation' could occur so as to limit the impact of regulatory permeation. However that is a trade-off that the firms would have to determine, between strategic and operational efficiency and the self-interest of avoiding regulation.

[46] Emilios Avgouleas, 'Financial Regulation, Behavioural Finance, and the Global Credit Crisis: In Search of a New Regulatory Model' (2008) at http://ssrn.com/abstract=1132665.

permeating effects of behavioural changes at a micro level could be rather powerful, traversing the boundaries within corporate groups and beyond.[47]

For example, several American and European banks have announced the review of their business relations with correspondent banks in African countries,[48] due to money laundering risks. In so doing, these banks may be responding to a need to improve their compliance culture, partly driven by the introduction of direct regulation of internal control functions.[49] In such a review, the changes in these banks' compliance culture may in turn affect the practices in their correspondent banks, creating pressure for those banks to improve their anti-money laundering compliance. At a broad level procedural legalisation has the potential to create powerful rippling effects where the transnational governance of corporate groups and business networks have proved challenging. Of course one could argue that these banks' behaviour is defensive in nature and creates obstacles for international financial flows and the access of developing countries to finance and capital. This point is taken up on the international platform as the Financial Stability Board[50] examines how best to help correspondent banks improve their due diligence procedures. The impact of behavioural change on the part of one corporation upon its wider network highlights the potential of procedural legalisation as a powerful regulatory strategy.

Next, we discuss corporate governance structures that support a stronger internal control culture at financial institutions, and institutional structures such as whistleblowing. Regulation has also introduced incentives to govern individual behaviour, in the form of personal responsibility and liability regimes in relation to firm compliance with substantive obligations, and the regulation of remuneration.

Regulation of Corporate Governance

Mandatory prescription for corporate governance is now introduced to support the effectiveness of internal control functions. For example, the EU Capital Requirements Directive makes it a Board responsibility to ensure adequate risk management systems in the firm.[51] Further, commentators[52] revealed that many

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[47] In this way, such changes could occur in a similar way to the norm cascades that Sunstein discusses when changing wider social norms, on which see: Cass R. Sunstein, 'On the Expressive Function of Law,' (1996) 144 University of Pennsylvania Law Review 2021; Cass R. Sunstein, 'Social Norms and Social Roles' (1996) 96(4) Columbia Law Review 903.

[48] 'Poor Correspondents', *The Economist* (14 June 2014).

[49] partly driven by intensive FCA enforcement too, for eg FCA's levy of £7.6 million fine on Standard Chartered for breaches of money laundering risk management.

[50] Financial Stability Board, *FSB Action Plan to Assess and Address the Decline in Correspondent Banking* (19 Dec 2016).

[51] Art 88, CRD IV Directive.

bank Boards lacked leadership in key strategic and risk decisions during the global financial crisis. This revelation has resulted in regulatory response in governing certain aspects of corporate governance, such as Board composition and the dedication of directors' time.

In terms of Board composition, the nomination committee of the Board must ensure that Board members bring a diverse slate of skills suitable for the business model,[53] and gender diversity is encouraged by a mandatory reporting obligation on gender ratio.[54] Further, firms of a certain scale or size need to institute a governing risk committee[55] on its Board in order to set risk appetite, frame policies for adequate risk management and oversight. Directors are also subject to prescriptive rules on time commitment. They are prohibited from taking more than one other executive appointment or 4 other non-executive appointments if appointed as an executive director to a bank Board.[56]

Although not necessarily in response to the more severe corporate governance requirements imposed, we observe that a number of bank Boards in the UK have for example, experienced rather frequent turnovers of late.[57] Directors seem to be less

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[52] For example: see Hamid Mehran, Alan Morrison, and Joel Shapiro, 'Corporate Governance and Banks: What Have We Learned from the Financial Crisis?' (June 2011) Federal Reserve Bank of New York Staff Report No 502 <http://ssrn.com/abstract=1880009>.

[53] Above.

[54] Above. Gender diversity may have an arguable connection with prudence in risk management, although this is still tenuous. In the financial sector, research on the effect of the male hormone testosterone on risk-taking on trading floors may have become rather important to the cause of championing for diversity. Perhaps the 'moderating' influences of female directors on bank and financial institution Boards would be necessary for overall risk governance. See John M Coates, Mark Gurnell and Zoltan Sarnyai, 'From Molecule to Market: Steroid Hormones and Financial Risk-Taking' (2010) 365 Philosophical Transactions of the Royal Society B: Biological Sciences 331; John M Coates and Joe Herbert, 'Endogenous Steroids and Financial Risk Taking on a London Trading Floor' (2008) 105 Proceedings of the National Academy of Science 6167; John Coates, *The Hour Between Dog and Wolf. Risk Taking, Gut Feelings, and the Biology of Boom and Bust* (New York: Penguin Press 2012). Further, it is believed that gender diversity on Boards would enhance critical and constructive challenge in Board discussions. See Melsa Ararat, Mine H Aksu and Ayse Tansel Cetin, 'The Impact of Board Diversity on Boards' Monitoring Intensity and Firm Performance: Evidence from the Istanbul Stock Exchange' (April 2010), at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1572283 on Turkish banks; MA Gulamhussen and Silva Maria Santos, 'Women in Bank Boardrooms and Their Influence on Performance and Risk-Taking' (April, 2010) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1615663 argues that gender diversity on bank Boards improves risk moderation.

[55] Art 88, CRD IV Directive, transposed in the PRA Rulebook, *Risk Control*.

[56] Above.

[57] For example, Barclays' Chief Executive Bob Diamond resigned in the wake of the LIBOR manipulation scandal after the global financial crisis and since appointed new Chief Executives in 2012 and 2015 respectively. Deutsche Bank has also had 2 turnovers of Chief Executives between

able to entrench power or be able to be complacent in a new environment that subjects them to direct regulatory governance and scrutiny. Such may be an indication in shifts in the financial sector's corporate cultures.

Regulating Other Organisational Frameworks or Structures

In order to ensure that regulatory prescriptions for internal control and corporate governance are not marginalised by firms in their implementation, the European Banking Authority has endorsed enterprise-wide risk management for banks.[58] The enterprise-wide risk management model is one where risk management is led at the strategic level by the Board, rolls out into all aspects of business and operations and is considered holistically. Risk management is not carried out in isolated silos in business units and is integrated into all aspects of information flows and oversight. With such endorsement, it would be difficult for banking groups to deliberately segregate their risk management or internal control policies in order to marginalise internal control functions.

Further, the UK has introduced mandatory organisational structures that support the work of internal control functions, for example, by compelling financial institutions to install a senior person responsible for maintaining a whistleblowing function[59] so that whistleblowers and informers are encouraged and offered a robust degree of protection[60] in order to overcome fears of retaliation. The reform is a result of implementation of the recommendations made by the Parliamentary Commission in 2013.[61] We observe for example that whistleblowers are coming forward to report

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2012 and 2016. Standard Chartered replaced its Chief Executive in the wake of the massive fine handed out by the FCA for failing to manage its anti money laundering risks, and HSBC is in the process of replacing its CEO and Chairman after being highlighted for failures in managing anti money laundering systems and controls.

[58] European Banking Authority, *EBA's Guidelines on Internal Governance* (27 September 2011). This continues to be endorsed in the Authority's consultation paper in 2016 on revising the above Guidelines, see http://www.eba.europa.eu/documents/10180/1639914/Consultation+Paper+on+Guidelines+on+internal+governance+%28EBA-CP-2016-16%29.pdf at para 130, under Section 13.

[59] PRA Rulebook, *General Organisational Requirements* (para 2.9).

[60] To this end the government is generally consulting on legal protection for whistleblowers in general and not limited to the financial sector, see Department of Business, Innovation and Skills (BIS), *Whistleblowing Framework: Call for Evidence* (12 July 2013) at https://www.gov.uk/government/consultations/whistleblowing-framework-call-for-evidence.

[61] House of Lords and House of Commons, *Changing Banking for Good* (Report of the Parliamentary Commission on Banking Standards) (12 June 2013) at Vol II, Chapter 6 generally at para 786; 792-797.

discomfort with financial institution culture and poor conduct.[62] This could be an early sign of changing corporate culture brought about by procedural legalisation.

Regulating Individuals - Remuneration

Next, regulatory prescriptions have been introduced to control bankers' remuneration, as the industry practices in relation to variable remuneration have been recognised to encourage perverse incentives for individuals.[63] Variable remuneration (bonuses), which form a large part of bankers' remuneration, are largely based on short-termist performance metrics, therefore incentivising individuals to engage in risk-taking behaviour and disregarding longer term consequences for the financial institution as a whole.

EU legislation now extends control over a wide range of bankers' remuneration, from Board level down to 'material risk takers' whose function affect their banks' key risk profiles or who earn a high level of remuneration commensurate with senior executives.[64] Such legislation, also transposed by the UK's PRA, includes a framework for award of remuneration based on longer-term and holistic metrics, and targeted control over bonuses.[65] In particular, control over bonuses severely limits guaranteed bonuses, and caps bonuses to 100% of fixed remuneration.[66] Further, 40% of bonuses must be deferred, and not to vest too soon, and at least half must be payable in securities-based instruments.[67] Bonuses are also subject to malus and clawback over substantially long periods, i.e. up to 10 years for senior executives and up to 7 years if certain conditions of wrong-doing, non-compliance or downturn in the firm's financial fortunes are satisfied.[68]

Governing individual incentives through remuneration remains a challenge, as manifested in the Wells Fargo scandal in 2016 that revealed staff setting up fictitious bank accounts because their bonuses were determined on the basis of the volume of

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[62] 'Lloyds Bank whistleblowers claim old-style methods and bullying tactics are returning to some high street branches (24 Nov 2015) at http://www.thisismoney.co.uk/money/saving/article-3330155/Lloyds-Bank-whistleblowers-claim-old-style-methods-bullying-tactics-returning-high-street-branches.html#ixzz43IXPZHdz.

[63] Capital Requirements IV Directive 2013 at Arts 92-95, PRA Rulebook, *Remuneration.*

[64] Commission Delegated Regulation (EU) No 604/2014 of 4 March 2014 supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards with respect to qualitative and appropriate quantitative criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile.

[65] Capital Requirements IV Directive 2013 at Arts 92-95, PRA Rulebook, *Remuneration.*

[66] Above.

[67] Above.

[68] PRA Rulebook, *Remuneration,* para 15.19.

new accounts acquired.[69] Further, this is an area that continues to be challenged by regulatory arbitrage as the industry attempts to create pay innovations that avoid regulation.[70] The difficulty with governing remuneration lies in the incompatibility of regulation with the competitive needs of banks and financial institutions for global talent.[71] It may also be argued that the prescriptive extent of EU legislation such as the bonus cap goes too far in shaping individual incentives and creates backlashes towards regulatory avoidance.

We are of the view that the effectiveness of remuneration regulation will likely lie in future successes of malus or clawback enforcements that make examples of individuals. As the conditions for malus and clawback are based very much on disconnecting reward from firm failure or material non-compliance, the enforcement of such regimes may provide the right incentives for individual behavioural change.

Regulating Individuals - Personal Responsibility and Liability

Financial sector reforms in the UK have also targeted individual conduct in financial institutions, recognising that collective culture is shaped by individual incentives[72] and behaviour. The UK has introduced a pioneering regime of individual responsibility and liability in financial institutions, targeted especially at senior persons.[73]

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[69] 'Wells Fargo Opened a Couple of Million Fake Accounts', *Bloomberg* (9 Sep 2016).

[70] Such as in role-based allowances which are structured to be neither fixed nor variable remuneration. But the EBA has clamped down in them, see http://www.eba.europa.eu/documents/10180/534414/EBA+Report+on+the+principles+on+remuneration+policies+and+the+use+of+allowances.pdf.

[71] See Longjie Lu, 'The End of Bankers Bonus Cap: How Will the UK Regulate Bankers Remuneration after Brexit?' (2016) 27 European Business Law Review 1091.

[72] Jonas Prager, 'The Financial Crisis of 2007/8: Misaligned Incentives, Bank Mismanagement, And Troubling Policy Implications' (2012) at http://ssrn.com/abstract=2094662, also remuneration incentives for individuals that can induce a form of self-interested risk-taking that can collectively pose prudential hazards for banks and financial institutions. See Markus K Brunnermeier and others, *The Fundamental Principles of Financial Regulation* (Geneva Reports on the World Economy, London: Centre for Economic Policy Research 2009); Financial Stability Board, 'Thematic Review on Compensation: Peer Review Report' (30 March 2010) http://www.financialstabilityboard.org/publications/r_100330a.pdf; Bernard S Sharfman, 'How the Strong Negotiating Position of Wall Street Employees Impacts the Corporate Governance of Financial Firms' (2011) 5 Virginia Business and Law Review 350.

[73] 'Bankers Terrified at New Regulations', *Financial Times* (8 March 2016).

The PRA and FCA have in place a pre-vetting and approval regime for a range of individuals[74] and senior persons who wish to be appointed in a financial institution. They need to satisfy the regulator of their 'fitness and propriety' which relate to integrity and competence.

For senior persons, defined[75] as executive directors, non-executive directors who are chairmen of Board committees and the key C-suite officers and Heads of Internal Control, they need to be approved by the relevant regulator in respect of specific areas of responsibility identified according to the regulator's role map.[76] Each senior person is approved with a statement of responsibilities which means that the failure to carry out such responsibilities will entail specific liability for the relevant senior person.[77]. All senior and certified persons are also subject to an on-going code of conduct.[78] Senior persons are subject to more obligations under the code of conduct than certified individuals, [79] in particular in relation to ensuring effective control over their areas of responsibilities and that adequate oversight is instituted.

The direct regulation of individual responsibilities and behaviour has great potential to change individual behaviour as individuals are strongly disincentivised to misbehave.[80] Senior persons may now be liable for non-compliance within his/her area of responsibility where s/he has not taken reasonable steps to prevent such breach. [81] Further, personal liability can be incurred for failing to adhere to the standards of conduct which include diligence, care, integrity, effective control and oversight.

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[74] PRA Rulebook, *Fitness and Propriety* and FCA Handbook FIT criteria.

[75] See PRA, *Approach to Non-Executive Directors in Banking and Solvency II Firms & Application of the Presumption of Responsibility to Senior Managers in Banking Firms* (23 Feb 2015).

[76] S59ZA, Financial Services and Markets Act 2000 as amended by the Financial Services Act 2010.

[77] Section 60(2A), Financial Services and Markets Act 2000 as amended by the Financial Services (Banking Reform) Act 2013.

[78] PRA Rulebook, *APER Conduct Rules;* FCA Handbook, COCON.

[79] PRA/FCA, *CP15/22 Strengthening Accountability in Banking: Final rules (including feedback on CP14/31 and CP15/5) and consultation on extending the Certification Regime to wholesale market activities* (July 2015).

[80] Bankers Terrified at New Regulations', *Financial Times* (8 March 2016). See empirical research in FCA Occasional Paper, *Incentivising Compliance with Financial Regulation* (Dec 2016).

[81] Sections 66A, 66B, Financial Services and Markets Act 2000 as amended by the Financial Services (Banking Reform) Act 2013. See also amendment to these sections in the Financial Services Bill 2015 that will place the onus on the regulator to prove that the senior person has not taken reasonable steps to prevent a regulatory contravention in his area of responsibility.

Enforcement against individuals by the PRA and FCA has been carried out in a number of high profile cases, such as against the former Chief Executive of Mitsui Sumitomo for failing to oversee that adequate systems of protection are instituted for protection of clients' money,[82] and against a senior business leader Achilles Macris at JP Morgan for failing to co-operate with the FCA in an open manner when early signs of JP Morgan's 'whale loss'[83] was being investigated.[84] The visibility of regulatory enforcement against individuals, and the serious consequence of disqualification from working in the financial services industry act as deterrents against individual misbehaviour. The UK's regime for governing individual behaviour may be the most pervasive example yet of procedural legalisation aimed at changing corporate conduct and culture. .

In the next Section, we survey how procedural legalisation is taking shape in anti-bribery regulation that applies to all corporations. It may be argued that financial sector regulation is special as prudential soundness and financial stability concerns are unique to the sector, hence warranting the adoption of procedural legalisation. However, we are of the view that procedural legalisation is not a regulatory design confined to the financial sector. Its approach of targeting micro-constituents within the corporation to affect their incentives and behaviour, in order to achieve a permeating effect throughout the corporate group and beyond, is pertinent to other issue areas where changing corporate culture or behaviour is needed.

(ii) Procedural Legalisation in Anti-Bribery Reform in the UK

It is the need to target corporate culture and behaviour that renders procedural legalisation a particularly useful regulatory tool when seeking to regulate corporate bribery.[85] By its very nature, bribery is a crime that is shrouded in secrecy[86] and motivated by personal gain (either directly or as an oblique consequence of the relevant corporation's success).[87] As a consequence, bribery is an offence that is

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82 http://www.fsa.gov.uk/static/pubs/final/yohichi-kumagai.pdf.

83 See 'JP Morgan makes $920m London Whale payout to regulators', *BBC News* (19 Sep 2013). The bank lost £6.2bn in risky derivatives trades overseen by a small coterie in the London office, hiding the losses from regulators until too late.

84 FCA Final Notice: Achilles Macris, at https://www.fca.org.uk/your-fca/documents/final-notices/2016/achilles-macris.

85 The effective regulation of bribery necessitates the control of a range of behavioural and organisation features, including those identified by Cressey's 'fraud triangle' of pressure, opportunity and rationalisation, each of which is amplified in the corporate setting and exacerbated in a global economy. See: Cressey, *Other People's Money, a Study in the Social Psychology of Embezzlement* (Patterson Smith, 1973).

86 As both the payer and the recipient of the bribe seek to conceal the payment.

87 Cressey, *Other People's Money, a Study in the Social Psychology of Embezzlement* (Patterson Smith, 1973) at 30.

not easily governed by orthodox regulatory design, which arguably risks failing to address the intrinsic motivation for such corrupt practices. However, trying to prohibit or prevent bribery within transnational corporations is, of course, challenging. Organisational hierarchies risk obscuring personal responsibility for compliance,[88] whilst the international reach of the group means that micro-constituents within the firm are subject to numerous (and potentially conflicting) regulatory demands and social norms.[89] As a result, individuals acting on the corporation's behalf are potentially less susceptible not only to extrinsic statutory mandates but also the non-legal behavioural constraints that may otherwise serve to restrain profitable, yet unethical, behaviour. From a supervisory perspective, these difficulties are exacerbated by the often significant separation (both geographically and structurally) between the senior management team and other individuals within the corporate structure.

It is against this backdrop that this Section explores how the Bribery Act 2010 sought, with early success, to adopt a form of procedural legalisation to manage corporate bribery risk. As shall be seen, the procedural legalisation regime adopted by the Bribery Act 2010 is less prescriptive than that discussed in respect of financial sector firms as it is predicated, in part, on non-binding guidance issued by the Ministry of Justice (the 'MOJ Guidance').[90] Nevertheless, notwithstanding the 'soft' nature of this guidance, the Bribery Act remains an important example of procedural legalisation. In particular, the role of internal policies, procedures and training have proven to be persuasive both to a determination of a breach of the Act and, in terms of reparation, to the court's willingness to sanction a deferred prosecution agreement ('DPA').[91]

Structure of the Bribery Act 2010 and Ministry of Justice Guidance

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[88] For example, within a hierarchical organisation, individuals can become task-focused, effectively 'out-sourcing' responsibility for wider decision-making to more senior members of staff. That is, an individual understands their obligation simply to achieve the objectives of the task given to them, even where this 'does not respond to the motives of the individual actor,' see: Stanley Milgram, *Obedience to Authority: An Experimental View*, (first published Tavistock Publications 1974, rev edn, Pinter & Martin 2010)

[89] Social norms being those of a group or community. That is an 'effective consensus obligation,' see: Robert Cooter, 'Expressive Law and Economics,' (1998) 27 Journal of Legal Studies 585, 587.

[90] The Ministry of Justice, *Bribery Act 2010: Guidance About Procedures which Relevant Commercial Organisations can put into Place to Prevent Persons Associated with them from Bribing (section 9 of the Bribery Act 2010)* (March 2011).

[91] See for example the Rolls-Royce Plc DPA (paras 6(v) and 25 – 34) and corresponding Statement of Facts (see, for example, paras 16-29) < https://www.sfo.gov.uk/cases/rolls-royce-plc/> accessed 3 February 2017.

The Bribery Act 2010 introduced a novel approach to corporate offending, which is now being replicated in other fields of corporate misconduct.[92] It sets out a corporate offence of failing to prevent bribery,[93] subject only to the defence that a commercial organisation had in place adequate procedures[94] designed to prevent the bribery from occurring.[95] The scope of the offence is broad and has expansive extra-territorial application.[96] In this way, the Act effectively governs not only the global corporation but also its business network, including suppliers and other third parties acting on its behalf. Indeed, it is the scope of the Act that resulted in significant global attention and its initial success in achieving changes to many corporations' internal control systems.

The Act does not specify what constitutes adequate procedures, leaving this as a matter for each company to determine.[97] The rationale for this approach, and the flexibility that it provides, is clear. Nevertheless, and not surprisingly, the uncertainty inherent within the defence was met with widespread industry criticism.[98] In response to this industry pressure, the Act mandated that the Secretary of State publish (non-binding) guidance as to the procedures that commercial organisations can put in place pursuant to section 7.[99] This MOJ Guidance provides a framework, as a matter of soft law, of the minimum standards that a corporation can (and arguably should) adopt in efforts to comply with the Act. As discussed later in this Section, the MOJ Guidance clearly highlights the perspective that micro-constituents

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[92] See for example n (4).

[93] Section 7(1), Bribery Act 2010.

[94] Section 7(2), Bribery Act 2010.

[95] For a more detailed discussion of section 7 see: Anna P. Donovan, 'Systems and Controls in Anti-Bribery and Corruption', in (Iris Hse-Yu Chiu and Michael McKee, eds), *The Law on Corporate Governance in Banks* (Edward Elgar, 2015), 236.

[96] Section 12, Bribery Act 2010

[97] This potential uncertainty is a hallmark of the 'new governance' approach in regulation theory, the (arguably unavoidable) weaknesses of which are now well acknowledged. On which, see Section D.

[98] The lack of definition is interesting, given the Law Commission's acknowledgement when discussing the term 'corruptly' that for 'a term which is not statutorily defined to be included in the definition of an offence, we must be confident that its generally understood meaning is unequivocal and that the common meaning is the meaning we would like imported into the offence' Law Commission, `*Legislating the Criminal Code: Corruption* (LC 248, 3 March 1998) ('Legislating the Criminal Code'), para 5.65. It remains to be seen whether (although it is unlikely) a commercial organisation will attempt a defence premised on the incompatibility of the adequate procedures defence with the European Convention requiring certainty of law. However, maintaining a claim that the law is too uncertain to be enforceable is a difficult task, see: *Kokkinakis v Greece (1993) 17 EHRR 397, [1993] ECHR 14307/88* and *Handyside v United Kingdom (application 5493/72*) (1976) 1 EHRR 737, [1976] ECHR 5493/72.

[99] Section 9(1), Bribery Act 2010.

within the corporation have potentially significant governance capacities and responsibilities.

The MOJ Guidance sets out six flexible and procedural but 'outcome focused'[100] principles that commercial organisations should implement.[101] These principles are premised on a balance between prescription and flexibility, encouraging firms to develop bespoke solutions to bribery risks without facilitating creative[102] or merely symbolic[103] compliance. The MOJ Guidance expects firms to implement holistic managerial and organisational changes to meet the Act's defence of adequate procedures. In doing so, procedural legalisation is used to influence organisations' internal controls and senior management responsibility. We note that even though the guidance is not binding, it is likely to comprise the minimum requirements for a robust defence and, as outlined above, is persuasive when looking at the small number of cases that have been prosecuted under the Act.[104]

Regulating culture and internal responsibilities

At a fundamental level, anti-corruption regulation needs to address the difficult question of corporate culture. Bribery often occurs when individual incentives, the firm's internal control functions (or lack thereof) and the firm's culture coalesce to form a normative environment that either facilitates or fails to adequately deter bribery.[105] Where individuals consider paying a bribe, they may be restrained by informal sanctions by peers (reflected in the norms of the corporation's culture, which acts as a powerful form of social ordering)[106] or by formal sanctions from their employer (as detected by internal controls and enforced by the firm). Where they are

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[100] MOJ Guidance, 20.

[101] These six principles are: (i) proportionate procedures; (ii) top-level commitment; (iii) risk assessment; (iv) due diligence; (v) communication (including training); and (vi) monitoring and review.

[102] As to the relationship between creative compliance and command and control style legislation see: Doreen McBarnet, 'Financial Engineering or Legal Engineering? Legal Work, Legal Integrity and the Banking Crisis,' in Iain MacNeil and Justin O'Brien (eds.) *The Future of Financial Regulation* (Hart Publishing 2010), 79.

[103] See: Edelman (n 24).

[104] See (n 91). See also the Standard Bank Plc DPA (paras 6 (vi), and 27 - 32) and Statement of Facts (especially part F, part I, Appendix 2 and Appendix 3) <https://www.sfo.gov.uk/2015/11/30/sfo-agrees-first-uk-dpa-with-standard-bank/> accessed 4 February 2017.

[105] For the power of social (group) norms on individual decision making see: Michael Wenzel, 'The Social Side of Sanctions: Personal and Social Norms as Moderators of Deterrence,' (2004) 28(5) Law and Human Behavior 547; Cass R. Sunstein, 'Social Norms and Social Roles' (1996) 96(4) Columbia Law Review 903.

[106] Benjamin E. Hermalin, *Economics & Corporate Culture* (2000) University of California, 2 available here < http://faculty.haas.berkeley.edu/hermalin/cultchds.pdf> (accessed 8 February 2016).

not so deterred, either by a permissive corporate culture, a weak environment of internal control or both, then there is, effectively, no basis to constrain self-interested behaviour.[107] Thus, the importance of culture should not be understated. The relatively low risk of individual prosecution means that it is these non-legal behavioral constraints that are instrumental to achieving meaningful individual behavioral change.

In seeking to mobilise these social constraints, the MOJ Guidance places collective responsibility on the Board to instil a 'zero-tolerance' culture to bribery.[108] The Guidance is, unsurprisingly, unequivocal that the obligation to eradicate bribery should supersede other (financial) incentives that may exist within the firm.[109] In this way, it seeks to act as a normative ordering function,[110] attempting to reinstate (or, indeed, potentially introduce) the primacy of ethical decision making over the financial pressures that may otherwise contribute to corrupt behaviour. A critical factor in achieving this objective is to interrupt the unintended consequences of the internal decision-making hierarchies that are essential to corporate life but can serve to insulate individuals from legal and moral responsibilities.[111] To do so, the MOJ Guidance looks to influence organisational roles and responsibilities (at both board and senior management levels) in two key ways.

First, the Guidance prescribes that the obligation to achieve a cultural shift (where necessary) within the firm falls firmly within the Board's remit. Whilst the board may not have day-to-day responsibility for ensuring compliance with the corporation's anti-bribery and corruption policies, it remains ultimately responsible (and accountable) for ensuring that the Act's objectives are met. This is reflected in the recent Rolls-Royce Plc DPA, which was clear that ultimate responsibility for 'identifying, assessing and addressing risks' remains with the board.[112] More specifically, the Guidance recommends that the Board should be involved in any key decisions concerning the management of bribery risk and is tasked with adequately communicating the firm's culture to both its employees and the third parties that it

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107 Charles O'Reilly, 'Corporations, Culture, and Commitment: Motivation and Social Control in Organizations,' (1989) California Management Review 31(4), 12.

108 On culture as a social control mechanism see: Charles O'Reilly and Jennifer Chatman, 'Culture as Social Control, Corporations, Cults and Commitment,' (1996) 18 Research in Organizational Behavior 157.

109 In this way, the Act potentially engages the expressive function of law. On which see: Cass R. Sunstein, 'On the Expressive Function of Law,' (1996) 144 University of Pennsylvania Law Review 2021; Elizabeth S. Anderson and Richard H. Pildes, 'Expressive Theories of Law: a General Restatement,' (2000) 148 University of Pennsylvania Law Review 1503.

110 See (n 107).

111 See (n 89).

112 Rolls-Royce Plc DPA (n 91), para 29.

engages with (discussed further below). As part of this responsibility, the Board is expected to make formal statements (both internally and to its external partners) stipulating the firm's anti-bribery stance and its commitment to engage in fair and honest business.

Secondly, to address the immediate challenge that a potentially nebulous requirement for cultural change may face, the MOJ Guidance encourages the imposition of individual responsibilities supported by organisational reporting lines and structures. In particular, it requires that there are individuals within the senior management team that have clear responsibility for the design, implementation and monitoring of anti-bribery procedures. Moreover, these individuals must have suitable access, and direct reporting lines, to the Board to enable them to discharge these functions and raise any compliance concerns with the board directly. They must be adequately positioned within the firm (to achieve the difficult balance of independence whilst being apprised of the risks that the business faces) and sufficiently resourced to mitigate bribery within a large organisation.[113] This delegation of day-to-day responsibility further distils another important function of the Board's responsibility (as stated by the MOJ Guidance). That is, the compliance team must be visibly supported by the Board to enable them to discharge their duties. In particular, they must be seen by other individuals within the organisation to possess the authority and backing of the Board to enable them to, in effect, counteract the commercial pressures that may give rise to resistance to some of the decisions that the compliance team may make (such as the refusal to sanction certain lucrative, but high risk, contracts).

Regulating Internal Systems and Controls

Operationally, the ability to commit a bribery offence coincides with perceptions of a relatively low risk of detection after the bribe has been paid. An organisation that has poor accounting procedures, inadequate oversight and review functions, ineffective internal audit and no procedures for proper due diligence provides its employees with extensive opportunities to engage in corrupt practices with relative impunity. Inadequacies in firms' internal systems are therefore instrumental in creating an ineffective control environment. Whilst most firms have always adopted some system of internal control, these are understandably focussed on the objectives of the firm, not necessarily the wider public concerns that the Act seeks to address.[114] In addition, these controls risk being merely 'cosmetic,'[115] stipulating a

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[113] Anna P. Donovan, 'Systems and Controls in Anti-Bribery and Corruption,' in (Iris Hse-Yu Chiu and Michael McKee, eds), *The Law on Corporate Governance in Banks* (Edward Elgar, 2015).

[114] Julia Black, 'Paradoxes and Failures:"New Governance" Techniques and the Financial Crisis' (2012) 75 Modern Law Review 1037.

[115] Kimberly D. Krawiec, Organizational Misconduct: Beyond the Principal-Agent Model (2005) 32 *Florida State University Law Review* 571, 572. See also: John C. Coffee, "Carrot and Stick"

seemingly robust policy on paper but failing to be adequately implemented and enforced.[116] Thus, procedural legalisation is employed by the Act and MOJ Guidance to distinctly target internal control functions and senior management in order to empower them to address firm weaknesses that are susceptible to allowing bribery to occur. The MOJ Guidance is clear that these procedures should be proportionate to the risks faced by the business and therefore must reflect the findings of a bespoke risk-assessment undertaken to determine the actual risks faced by the organisation.[117]

Giving the need to tailor internal processes to a particular corporate environment, neither the Act nor the MOJ Guidance prescribe what procedures or policies a firm must adopt (although the MOJ Guidance provides a non-exhaustive list of policies that a firm should consider).[118] Ultimately, the internal control functions of the corporation are responsible for the bespoke design and implementation of such policies, predicated on a robust and regular risk assessment. However, as a minimum, these procedures will likely include policies that set out the firm's overarching commitment to bribery prevention together with specific policies to prevent or detect bribery. Common controls and policies include those concerning gifts and hospitality, financial reporting and controls, facilitation payments and whistle-blowing. A particularly acute risk facing international organisations is the engagement of third parties, which is discussed further in the next section.

Recognising the role of micro-constituents in combatting bribery risk, the MOJ Guidance recommends that these procedural changes should be supported by communication and training, which is to be rolled out throughout all levels of the organisation.[119] To improve compliance culture, it is imperative that communication can be made openly and easily throughout the corporation. That is, both *to* the senior management and *by* the senior management. The board needs to convey a culture of zero-tolerance to bribery whilst reassuring staff that compliance with this

Sentencing: Structuring Incentives for Organizational Defendants (1990) 3(3) *Federal Sentencing Reporter* 126, 127.

[116] This issue of the proper implementation of anti-bribery policies is a common feature of enforcement actions in the UK. Most companies will have adopted an adequate policy on paper. However, the breach arises when they have not properly implemented that policy. This can be seen in the recent case of *SFO v Standard Bank plc* as well as FCA enforcement actions in this field. See the FCA Final Notice in respect of JLT Specialty Limited (19 December 2013) <http://fca.org.uk/static/documents/final-notices/jlt-specialty-limited.pdf> (last accessed 7 February 2016).

[117] Principle 1, MOJ Guidance. Following the initial assessment, the risk-assessment should be subject to periodic review and repeated following 'trigger' events, such as the acquisition of a new company or the entry into a new product market or jurisdiction.

[118] Principle 1, MOJ Guidance.

[119] Principle 5, MOJ Guidance.

culture, even against the seeming self-interest of the firm, will be rewarded. A key part of this will be publishing enforcement decisions in respect of any breach of policy. Further, those on the 'front line' of the business need to inform management of the risks that they encounter together with any difficulties that they experience when implementing internal policies in practice. One important aspect of this communication exercise is the periodic and bespoke training of staff. The Guidance is clear that training must be tailored to each aspect of the workforce including in some instances to third parties.

Procedural Legalisation Affecting Third Parties

Transnational corporations face significant exposure under the Act in respect of the conduct of third parties acting on their behalf, conduct that is specifically caught by the broad remit of section 7. The corporate offence extends not only to corporate employees or (potentially) subsidiaries but also to other 'associated persons'[120] that bribe with the intent of, *inter alia*, retaining business or obtaining an advantage in the course of business for the corporation.[121] Moreover, the broad extra-territorial reach of the offence further increases the potential liability that a corporation has for third parties and, as a consequence, the necessary scope of internal procedures that are adopted by an organisation to satisfy the Act's defence. Managing this third party risk is not easy. As explained earlier, the geographical structure of the transnational firm means that not only is effective control of such third parties challenging, but also that some parties may be operating in an environment where bribery (or certain forms of it) are viewed as commonplace or normatively acceptable. However, the clear risk that an external partner will commit bribery on the firm's behalf means that to meaningfully address corporate corruption, it was necessary for the Act to be structured in this way.[122]

The MOJ Guidance encourages organisations to introduce robust due diligence procedures that should be followed before engaging third parties.[123] The range of third parties that could be caught includes those within the corporation's supply chain, lobbyists, introducers and local contractors. This due diligence should be undertaken on a risk-based approach, having regard to the nature of the third party

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[120] Sections 7(1) and 8, Bribery Act 2010.

[121] Section 7(1), Bribery Act 2010.

[122] The risk of bribery being undertaken by a third party has, traditionally, been a significant exposure for corporations. A number of enforcement actions undertaken the Financial Services Authority (as the FCA was then known) under its Systems and Control requirements related to the actions of third parties. See for example: the FSA's final notice against Aon Limited. Aon was fined £5.25 million for, *inter alia*, failing to maintain effective systems and controls for countering the risks of bribery and corruption associated with payments to overseas third parties. See: FSA Final Notice to Aon Limited (6 January 2009) <http://www.fsa.gov.uk/pubs/final/aon.pdf> accessed 10 September 2016.

[123] Principle 4, MOJ Guidance.

relationship, the identity of the third party, their territory of operation and the industry that they operate in. These controls extend to both internal procedures for engaging the third party and monitoring payments to them, together with the investigation of, and interview with, the third party itself.

The consequence of this requirement is that procedural legalisation is used to change behaviour within and beyond the corporation through the interaction of micro-constituents that are now governed by certain mandatory procedural structures. Further, a corporation may also manage the bribery risk in relation to its third party agents by contracting for rights to see books and records, and including warranties in any contracts that they enter into on the corporation's behalf. Third party agents may also have to be subject to periodic training. A considerable part of the success of the Act is attributable to the fact that it, effectively, extends its procedural requirements to a significant range of corporate actors.[124]

In sum, procedural legalisation as applied in anti-bribery regulation targets senior management and internal control, achieving some extent of prescription but not as extensively as under financial sector regulation. The flexibility that the soft guidance provided by the MOJ gives to corporations in implementing internal controls, and to the courts in deciding whether these are adequate, is to be welcomed. However, the effectiveness of this hybrid approach between a regulatory requirement for 'adequate procedures' and soft guidance as to what this might entail does depend upon the robust enforcement of the Act. Whilst the UK Serious Fraud Office has been steadily enforcing against companies, and implicated senior management, this action needs to continue for the Act to retain its position as an international gold-standard in anti-corruption initiatives and for the effectiveness of the non-binding MOJ Guidance to continue.[125]

Procedural legalisation can create incentives that cascade though the corporate group and to inter-relations with the corporation. It is hoped that corporate culture can be gradually shaped and changed and this could achieve a regulatory breakthrough particularly in fields that are unresponsive to command and control regulation or prone to creative compliance. Procedural legalisation in the rather mature and precise form as applied to the financial sector, or in a softer form as applied to regulation against bribery, has the potential to be used more widely in corporate regulation, particularly for complex and stubborn issues where progress in

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[124] Currently, the precise scope of the Act's reach is unclear. On reading the Act, the impact on a corporation's supply chain is significant. However, the MOJ Guidance (para 39) seemingly limits this to immediate counter parties (although this interpretation would appear to undermine the mischief of the Act).

[125] Although the SFO has itself faced institutional and resource challenges, which needed to be addressed, enforcement by the SFO is increasingly (particularly following the introduction of DPAs) supporting the efficacy of procedural legalisation. The impact on corporate culture of course remains to be seen.

changing corporate behaviour and culture has hitherto been limited using other regulatory techniques.

In the next Section, we argue that procedural legalisation indeed challenges established corporate law theories that have been instrumental in creating barriers to effective corporate regulation. Procedural legalisation reaches deep into corporations' systems, processes and responsible individuals, and 'regulating beneath the corporate veil' can be challenged by both the 'real entity' and 'nexus of contracts' theory of the corporation, even if both theories are not *prima facie* reconcilable. However, Section D argues that regulating beneath the veil is anchored in modern regulation theory which is able to expose the limitations in the theoretical conceptions of the corporation. It is a de-constructivist approach that can finally achieve a breakthrough in corporate regulation hampered by prevailing corporate law theories.

C. Relationship of Procedural Legalisation to Corporate Law

It is trite law that a company is, upon registration, a separate person from its members.[126] This remains true even in a group situation, where individual entities within the group retain their separate personality notwithstanding commonality of ownership.[127] By introducing regulation *within* the corporate structure, it can be argued that procedural legalisation is incompatible with theoretical conceptions of corporate personhood. However, the theoretical premises are limited and corporate law has over the years introduced mandatory regulation that intervenes into the internal order *within* the corporation.

The 'real entity' theory of the corporation seeks to characterise the nature of the corporation not simply as a legal abstract but as a social, living, organism. Multiple individuals associating with each other to form a corporate entity create a separate and independent personality.[128] For advocates of this school of thought,[129] the function of law is to recognise this personality,[130] which 'enjoys any rights and duties

[126] *Salomon v A. Salomon & Co* [1897] AC 22.

[127] However, this characterisation is not without its challenges and has contributed to extensive academic discourse as to the nature and origins of the firm, and, as a corollary, the legitimacy of government interference with it (through the imposition of regulation). Further, attempts to recognise a 'single economic unit' approach to corporate groups (in *DHN Food Distributors Limited v Tower Hamlets LBC* [1976] 1 WLR 852) was quickly disputed and overruled (*Woolfson v Strathclyde Regional Council* [1978] UKHL 5; *Adams v Cape Industries* [1990] Ch 433).

[128] Martin Petrin, Reconceptualizing the Theory of the Firm – From Nature to Function, (2013) 118(1) Penn State Law Review 1, 6.

[129] This theory is primarily associated with the work of Gierke. See: Otto von Gierke, *Political Theories of the Middle Age* F. Q. Maitland (ed) (1990).

[130] E. Freund, *The Legal Nature of Corporations* (University of Chicago Press, 1897), 13.

that [it] could exercise.'[131] In this way, the real entity theory supports the protection of separate personality and its consequences including the protection of limited liability.[132]

In contrast, the dominant Anglo-American theory as to the origin of the firm is contractarianism.[133] For contractarians, the company is essentially a 'nexus of contracts,'[134] an efficient means of organising multiple 'factors of production.'[135] A company exists to centralise the organisation's operations, avoiding the transaction costs of individually negotiating on the open market to secure the necessary inputs (such as labour and raw materials) required to achieve the firm's objectives. The theory establishes the 'quintessentially private and self-ordered nature of a company's management affairs,'[136] which should be mainly free from state intervention. For contractarians, most governmental interference with the private conduct of the organisation is illegitimate as company law should only embody the default terms that the parties to the nexus would have agreed, i.e. their optimal 'hypothetical bargains'.[137]

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131 Martin Petrin, Reconceptualizing the Theory of the Firm – From Nature to Function, (2013) 118(1) Penn State Law Review 1, 6.

132 *Carlen v Drury* (1812) 1 Ves & B 154.

133 Key works in this field include: R. Coase, '*The Nature of the Firm*' (1937) 4(16) Economica 386-405 (where Coase noted, *inter alia*, that transaction costs incurred in going to market could be reduced by internalising the costs within a firm) and later his work "*The Problem of Social Cost*" 3 Journal of Law and Economics 1 (1960), 1-44; A. Alchian and H. Demsetz, *Production, Information Costs, and Economic Organization*" 62 Am. Econ. Rev 777 (1972) (who, *inter alia*, identified the importance of monitoring to avoid shirking within the corporation); M. Jensen and W. Meckling, "*Theory of the Firm: Managerial Behavior, Agency Cost and Ownership Structure"* 3 J. Fin. Econ. 305 (1976) (to whom the phrase 'nexus of contracts can be attributed); F. Easterbrook and D. Fischel, *The Economic Structure of Corporate Law"* (1991, Harvard University Press, Cambridge MA) (who suggested that shareholders as residual claimants could be protected by allocating shareholder wealth maximisation as the primary corporate purpose).

134 On this see M. Jensen and W. Meckling, "*Theory of the Firm: Managerial Behavior, Agency Cost and Ownership Structure"* 3 J. Fin. Econ. 305 (1976). In his paper, "*Meta-Contracts, Corporate Governance, And Bank Regulation*" A. Morrison suggests that the 'nexus-of-contracts' in fact comprises of two arrangements: the 'real' nexus, which is the relationship between the firm (or entrepreneur) and the real economy being the "means by which the entrepreneur generates social value" and the *meta-contract* being the financial contract between the entrepreneur and the investors.

135 E. Fama and M. Jensen, "*Separation of Ownership and Control*" 26 Journal of Law and Economics (1976) 301, 303.

136 Marc Moore, Private Ordering and Public Policy: the Paradoxical Foundations of Contractarianism (2014) 34 *Oxford Journal of Legal Studies* 693, 697.

137 Easterbrook & Fischel, The Corporate Contract, (1989) 89 *Columbia Law Review* 1416, 1444.

Albeit by different theoretical pathways, corporate law theories would seem unable to support what procedural legalisation seeks to achieve. Under the real entity theory, introducing procedural legalisation could be perceived to be an illegitimate intrusion into the internal order of the corporate personality, violating the personhood of the real entity. Under the nexus of contracts theory, procedural legalisation is anomalous as it intrudes upon the contractual freedoms of the constituents in the 'nexus' and would arguably create distortions in their bargaining order.

Both theoretical premises are however incomplete. The real entity theory is not a unified living organism like natural legal persons. Indeed, the corporation acts via the decision-making of its organs, the Board and its shareholders in general meeting, such as in making a decision to sue,[138] and in removing directors via a shareholders' ordinary resolution at general meeting.[139] Corporate law has also introduced mandatory legislation that looks into the internal order within the corporation to determine the corporation's responsibility. For example, the Corporate Homicide and Manslaughter Act 2007, which attributes gross negligence in internal management and control to the corporation so as to make the corporation liable for homicide. The nexus of contracts theory places too much emphasis on the freedom of 'contracting' constituents beneath the veil to achieve a negotiated state of order, while ignoring both the realities of imperfect contracting due to imbalances of power or information among constituents, and the possible externalities that can be caused by private collective action.[140] Mandatory company law does not reflect the strict premises of this theory and has indeed intervened in the freedom of exercise of power, for example, on the part of majority shareholders to secure the overall good of the company in constitutional amendments.[141]

The theoretical accounts of corporate personhood are incomplete and present no real objections to mandatory regulation *within* the corporate structure. Petrin[142] also argues that corporate theory is often mis-used to serve certain insular interests.[143] Procedural legalisation is not incompatible with corporate law. However, as

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[138] Breckland Group Holdings Ltd v London & Suffolk Properties Ltd [1989] BCLC 100.

[139] Section168, Companies Act 2006.

[140] i.e. the nexus of contracting constituents can collectively agree on an internal order, but such an internal order causes harm and social cost that is externalised unto third parties or the environment.

[141] *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656; *Arbuthnott v Bonnyman and others* [2015] EWCA Civ 536.

[142] Martin Petrin, 'Reconceptualizing the Theory of the Firm—From Nature to Function' (2013) 118 Penn State Law Review 1.

[143] The corporation asserts its 'real entity' in order to appropriate constitutional rights and to internalise the cost of wrong-doing by its employees. But it also asserts its private nature as being merely a 'nexus of contracts' in order to maintain its insular existence and resist public regulation where possible, above.

procedural legalisation introduces a new expanse of mandatory regulation within the corporate structure, we argue that there is a need to account for its legitimacy. In the next Section, we provide such an account based on 'new governance' approaches in regulation theory.

D. Foundation for Procedural Legalisation as a Form of Corporate Regulation - Perspectives from Regulation Theory

Procedural legalisation may be regarded as having its roots in an area of regulation theory known as 'new governance'. 'New governance' is a broad term that covers various regulatory innovations focused on decentralised, participatory, problem-solving approaches to regulation, as opposed to traditional regulation's focus on centralised dictation of rules developed by experts with state-imposed penalties for non-compliance.[144] It is increasingly acknowledged in political science literature that modern platforms of authority for problem solving come from a variety of state-based and non-state-based sources.[145] The governance of an issue area therefore departs from traditional command-and-control regulation, which places emphasis on the state being able to prescribe obligations and to secure the regulated entities' compliance by enforcement. It is increasingly recognised that states may not be optimally placed to prescribe and control in areas where non-state actors interact with regulated entities and co-exert forms of authority. The governance of transnational corporate behaviour may be regarded as situated in a 'decentred'[146] regulatory space.[147]

Black argues that decentred regulation is premised on five preconditions, namely complexity, fragmentation, interdependencies, ungovernability and the rejection of a

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[144] See David Hess, 'The Three Pillars of Corporate Social Reporting as New Governance Regulation: Disclosure, Dialogue, and Development' (2008) 18 Business Ethics Quarterly 447, and Bradley C Karkkainen, ''New Governance' in Legal Thought and in the World: Some Splitting as Antidote to Overzealous Lumping' (2004-5) 89 Minn. L. Rev. 471, 471.

[145] See for eg Frank Vibert, *The New Regulatory Space: Reframing Democratic Governance* (Cheltenham: Edward Elgar 2014) at chapters 1 and 2.

[146] Julia Black, 'Critical Reflections on Regulation' (2002) 27 *Australian Journal of Legal Philosophy* 1.

[147] Contemporary literature is generally acknowledging the rise of governance, which is a pluralistic concept that explains how spaces for problem solving and dialogue are populated by many actors, and not monopolised by regulators or governments. See James N Rosenau and Ernst-Otto Czempiel, *Governance without Government: Order and Change in World Politics* (Cambridge: Cambridge University Press 1992) as an earlier classic treatise on this issue; Stephen P Osborne (ed), *The New Public Governance?: Emerging Perspectives on the Theory and Practice of Public Governance* (Oxford: Routledge, 2009), at Part I. On financial regulation specifically, see Isabelle Huault and Chrystelle Richard (eds), *Finance: The Discreet Regulator* (Abingdon: Palgrave Macmillan, 2012) on how non-regulatory actors provide leadership in governing finance.

clear private-public distinction.[148] 'Complexity' refers to the nature of problems that need to be solved. 'Fragmentation' refers to the diffusion of knowledge, resources and capacity for control in the regulatory space. 'Interdependencies' refers to the dynamics between participants in the regulatory space, co-producing and co-enforcing norms of governance. 'Ungovernability' refers to the autonomy and unpredictability of actor behaviour in the regulatory space, posing challenges to assumptions made by regulatory authorities. In a decentred landscape, governance is 'polycentric'[149] as all relevant actors, public or private, contribute to and influence governance in a landscape of distributed power among many actors. In essence, state-based authorities jostle for governance power with international organisations, business and industry, industry associations, think-tanks and other private sector for-profit and not-for-profit organisations.[150] Hence, modern governance initiatives often feature a mixture of state-based frameworks, private sector implementation, and third party or market monitoring.

In this context, regulation can be regarded as an exercise that leverages upon different governance capacities, not necessarily in a co-ordinated manner. In the area of transnational corporate behaviour, the power, capacity and resources of transnational corporations could dwarf some states, and give rise to issues that may be difficult to regulate using traditional regulatory techniques. Hence, the governance of transnational corporate behaviour needs to leverage upon corporations themselves in forms of coordination and collaboration with the governance actorhood of states, stakeholders, international organisations and so on.[151]

One of the 'new governance' approaches to regulation, meta-regulation,[152] focuses very much on the regulated firms themselves being able to contribute to aspects of self-governance. Meta-regulation refers to a regulatory approach that empowers and enhances the capacity of corporations to self-regulate, but connects 'the private justice of the internal management system' to the 'public justice of accountability'.[153]

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[148] Above.

[149] John Gerard Ruggie, 'Regulating Multinationals: The UN Guiding Principles, Civil Society, and International Legalization' in César Rodriguez-Garavito (ed.), Business and Human Rights: Beyond the End of the Beginning (2014) at http://ssrn.com/abstract=2474236.

[150] Julia Black, 'Critical Reflections on Regulation' (2002) 27 *Australian Journal of Legal Philosophy* 1.

[151] John Gerard Ruggie, 'Regulating Multinationals: The UN Guiding Principles, Civil Society, and International Legalization' in César Rodriguez-Garavito (ed.), Business and Human Rights: Beyond the End of the Beginning (2014) at http://ssrn.com/abstract=2474236; Glen Whelan, Jeremy Moon, & Marc Orlitzky, 'Human Rights, Transnational Corporations, and Embedded Liberalism: What Chance Consensus?' (2009) 87 Journal of Business Ethics 367.

[152] Overview of this area can be found in Sharon Gilad, "It Runs in the Family: Meta-regulation and its Siblings" (2010) 4 *Regulation and Governance* 485.

[153] Christine Parker, *The Open Corporation* (Cambridge: Cambridge University Press 2000), 246.

Parker proposes that firms' capacity to self-regulate may be enhanced by value orientation, management commitment, the acquisition of skills and knowledge, and the design of internal processes and systems. Such 'self-regulation' should then be accountable to regulators and stakeholders in order to achieve not just 'compliance' but responsibility towards society more broadly. Parker envisages that 'meta-regulation' would improve the permeability of the corporation to public accountability.[154]

Meta-regulation can thus be seen as a form of non-intrusive or 'reflexive' law that restrains over-prescription and over-intrusion by command-and-control regulation in favour of less 'formalistic' and more responsive approaches that reflect changes in social order.[155] Hence, early approaches in meta-regulation are very much based on skeletal regulatory frameworks that deal with corporate organisation or processes that firms are free to adapt. Firms develop their own systems and control, not by standardised prescription, to meet the overall objectives of public accountability. An example is management-based regulation discussed by Coglianese and Lazer,[156] describing how regulation could provide frameworks for the planning, management or implementation of certain strategies for compliance by firms, in order to secure certain substantive objectives. These frameworks are not highly prescriptive and firms can implement appropriate systems or processes tailored to their needs while effectively achieving regulatory expectations.[157]

However, meta-regulation suffers from certain weaknesses. The reflexive nature of meta-regulation means that regulatory frameworks are often broadly-based. But firms may pervert the discretion given to them, by implementing procedures that seem to comply but are only superficial and box-ticking in nature. Further, firms can even design systems and procedures that appear compliant while gaming the regulatory regime, such incentives are likely to be kept under control only if regulators are vigilant and critical in their supervision.[158] The Basel II Capital Accord

[154] Christine Parker, *The Open Corporation* (Cambridge: Cambridge University Press 2000).

[155] For example see Gunther Teubner, 'Substantive and Reflexive Elements in Modern Law' (1983) 17 Law and Society Review 239.

[156] Cary Coglianese and David Lazer, 'Management-Based Regulation: Prescribing Private Management to Achieve Public Goals' (2003) 37 Law and Society Review 691.

[157] Sharon Gilad, "It Runs in the Family: Meta-regulation and its Siblings" (2010) 4 *Regulation and Governance* 485; Cristie Ford, 'Macro- and Micro-Level Effects on Responsive Financial Regulation' (2011) 44 *University of British Columbia Law Review* 589; Cristie Ford, "New Governance, Compliance, and Principles-Based Securities Regulation" (2008) 45 *American Business Law Journal* 1; Colin Scott, "Regulating Everything: From Mega- To Meta-Regulation" (2012) 60 *Administration* 61.

[158] See chapter 1, Iris H-Y Chiu, *Regulating from the Inside: The Legal Framework for Internal Control at Banks and Financial Institutions* (Oxford: Hart 2015).

is an example in financial sector regulation that highlights the weaknesses of meta-regulation. [159]

The micro-prudential regulation framework developed for the most sophisticated banks and financial institutions in 2006 is a form of meta-regulation.[160] Micro-prudential regulation for banks first developed in 1988 based on a set of prescriptive standards for banks to adopt in determining the riskiness of their assets, so that they could ensure adequate capital is set aside for their assets.[161] The Basel II Capital Accord[162] moved away from the prescriptive standards as they were one-size-fits-all and too crude in measuring risk profiles. Hence, the Accord allowed banks with more sophisticated internal risk management systems to use their internal models and systems to determine certain aspects of riskiness of their assets.[163] This to an extent allowed banks to determine their capital adequacy compliance. Although it has been intended that regulatory scrutiny should be exercised over firm implementation, so that regulators are operating at a meta-level of supervision, regulators have found it hard to make judgments on the technical robustness of banks' internal models. Hence, the meta-regulatory approach in micro-prudential regulation has actually become a form of self-regulation in banks. This is a chief weakness of meta-regulation.[164] In reality, as commentators have pointed out, banks that were in a position to determine their own capital charges have tended to set aside less capital

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[159] See chapter 12, Mads Andenas and Iris H-Y Chiu, *The Foundations and Anatomy of Financial Regulation* (Oxford: Routledge 2014).

[160] Also discussed in Robert F Weber, 'New Governance, Financial Regulation, and Challenges to Legitimacy: The Example of the Internal Models Approach to Capital Adequacy Regulation' (2010) 62 Administrative Law Review 783.

[161] This is the standardised 'risk-weighting' approach, see Basel Committee on Banking Supervision International Convergence of Capital Measurement and Capital Standards (July 1988) at http://www.bis.org/publ/bcbs04a.pdf.

[162] Implemented in the European Parliament and Council Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions [2006] OJ L77/1 (Capital Requirements Directive).

[163] This approach is known as the Internal-ratings based approach (IRB). Banks under the Foundation IRB approach can use their internal information and ratings to determine how likely a borrower would default on its loan. The bank's determination of a borrower's probability of default allows the bank to feed its discretion into the determination of the credit risk profile of the borrower and hence the risk-weight of the loan asset. Under the Advanced IRB approach, banks which prove to the regulator that they are highly sophisticated risk management models can determine all aspects of a borrower's credit risk and derive the risk-weight of their loan asset without reference to standardised measurements of riskiness prescribed in the Accord. See Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework -- Comprehensive Version* (June 2006) at http://www.bis.org/publ/bcbs128.htm.

[164] Larisa Dragomir, *European Prudential Banking Regulation and Supervision* (Oxford: Routledge 2010) at 124ff.

and taken on more risk,[165] putting their profit objectives above the regulatory objective of soundness and prudence. The backlash against the near-self-regulatory approach in Basel II has resulted in the return of more prescriptive standards for capital adequacy in the Basel III Capital Accord introduced in the wake of the global financial crisis.[166] However as the Basel III Accord cannot revert to simplistic assumptions of riskiness such as under the Basel I Accord, the discretionary approaches by banks discussed above are not superseded. Nevertheless, banks using them are subject to international surveys of their implementation differences and to greater supervision by regulators.[167]

The global financial crisis 2007-9 has indeed brought about more reflective thinking in relation to the achievements and weaknesses of meta-regulation. Ford[168] articulates that the chief weakness of meta-regulation lies in it being susceptible to firm abuse. Meta-regulation may be criticised as 'trusting' too much in the corporation, and regulators have not been sufficiently engaged to ensure that firm implementation is consistent with regulatory objectives. The fallibility of 'trust' in the corporation lies in the failure to understand the motivations and processes related to firm implementation, which is undertaken by micro-constituents in the corporation.

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[165] Michael McAleer, Juan-Angel Jiménez-Martin and Teodosio Pérez- Amaral, "What Happened to Risk Management During the 2008-2009 Financial Crisis?" in Robert W Kolb (ed), *Lessons from the Financial Crisis* (New Jersey: John Wiley, 2010) at 307; Paul H Kupiec, "Financial Stability and Basel II" (FDIC Research Paper 2006-10) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=942297; Michael Jacobs Jnr, "An Empirical Study of the Returns on Defaulted Debt and the Discount Rate for Loss-Given-Default" (2009) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1425146; Jukka Vaukhonen, "Bank Safety and Basel II" (Bank of Finland Research Paper 2009) at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1513239.

[166] For example, the Basel III Capital Accord introduces absolute additional buffers to bolster banks' compliance with capital adequacy. Although these buffers are based on risk-weighted assets, which can be determined with the banks' discretion as discussed in n163, the increased ratio of capital adequacy that banks have to maintain may exert a 'braking' influence upon excessive risk-taking and pushing the boundaries of capital adequacy regulation. See Basel Committee on Banking Supervision, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (rev June 2011, Basel: BIS 2010) <http://www.bis.org/publ/bcbs189.pdf.

[167] For example the Basel Committee surveys banks using the discretionary IRB approaches for consistency of implementation, Basel Committee, *Basel III Regulatory Consistency Assessment Programme* (Oct 2013) at http://www.bis.org/publ/bcbs264.htm; Basel Committee, *Reducing Excessive Variability in Banks' Regulatory Capital Ratios: A Report to the G20* (Nov 2014) at para 2. Such work is also undertaken by the European Banking Authority which desires to reduce inconsistencies in banks' IRB implementation and hence check any potential abuse of their discretion in using these approaches, see for example EBA, *Fourth Report on the Consistency of Risk Weighted Assets* (11 June 2014) at http://www.eba.europa.eu/documents/10180/15947/20140611+Fourth+interim+report+on+the+consistency+of+risk-weighted+asset.pdf.

[168] Cristie Ford, 'New Governance in the Teeth of Human Frailty' (2010) Wisconsin Law Review, see http://www.mfdf.org/images/DirResPDFs/NewGovernanceintheTeethofHumanFrailty.pdf.

Without such understanding, any ‘trust’ in corporations to implement their self-governance is misplaced and naïve.

Procedural legalisation now takes us one step towards reconstructing such trust on a sounder footing, and re-introduces regulatory governance over micro-constituents that shape corporate behaviour. Regulators, particularly within the financial services sector, are able to have more meaningful engagement in supervising firm implementation, as they are able to look for more precise pockets of responsibility within the firm, target supervisory dialogue with the relevant micro-constituents and construct more specific criteria for evaluating firm implementation.

That said, as we have seen in Section B, this engagement is not as prevalent within the anti-bribery sphere. Whilst the relative independence afforded to corporations by the Bribery Act 2010 reflects a deliberate effort to enable proportionate and bespoke procedures to be adopted, this does come at the risk of uncertainty and a lack of enforcement (in all but the largest transgressions). This potential shortcoming of the regime has not been remedied by the recent sanction of DPAs under the Act. Whilst these DPAs give insight into those internal control frameworks that have proven to be insufficient, these clearly egregious examples provide little guidance to those organisations that are not similarly positioned. Moreover, the DPAs leave the detail of the revised internal controls that are to be implemented in reparation as a matter for the corporation and its appointed monitor. As a consequence, this lack of disclosure again limits the amount of guidance that the DPA can offer to other organisations looking for insight into how the Act might be complied with and enforced. Against this, we do not suggest that the anti-bribery regime should (at this stage) adopt a procedural legalisation regime that is as prescriptive as that engaged by financial services regulation. However, without more active enforcement of the Act some movement towards binding guidance may need to be contemplated. As a minimum, consideration should be made to putting the current soft law requirement of a periodic risk assessment on a mandatory footing (whilst retaining, as a matter of soft law, guidance on how to respond to any identified risks). This mandatory reporting requirement will potentially enhance individual responsibility (as the board cannot deny knowledge of the risks identified in the report), contributing both to the implementation of effective internal controls or, if necessary, enforcement efforts by the regulator.

The social and regulatory appetite for exerting more governance and control over financial services has accelerated after 2007 and culminated in expansive,[169] prescriptive[170] and paternalistic[171] regulation in the financial sector. This impetus has

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[169] J De Larosière and others, *Report by the High Level Group on Financial Supervision in the EU* (Brussels, 25 February 2009) http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf.

[170] For example The Markets in Financial Instruments Directive and Regulation 2014 has become prescriptive with regard to trade reporting and financial intermediary conduct; The European Markets

paved the way for addressing and reforming the inadequacies of meta-regulation approaches that have become too permissive. Procedural legalisation can be seen as an improvement upon the weaknesses of meta-regulation.

Nevertheless, it is not immediately obvious that procedural legalisation is an extension or refinement of meta-regulation. This is because it seems to depart from the de-centred tenet in new governance approaches by re-asserting state-based authority in demanding regulatory compliance. The prescriptive nature of procedural legalisation seems removed from being collaborative with firm-specific needs and indeed introduces compliance cost. It would appear that procedural legalisation (within the financial services sector at least) intends to dis-empower corporations from exercising implementation discretion. It can be argued that procedural legalisation boosts the position of regulators vis a vis regulated firms, and places regulators in a position where command-and-control techniques could be well-placed to resume. In this way, procedural legalisation can be framed in a more antagonistic than collaborative manner, departing from the ‘new governance’ tenet.

However, we argue that procedural legalisation is not only consistent with the ‘new governance’ tenet of de-centred participation and problem-solving, but that it appropriately refines meta-regulation to address its weaknesses. In doing so, procedural legalisation provides a *new* ‘new governance’ account of corporate regulation.

Although procedural legalisation is far more prescriptive than meta-regulation, we argue that its prescriptive nature is the part represented by the state’s participation in the de-centred landscape for governing corporations, and to an extent, in offering standardisations in optimal structures for corporations based on lessons learnt post-scandals or crises. Hence, procedural legalisation does not depart from the de-centred landscape but merely refines the nature of the state’s role in that landscape. By introducing regulatory standardisations for structures and processes, the state arguably mediates the efficiency values of the internal order of the firm with the broader social values of corporate power and responsibility, therefore providing a richer account regulatory standardisation beyond transaction-cost reduction.

Further, it can be argued that inadequate attention has been paid to the different incentives and governance capacities of micro-constituents within the corporation, and hence they have been insufficiently empowered to participate in the de-centred governance landscape. By introducing procedural legalisation, micro-constituents within the corporation are given distinct visibility in their governance role, providing a

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Infrastructure Regulation 2010 is highly prescriptive as to the types of transactions that have to be centrally cleared and prudential requirements for clearing houses and the Capital Requirements Directive and Regulation 2014 is highly prescriptive on the prudential regulation applicable to banks.

[171] See discussion on consumer protection regulation in chapter 8, Mads Andenas and Iris H-Y Chiu, *The Foundations and Anatomy of Financial Regulation* (Oxford: Routledge 2014).

richer balance in the dynamics of governance. Further, procedural legalisation can be regarded as introducing the necessary standards for corporations to regain trust for their governance role and capacity in the de-centred landscape. After corporate scandals and crises, the credibility of corporations in supplying a governance role for themselves is inevitably put into doubt. Moreover, it is neither practicable nor balanced to exclude their governance role. In this manner, 'procedural legalisation' provides a new basis for the actorhood of corporations in the governance landscape, and can be regarded as a more refined account of the dynamics in the de-centred landscape, consistent with 'new governance' approaches.

Importantly, procedural legalisation is able to place the micro-constituents within the corporation onto the same de-centred platform to maximise their governance capacity. Procedural legalisation places internal control functions for example in the de-centred governance landscape, being empowered to monitor the financial institution for compliant behaviour. The due diligence functions in a corporation are highlighted in order to champion anti-bribery behaviour. This approach achieves a form of corporate regulation through de-constructing the firm's internal structures and functions, giving them a distinct governance identity. This is consistent with the 'new governance' tenet that reaches out to leverage upon the governance capacity and actorhood of a wide range of players in the de-centred landscape. Whether we apply the real entity theory or the nexus of contracts theory, we have created a blind spot as to the actorhood of micro-constituents within the corporation. The real entity theory subsumes micro-constituents such as individuals or departmental groupings under the organisational umbrella of the corporation, but it is already well recognised by both organisational science and corporate governance theorists that micro-constituents are not homogenous and indeed very different. micro-constituents

Although the 'nexus of contracts' theory pays regard to micro-constituents beneath the corporation, micro-constituents are regarded only as economic agents interested in organisational efficiencies and financial wealth-creation in their self-interest. Taking this view, the role of regulation vis a vis such micro-constituents can only be limited to facilitating their transactions. This is an unduly narrow conception of micro-constituents, ignoring their attributes, capacities and interests, and the wider consequences of their collective action. Hence, 'procedural legalisation' can de-construct the unduly narrow and insular conception of the nature of micro-constituents assumed by the 'nexus of contracts' theory, and allow us to fully consider their actorhood and responsibilities in the de-centred governance space for transnational corporations. Reaching into the tenets of the 'new governance' approach in modern regulation theory, procedural legalisation can be firmly anchored and represent a new milestone in corporate regulation.

Nevertheless, reaching into 'new governance' to provide a theoretically supportable account of procedural legalisation does not mean carte blanche for regulators to introduce micro-management of corporations. Regulatory design must be based on identifying the extent of actorhood and capacity on the part of micro-constituents, so that the governance of their behaviour can be articulated precisely and in proportion to their governance capacity. In the next Section, we argue that procedural legalisation can be further developed in two respects in order to be effective. First, insights from organisational behaviour are necessary to highlight possible achievements and limitations of regulation targeted at micro constituent behaviour. Secondly, there is a need to ensure that an adequately designed enforcement regime flanks the objectives intended to be achieved in procedural legalisation.

E. **The Need for Further Development of Procedural Legalisation**

The key achievement of procedural legalisation is the mobilisation of micro-constituents' governance capacity within the corporation. However, as the goal in mobilising micro-constituents' behaviour lies in changing corporate behaviour and culture, the links need to be established between micro-constituents' behaviour and corporate decision-making, culture and behaviour. Hence, we need to understand insights from organisational science[172] and behavioural research[173] in order to ascertain how changes in micro constituent behaviour could have ramifications through the organisational fabric. Studies on the organisational attributes, features and factors that drive or prevent ethical decision-making and embedment in corporate culture do not provide an exact scientific method as to how regulation can be designed.[174] We advocate that interdisciplinary insights should not be used simply and in a formulaic manner, but regulators should be clearly aware that they are wading into the area of law and behaviour and should use these insights judiciously in regulatory design.

Parker and Nielsen[175] argue that procedure-based regulation can change firm culture, by promoting the values of oversight, accountability, respect for processes, intra-firm

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[172] For eg see Lynn A Stout and Margaret Blair, 'Trust, Trustworthiness and the Behavioral Foundations of Corporate Law' (2001) 149 University of Pennsylvania Law Review 1735 clearly disavows the rational self-interested economic agent assumption made of organizational constituents in a corporation and advocate that their social dimensions and behavior in a group or organizational context be given attention.

[173] Thomas Gilovich, Dale Griffin and Daniel Kahneman (eds), *Heuristics and Biases: The Psychology of Intuitive Judgment* (Cambridge: Cambridge University Press 2002); Daniel Kahneman and Amos Tversky (eds), *Choices, Values and Frames* (Cambridge: Cambridge University Press 2003).

[174] See for eg Linda K Trevino, Stuart A Youngblood, 'Bad Apples in Bad Barrels: A Causal Analysis of Ethical Decision-Making Behavior' (1990) 75 Journal of Applied Psychology 378-385; Eugene McKenna, *Business Psychology and Organisational Behaviour* (Psychology Press 2000) at 187ff.

[175] Christine Parker and Vibeke Lehmann Nielsen, 'Corporate Compliance Systems : Could They Make Any Difference?' (2009) 41 Administration and Society 3; Christine Parker and Sharon Gilad, 'Internal Corporate Compliance Management Systems: Structure, Culture and Agency' in Christine Parker and Vibeke Lehmann Nielsen (eds), *Explaining Compliance: Business Responses to Regulation* (Cheltenham: Edward Elgar 2011) at 170.

coordination and intra-firm education. Killingsworth[176] opines that procedural clarity has an important part to play in embedding corporate culture. Procedural clarity, coupled with fair implementation, encourages all within the organisation to subscribe to the substantive values underlying the procedures. Hence, procedural legalisation in financial sector regulation can contribute towards the building up of a financially prudent culture, and could contribute to a zero tolerance culture towards bribery in the anti-bribery situation. Consistent organisational implementation is crucial to changing corporate culture.[177] Moreover, reinforcement from senior management[178] is important to support the enduring quality of such changes.

However, in comparing the scope and extent of procedural legalisation in financial regulation to that in anti-bribery regulation, the former can be regarded as much more developed with its multi-pronged approach in targeting corporate governance, internal control functions, other organisational institutions such as whistleblowing, and individual incentives and personal responsibility. These together constitute a multi-pronged model which can form a blueprint for procedural legalisation in other areas of corporate sector regulation. In this manner, anti-bribery regulation may be evolving towards this mature blueprint, and it may take a major corporate scandal to make the tipping point.

The growing popularity and importance of procedural legalisation as a regulatory means to change corporate behaviour is also witnessed in recent regulatory developments in relation to 'due diligence' frameworks for corporations in the areas of modern slavery,[179] business and human rights[180] and corporations' environmental and social footprint,[181] although such frameworks are less developed than under anti-bribery regulation. Our study may therefore shed some light in the incremental developments in procedural legalisation: meta-regulatory frameworks may give way

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[176] Scott Killingsworth, 'Modeling the Message: Communicating Compliance through Organisational Values and Culture' (2012) 25 Georgetown Journal of Legal Ethics 961.

[177] Robert E Scott, 'The Limits of Behavioral Theories of Law and Social Norms' (2000) 86 Virginia Law Review 1603.

[178] See for eg Peter Montagnon, 'Culture by Committee: Pros and Cons' (2016) at www.ibe.org.uk/userassets/survey/boards_culture_survey_interactive.pdf.

[179] Section 54, UK Modern Slavery Act 2015.

[180] EU Directive amending the Fourth Company Law Directive on companies' annual reporting and introducing narrative reporting, see http://www.europarl.europa.eu/sides/getDoc.do;jsessionid=27F1AA74DC4AEB80AE6ED2752AB801D6.node1?pubRef=-//EP//TEXT%20TA%20P7-TA-2014-0368%200%20DOC%20XML%20V0//en.

[181] In this respect the US is also imposing similar corporate regulation in terms of corporate transparency for 'due diligence' systems that ensure that no conflict minerals are used by the corporation or its supply chain. See s1502, Dodd-Frank Act 2010 and SEC final rules in http://www.sec.gov/rules/final/2012/34-67716.pdf.

to soft law that more precisely delineate organisational structures and expectations for corporate culture (such as in anti-bribery regulation) and ultimately to legalised structures and frameworks if the regulatory objective is perceived not to be met. Hence, if corporate behaviour is not significantly improved or if a major corporate scandal breaks out, the developing nature of meta-regulatory frameworks may crystallise into more mature procedural legalisation such as under financial regulation.

It may be argued that procedural legalisation only reflects regulators' anxiety to impose more control in the wake of a corporate scandal or crisis, as is the case with financial regulation which responded to social appetite for reform after the global financial crisis. However, we are of the view that resort to procedural legalisation is not merely a knee-jerk policy response. Procedural legalisation in financial regulation is based on and consistent with a range of empirical research into organisational and governance flaws.[182] Procedural legalisation reflects the integration of policy with regulation theory, corporate governance and organisational behaviour and is arguably multi-disciplinary and informed.

Nevertheless, critical insights from organisational behaviour would remain crucial to appraising the effectiveness of procedural legalisation as we continue to observe how corporate and individual behaviour change with time.

Obstacles in Organisational Structures

Gunningham et al[183] point out that procedure-based regulation that targets certain groupings in an organisation may have limited impact on changing corporate culture and behaviour if the leadership from such groupings is unable to percolate all levels. Organisational dynamics may in some cases facilitate procedural legalisation and in some cases obstruct its effective outworking. Regulators need to be mindful of entrenched organisational structures such as silos.

Behavioural Biases

Further, regulators may also wish to draw upon insights from behavioural theories in order to address unintended consequences of regulatory impact on micro constituent behaviour. Behavioural theories have become important as the assumption of rationality in human behaviour, decision-making and choice is greatly misplaced.[184]

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[182] Extensively studied in Iris H-Y Chiu, *Regulating from the Inside: The Legal Framework for Internal Control at Banks and Financial Institutions* (Oxford; Hart Publishing 2015).

[183] Neil Gunningham and Darren Sinclair, 'Organizational Trust and the Limits of Management-Based Regulation' (2009) 43 Law and Society Review 865.

[184] Russell B Korobkin and Thomas S Ulen, 'Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics' (2000) 88 California Law Review 1051; FCA Occasional Paper, *Behaviour and Compliance in Organisations* (Dec 2016).

For example, as internal control functions have always been framed as serving the firm's purposes, framing their functions towards changing the corporate culture and securing regulatory objectives may run counter to their anchor heuristic. The anchor heuristic describes people as likely to stick to their first choices, decisions or understandings, as these have been internalised and accepted earlier. So, would internal control functions feel pressured by their new regulatory obligations and responsibilities, and struggle in divided loyalty - serving the firm's purposes and securing regulatory compliance?[185]

Further, people tend to take the path of least resistance. As regulatory reforms targeted at changing micro constituent behaviour requires them to make an effort to recognise a new framing of their roles, and take steps to undertake new procedures, would they rely on minimal compliance and box-ticking? [186] What is the risk of under-achievement of the governance capacity of micro-constituents and would substantive outcomes be affected micro-constituents[187] Further, people also tend to be risk-averse, and regulatory reforms targeting micro-constituents, which often augment their personal liability, may create organisational distortions and unintended consequences such as individual defensiveness and blame-shifting within and beyond the corporation.

Excessive Procedural Legalisation - Missing the Wood for the Trees?

Regulators should avoid being excessively focused on procedural compliance and become gradually disengaged from substantive issues of actual corporate behaviour and social implications.

It remains to be seen if the mature form of procedural legalisation in financial regulation is indeed an epitome for the development of this approach. Is there an advantage retaining a certain extent of open-texturedness or reflexivity? An open-textured approach emphasises values, ethics and morals which provide strong impetuses for individual action too.[188] Excessive procedural legalisation may detract focus away from the 'moral message'. For example, the UK Bribery Act does not

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[185] Discussed extensively in Iris H-Y Chiu, *Regulating (from) the Inside: The Legal Framework for Internal Control in Banks and Financial Institutions* (Oxford: Hart 2015).

[186] For a broader discussion of creative compliance see Doreen McBarnet's work in this area, including: D. McBarnet and C. Whelan, 'Creative Accounting and the Cross-eyed Javelin Thrower,' (1999) E. A. F., 105 (Jun), 13; D. McBarnet, 'After Enron Will "Whiter Than White Collar Crime" Still Wash?' (2006) Brit. J. Criminol. 46(6), 1091 and D McBarnet and C. Whelan, 'The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control' (1991) 54 Mod. L. Rev. 849.

[187] Kimberly D Krawiec, 'Cosmetic Compliance and the Failure of Negotiated Governance' (2003) 81 Washington University Law Quarterly 487; Lawrence A Cunningham, 'The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills' (2003) at http://ssrn.com/abstract= 444600, (2003) 29 Journal of Corporation Law 267.

[188] FCA Occasional Paper, *Behaviour and Compliance in Organisations* (Dec 2016).

prescribe the exact systems and controls that are required in excessive detail. This could be one of the Act's greatest successes, as the Board is forced to focus on how the corporation can achieve holistic changes both internally and in relation to external partners. The open-textured element encourages regulators to evaluate behaviour meaningfully in light of regulatory objectives and not merely rely on simple indicators of non-compliance. Hence there is a need to determine the design of procedural legalisation that achieves the embedment of values and not just the embedment of procedures that streamline actions and decisions.

Credible Enforcement

Further, procedural legalisation needs to be supported by appropriate enforcement regimes in order to embed individual incentives and behaviour, which cascade into organisational and cultural change.[189] In this respect the reforms in financial regulation have achieved clarity in personal responsibility and liability, although we need more empirical insights from behavioural science as to what balance of defensiveness/risk aversion[190] is achieved in tandem with more care and ownership of personal responsibility.

However, where anti-bribery is concerned, enforcement is still targeted at the corporation. Would the micro-constituents in the corporation interpret this message as meaning that the ultimate cost of enforcement is still borne by the corporation and therefore no different from a business cost? It is important for regulators to consider the design of enforcement regimes in their complementarity with procedural legalisation so that the regulatory objectives are not undermined. Empirical research seems to support the institution of individual responsibility and liability regimes so that compliance can be internalised and enforcement acts as a deterrent to change individual incentives. Procedural legalisation has the potential to become a powerful regulatory technology. It can de-construct existing legal and power structures in order to tease out weak links, pockets of sub-optimalities and perverse incentives. Although procedural legalisation in financial regulation is by far more extensive than in any other area of corporate sector regulation, it remains to be seen if that is the epitome of development in this regulatory approach. There is a need to continue

[189] Enforcement provides the requisite deterrent effect for individuals, see FCA Occasional Paper, *Behaviour and Compliance in Organisations* (Dec 2016).

[190] Insights from theories of punishment and impact on behaviour are important. The negative effects of punishment may heighten risk aversion and induce organizational behavioural modification but may also induce perverse liability-shifting strategies. Complex psychologies may be at play in discerning negative, positive or perverse perceptions. See for example Fred Luthans, 'The Role of Punishment in Organizational Behaviour Modification' (1973) Public Personnel Management 156; RM Church, `The Varied Effects of Punishment on Behaviour' (1963) 56 Organisational Behaviour and Human Decision Processes 246-265; Derek Rollinson et al, 'The Disciplinary Experience and its Effects on Behaviour: An Exploratory Study' (1997) 11 Work Employment & Society 283; Laurie J Mullins, *The Essentials of Organisational Behaviour* (Pearson 2006).

absorbing insights from organisational behaviour and consider what constitutes effective enforcement. We acknowledge that at a certain point, support for procedural legalisation has to come from *ex post* legitimacy. We turn now to discuss future directions for research.

F. **Directions for Future Research**

Procedural legalisation offers a new technology in effective corporate regulation by targeting micro constituent behaviour and structures within a corporation, with the potential of achieving corporate behavioural change and rippling effects to the transnational corporate group and its business network. We however recognise that insights from organisational behaviour are key to exploring its scope, effectiveness and limitations. Hence, we suggest that future research directions (including inter-disciplinary ones) in this area can be focused on the *ex post* legitimacy of this approach. These include:

(a) empirical research on the effectiveness of procedural legalisation, measured against corporate behaviour, for example, mapping against decreased levels of corporate fines, supervisory events or individual liability;[191]
(b) normative research on the optimal means of enforcement complementing procedural legalisation.[192]

Further the *ex post legitimacy* of procedural legalisation may be examined in a broader context in relation to other governance mechanisms such as:

(a) the inherent limitations of procedural legalisation, in terms of insights from organisational behaviour and science and/or psychoanalyses of individual behaviour;
(b) how procedural legalisation interacts with the efficiencies, political and cultural aspects of organisation design in transnational corporations; and
(c) the impact of procedural legalisation on private litigation and civil obligations such as the development of enterprise liability doctrines.

We also think that procedural legalisation can further theoretical and normative research into:

(a) the broader context of regulation theory, such as how meta-regulation should be developed;
(b) the development of corporate law theories and the governance of transnational corporations; and

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[191] Such as Lori Snyder Bennear, 'Are Management-Based Regulations Effective? Evidence from State Pollution Prevention Programs' (2007) 26 Journal of Policy Analysis and Management 327.

[192] This is particularly timely given the recent introduction of Deferred Prosecution Agreements in England and Wales pursuant to the Crime and Courts Act 2013 for breaches of s 7, Bribery Act 2010. The first and, at the time of writing, only UK DPA was approved in November 2015 in the matter of *SFO v Standard Bank plc*.

(c) the broader context relating to the distinctions and optimalities between soft and hard law as instruments of global governance.