OPTIMAL LEVEL OF TRANSPARENCY AND DISCLOSURE OF INFORMATION: THE DIALECTIC OF TRANSPARENCY AND DISCLOSURE VIS-À-VIS CONFIDENTIALITY IN THE BANKING SECTOR

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DECLARATION

The work presented in this thesis is my own.

ABSTRACT

There has been growing interest in enhancing bank transparency, and this thesis starts from the premise that bank information is a fundamental tenet of the operations of banking. From the banks' perspective, too much disclosure does not lead to the most expedient way of running its business. The duties, obligations or liabilities established for a bank matter. These duties or liabilities could either be actualised through regulatory obligations, these being securities markets regulation or bank prudential regulation, or private law and contractual obligations related to information held by a bank. Such obligations cause tension between the authorities that have a vested interest in the disclosure or non-disclosure of bank information.

Table of Contents

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LEGISLATION

United Kingdom

Anti-Terrorism Crime and Security Act 2001

Bank of England Act 1998

Bank of England and Financial Services Act 2016

Bankers' Books Evidence Act 1879

Banking Act 2009

Civil Procedure Rules 1998

Companies Act 1947

Companies Act 2006

Crime Act 2003

Crime and Courts Act 2013

Criminal Justice Act 1987

Data Protection Act 1998

Drug Trafficking Act 1994

Enterprise Act 2002

Enterprise Act 2003

Evidence Act 1975

Finance Act 2011

Financial Services (Banking Reform) Act 2013

Financial Services Act 2010

Financial Services and Markets Act 2000

Income and Corporation Taxes Act 1988

Insolvency Act 1986

Money Laundering Regulations SI 2007/2157

Police and Criminal Evidence Act 1984

Proceeds of Crime Act 2002

Reporting of Savings Income Information Regulations 2003 SI 2003/3297

Senior Courts Act 1981

The Money Laundering, Terrorist Financing and Transfer of Funds Regulations 2017 SI 2017/692

Terrorism Act 2000

United States of America

Bank Secrecy Act 1970

Community Reinvestment Act

Dodd–Frank Wall Street Reform and Consumer Protection Act 2010

Emergency Economic Stabilization Act of 2008

Emergency Economic Stabilization Act of 2008

Federal Reserve Act 1913

Financial Choice Act of 2017

Financial Services Modernization Act of 1999

Freedom of Information Act

Jumpstart Our Business Startups Act

National Bank Act of 1864

Sarbanes-Oxley Act of 2002

Securities Act of 1933

Securities and Exchange Act of 1934

The Bank Holding Company Act of 1956

The Foreign Account Tax Compliance Act

The Patriot Act 2001

The Right to Financial Privacy Act of 1978

Other

Austrian Banking Act of 1993

Banking Act of Singapore of 2003

Swiss Banking Act of 1934

EU Directives, Regulations and International Conventions

Commission Directive 2003/124/EC of 22 December 2003 Implementing Directive 2003/6/EC of the European Parliament and of the Council as regards to Definition and Public Disclosure of Inside Information and the Definition of Market Manipulation [2003] OJ L339/73

Consolidated version of the Treaty on the Functioning of the European Union [2012] OJ C326/01

Convention of 18 March 1970 on the Taking of Evidence Abroad in Civil and Commercial Matters

Council Directive 89/592/EEC of 13 November 1989 Coordinating Regulations on Insider Dealing [1989] OJ L334/30

Directive 2003/48/EC of 3 June 2003 on Taxations of Saving Income in the Form of Interest Payments

Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse)

Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC

Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about

issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC

Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013 amending Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and Commission Directive 2007/14/EC laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC

International Convention for the Suppression of Financing of Terrorism 1999

OECD Model Tax Convention

OECD's the Multilateral Convention on Mutual Administrative Assistance in Tax Matters and the Multilateral Competent Authority Agreement

Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC

Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC

United Nations Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (The Vienna Convention) 1988

CASES

United Kingdom

A & Ors v Hayden [1984] 156 CLR 532

Allies Mills Pty Ltd v Trade Practices Commission (1981) 34 ALR 105

British Steel Corp v Granada Television Ltd [1982] AC 1096

Foley v Hill (1848) 2 HL Cas 28

Governor&Company of The Bank of Scotland v. A Ltd [2001] EWCA Civ 52

Initial Services v Putterill [1968] 1 QB 396

Joachim v Swiss Bank Corporation (1921) All ER 92

Kaupthing singer &Friedlander v Coomber and Burrus [2011] EWCH 3589 (Ch)

Libyan Arab Foreign Bank v Bankers Trust Co [1989] QB 728

Mitsui& Co Ltd v Nexen Petroleum UK Ltd [2005] 3 All ER 511

Norwich Pharmacal Co v Customs and Excise Commissioners [1974] AC 133

Pharaon v BCCI SA [1998] 4 All ER 455

Price Waterhouse v BCCI Holdings (Luxembourg) SA [1992] BCLC 583

Shah v HSBC [2012] EWHC 1283(QB)

Squirrell v National Westminster Bank Plc and Her Majesty Customs and Excise [2005] EWCH 664

Tournier v National Provincial and Union Bank of England [1924] 1 KB 461

X AG v A Bank [1983] 2 All ER 464

Weld Blundell v Stephens 1920, AC 956

Williams v Summerfield [1972] 2 QB 512

United States of America

Bloomberg L.P. v Board of Governors of the Federal Reserve System 601 F.3d 143(2d Cir. 2010), cert denied sub nom. Clearing House Ass'n L.L.C. v. Bloomberg L.P.,US (2011)

Burlington & Quincy.R.R. Co. v. McGuire, 219 US 549 (1911)

C v. Bank of America Corporation (2009) Civ 6829 (SDNY)

Judicial Watch, Inc. v. US Dept. of Treasury, 796 F. Supp.2d 13 (DDC 2011)

Peterson v Idaho First National Bank, 367 P2d 284 (Idaho 1961)

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SEC v Youmans, 543 Fed. Supp.1292 (E.D.Tenn.1982)

Securities and Exchange Commission v. Bank of America Corporation, Civil Action Nos. 09-6829,10- 0215(SDNY)

McKinley v. Board of Governors of Federal Reserve System, 647 F. 3d 331(DC Cir 2011)

TSC Indus. Inv. v. Northway, Inc. 426 US 438 (1976)

Other Cases

Canadian Imperial Bank of Commerce v Sayani [1994] 2 WWR 260(Canada)

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Lesser Antilles Trading Co Ltd v Bank of Nova Scotia [1985] LRC(Comm)39(Bahamas)

Spector Photo Group and Van Raemdonck v Commissie voor het Bank-, Financie- en Assurantiewezen (ECJ) (Case C- 45/08), 23 Dec 2009 (European Court of Justice)

ACRONYMS

American International Group	AIG
Anti-Money Laundering	AML
Bank Holding Company	BHC
Bank of America	BoA
Bank of England	BoE
Bank Regulatory/Supervisory Agency	BRA
Basel Committee on Banking Supervision	BCBS
Central Bank	CB
Code of Market Conduct	CoMC
Confidential Treatment Order	CTO
Confidential Supervisory Information	CSI
Counter Terrorism Financing	CTF
Credit Rating Agency	CRA
Disclosure and Transparency Rules	DTR
Dodd–Frank Wall Street Reform and Consumer Protection Act	Dodd-Frank
Efficient Market Hypothesis	EMH
Emergency Lending/Liquidity Assistance	ELA
European Banking Authority	EBA
European Central Bank	ECB
European Commission	EC
European Community	EC
European Court of Justice	ECJ
European Securities Markets Authority	ESMA
European Systemic Risk Board	ESRB

European Union	EU
Fair Value Accounting	FVA
Federal Deposit Insurance Corporation	FDIC
Federal Reserve	Fed
Federal Reserve Bank of New York	FRBNY
Financial Action Task Force	FATF
Financial Conduct Authority	FCA
Financial Institution	FI
Financial Services Modernization Act of 1999	GLBA
Financial Policy Committee	FPC
Financial Services and Markets Act 2000	FSMA
Financial Services Authority	FSA
Financial Stability Board	FSB
Financial Stability Oversight Council	FSOC
Freedom of Information Act	FOIA
Global financial Crisis	GFC
Halifax Bank of Scotland	HBOS
Her Majesty's Revenue and Customs	HMRC
International Monetary Fund	IMF
Lender of Last Resort	LoLR
Listing Rules	LR
London Stock Exchange	LSE
Management's Discussion and Analysis of Financial Condition and Results of Operations	MD&A
Mandatory Disclosure	MD
Market Abuse Directive	MAD

Market Abuse Regulation	MAR
Material Adverse Change	MAC
Merrill Lynch	ML
Monetary Policy Committee	MPC
Money Laundering	ML
Northern Rock	NR
Office of the Comptroller of the Currency	OCC
Prospectus Directive	PD
Prospectus Rules	PR
Prudential Regulation Authority	PRA
Sarbanes-Oxley Act of 2002	SOX
Securities Act of 1933	1933 Act
Securities Exchange Act of 1934	1934 Act
Securities Exchange Commission	SEC
Single Supervisory Mechanism	SSM
Societe Generale	SG
Special Purpose Vehicle	SPV
Suspicious Activity Report	SAR
Systemically Important Financial Institution	SIFI
Terrorism Financing	TF
The Foreign Account Tax Compliance Act	FATCA
The Organisation for Economic Co-operation and Development	OECD
Too-Big-to-Fail	TBTF
Transparency Directive	TR
Treaty on the Functioning of the European Union	TFEU
Troubled Asset Relief Program	TARP

UK Listing Authority	UKLA
United Kingdom	UK
United States of America	US

INTRODUCTION

1. Overview of the Research

Banks,[1] as informational and financial intermediaries, quasi-public institutions and commercial firms, are subject to a web of laws, which require them to disclose information to outsiders via variety of channels by virtue of public law requirements.[2] However, information collected, monitored and produced by banks is important for a bank, and in truly rare circumstances such as financial crises, its disclosure can easily damage the reputation of such confidence-driven institutions and can lead to information-based banking panics and runs or eventual loss of confidence to the banks and also the state. Considering the profound importance of public confidence in the formation and function of financial markets, banks' roles in the financial system in bridging the trust gap by creating an illusion to both borrowers and lenders mean that trust and public confidence are underlying constituents in creating liquidity and also destroying it. Even though the role of trust and public confidence is not fully reflected in consideration of the

[1] The term 'bank' in this thesis is used to describe financial institutions which accept deposits from the public and create credit. However, while the focus is on commercial banks, references are occasionally made to investment banks due to organisational structure of banks (i.e. universal banking or bank holding company (BHC) models).

[2] This thesis, while recognising contemporary and comparative analysis and discussion about the difficulty of establishing a single, all-inclusive and doctrinally dispositive way to provide a clear-cut legal taxonomy and differentiate public and private domains, uses the term 'public law' as an overarching concept conveying the legal rules which control the relations between institutions of state, between the state and individuals and between individuals who are of direct concern to the state. It mostly makes references to regulatory law that relies on the command-and-control system. See Cormac Mac Amhlaigh, Claudio Michelon, and Neil Walker, *After Public Law* (OUP 2013) ch 2,4,5; Jonathan Law*, A Dictionary of Law* (9th edn, OUP 2018). Following this simplified line of thought, public agencies/ organs/ bodies are used here to describe the organisations dealing with the constitution and the application and enforcement of public law provisions.

function of law in financial markets and is often neglected; the links between banks and the rest of the financial system prove that bank information disclosure plays a vital role in the level of trust and confidence that has an impact upon both microstability and macrostability.

There is an increasing demand for bank transparency, including both in its relations with persons and its information as a firm in financial markets. Though there is a compelling and growing body of studies showing bank disclosures serve to improve market discipline, prevent wrongdoings and crimes, and contribute to efficient allocation of resources and financial stability and resiliency, which is in accordance with the overarching objectives of disclosure regulations in general, this thesis suggests that there is room for further discussion about the bank's position in providing information and the potential drawbacks of such disclosures. It does so by critically appraising the natural dialectic and even conflict between bank prudential regulators and securities markets regulators by placing banks, as information sources, at the centre of the discussion and exploring the additional complications peculiar to bank information disclosure.

So, what refers to bank information? Bank information here is a multidimensional concept that is perceived as having a bottom-up structure: i) Banks are producers of non-aggregated information based on their information collection, monitoring and creation functions that are part of their everyday operations, acting as a bridge between lenders and borrowers. ii) They are also producers of aggregated information, which refers to information about banks themselves and collective understanding about the banking system. This type of information is a collective product of banks' information collection and monitoring activities and it is the kind of information that banks' prudential and stability regulators are particularly interested in.

There is an ever-increasing call for bank information, which motivates an exploration of private and public interests and also two conflicting public interests, one being investor protection, market efficiency, integrity and other ensuing positive externalities attached to public disclosure, and another being the protection of the safety and soundness of the banking system and the prevention of systemic or financial instability, involved in its disclosure. This thesis attempts to shed light on different but related aspects of bank information disclosure to demonstrate a broader appreciation of whether the optimal level of information disclosure is possible for banks.

1.1. Research Background

It is commonly claimed that banks are special or different than other firms in many ways.[3] This assertion includes the relevance of public confidence that forms one of the most important aspects of the operation of the banking sector. Implicit and explicit government guarantees, bank safety and soundness regulations and supervision are designed to promote confidence and therefore protect the overall stability of the financial system. Disclosure of adverse bank information is likely to produce more damaging outcomes than a firm operating in another industry due to banks' social, economic and systemic place in the financial system. So that, bank failures and runs on individual banks have the power to the trigger systemic instability and contaminate the whole system.

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[3] They serve many functions to the society with their liquidity, maturity and credit transformation roles in the financial and social system and their relevance with the monetary policy and allocation of resources in the economic system is well acknowledged. R. Levine and S. Zervos, 'Stock Markets, Banks, and Economic Growth' (1998) 88(3) The American Economic Review 537; Douglas W. Diamond and Raghuram G. Rajan, 'Liquidity Risk, Liquidity Creation, and Financial Fragility: A Theory of Banking' (2001) 109(2) Journal of Political Economy 287; F. Allen, E. Carletti and X. Gu,'The Role of Banks in Financial Systems' in A. N. Berger, P. Molyneux and J. OS. Wilson (eds), *The Oxford Handbook of Banking* (2nd edn, OUP 2015) ch 2.

In the recent literature on financial crises, links between bank information provision and transmission, transparency and its effects on systemic and financial stability have come to prominence. Increasing recognition of the significance of bank information disclosure to the mechanisms that maintain and promote public confidence, welfare and development has underpinned transparency-stability view in the way that availability of timely, relevant and reliable bank information is deemed necessary for addressing market failures (that rationalises the regulation of bank transparency in the economic sphere), protecting the systemic and financial stability and depositors, as well as promoting good governance and accountability. Transparency is seen as a panacea for deficiencies in regulation and for the practices involving market abuse, corruption, abuse of power, money laundering (ML) and terrorism financing (TF).[4] The links between confidence, stability and bank information disclosure highlight the broader concept of the democratic setting where the information provision allows the capital to be directed to its most productive uses, prevents misconduct, fraud, corruption and other wrongdoings and holds those accountable for their actions. So, the meaning of bank transparency has gone beyond corporate rhetoric. Yet, a critical reflection on the possible negative and unintended effects of bank disclosures and limitations on bank transparency (as transparency is bounded to receivers' end) has been necessary after the reignition of the dialectic between the main objectives of bank prudential regulation and capital markets regulation.

Bank opacity has been cited as one of the main reasons for the recent global financial crisis (GFC).[5] Though the functionality of the market discipline concept which

[4] Christine Kaufman and Rolf H. Weber, 'The Role of Transparency in Financial Regulation' (2010) 13(3) Journal of International Economic Law 779,784.

[5] Gary Gorton,'The Development of Opacity in US Banking' (2014) 31(3) Yale Journal on Regulation 825.It should be noted that the term GFC encompasses the first phase of the crisis

establishes that private sector agents monitor the bank and act on the information by punishing bad behaviour has been proved to be insufficient and not self-sustaining to maintain public confidence and discipline banks for their investment, governance and risk-taking behaviours during the GFC,[6] the importance of bank transparency has been reiterated throughout the post-crisis world by the introduction of disclosure of stress test results, renewed capital adequacy and risk disclosures and other disclosure channels such as capital markets mandatory transparency rules that mandate banks to share information. So, banking disclosure initiatives that emphasise the disciplining effect of public disclosures use transparency-stability approach as a base and the rule- and policy-making for imposing greater transparency is motivated by the *ex ante* and *ex post* contribution of bank opacity to the GFC: *ex ante* by lack of market discipline and *ex post* by uncertainty about risk-taking behaviours, corporate governance practices, solvency and liquidity of banks.[7] While doing that, the new regulatory order highlights the importance of financial stability, contagion channels between financial institutions (FI) and potential for systemic risk. It also identifies bank information disclosure to be vital for macroprudential and microprudential objectives.[8]

(2007-9) not sovereign debt, fiscal or currency crises that occurred later on as the emphasis will be on the underpinning factors of the GFC that triggered the tension in the first place.

[6] There have been several reasons asserted for that, namely because market participants could not monitor and use information efficiently and the methods used to provide information lacked the ability to reflect risks so that adequacy of transparency was itself in doubt.Benton E. Gup, 'Market Discipline: Is it Fact or Fiction? (2003) SSRN WP (accessed May 13, 2016) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=449841. Application of market discipline is generally tied to several factors: information provision to the market and the regulators; and credit ratings and accounting standards that deliver more accurate and transparent information.

[7] Joachim Jungherr, 'Bank Opacity and Financial Crises' (2016) Barcelona GSE Working Paper Series No: 882(accessed May 20,2017)https://www.barcelonagse.eu/research/working-papers/bank-opacity-and-financial-crises.

[8] Bank prudential regulators also use disclosure as a regulatory tool.

There is a long-standing discussion across law, finance and economics about the best regulatory technique for handling information and its provision to markets. Disclosure theories explain the philosophy and objectives of the dissemination of information on the marketplace with the resulting externalities and benefits, costs and restrictions of transparency via disclosure regimes.[9] Although different conclusions accrue from these different perspectives, there is a general consensus on the benefits of public disclosures, such as increased competition, investor protection, price accuracy, reduced transaction costs, increased public confidence, deterrence of fraudulent practices and other interlinked advantages and positive externalities emanating from disclosure. Setting aside the classic questions about whether markets provide incentives for voluntary disclosure of socially and economically efficient levels of information in the absence of disclosure regulations or not;[10] or whether market discipline of firms underpinned by contracts and courts is efficacious enough to accomplish optimal level of disclosure;[11] or what is the balance between the level of government interference and the severity of market failures that require regulatory intervention, the merits of a mandatory disclosure (MD) regime are well-accepted and often-praised. Yet, the common argument against disclosure is

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[9] For example, see George J. Stigler, 'Public Regulation of the Securities Markets' (1964) 37(2) The Journal of Business 117;John C Coffee, 'Market Failure and Economic Case for a Mandatory Disclosure System' (1984) 70(4) Virginia Law Review 717;Roberto Romano, 'Empowering Investors: A Market Approach to Securities Regulation' (1998) 107 Yale Law Journal 2359;Merritt B. Fox, 'Retaining Mandatory Securities Disclosure' (1999) 85(7) Virginia Law Review 1335.

[10] This idea is based on the view that financial markets collect the private information and assumptions and therefore information production and aggregation help to foresee future events and market prices reveal essential and useful information about firms. F. A. Hayek, 'The Use of Knowledge in Society' (1945) 35(4) American Economic Review 519.

[11] Robert Bushman and Wayne R. Landsman, 'The Pros and Cons of Regulating Corporate Reporting: A Critical Review of the Arguments' (2011) 40(3) Accounting and Business Research 259.

proprietary costs[12] and the value attributed to information in general. This is because information is costly to produce, and its disclosure might damage the reputation or competitive position of firms.[13] This applies to banks as the public good character of disclosed information and the costs attached to disclosures place a question mark over the economics of disclosure. Yet, the regulator, focused on social welfare and economic efficiency, operates on public interest considerations where individual interests are subordinated and a level playing field established by MD of information rule cuts these concerns to a certain extent. So, one common argument about banks' incentives to be more opaque is associated with the general arguments applicable to all firms.

A more specific one is associated with the sui generis characteristic and place of banks in the financial system, which underlies the links between financial stability and banking business. The theory, known as the Hirshleifer effect, establishes that greater disclosure might lessen welfare because it decreases risk-sharing opportunities for economic agents.[14] This means that bank transparency might increase or intensify the potential for bank runs: If the realization of shocks is undiscovered in the marketplace, short-term creditors – who are the major contributors for the maturity transformation function of banks – may roll over their contracts with the bank, thus engaging in risk-sharing

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[12] Ronal A. Dye, 'Proprietary and Nonproprietary Disclosures' (1986) 59(2) The Journal of Business 331.

[13] These costs are not just related to production. There are other important costs related to disclosure. Public disclosure might cause public participants to disregard private information and lessen their private incentives to acquire information. It can also decrease the government's ability to learn from market prices. Stephen Morris and Hyun Song Shin, 'Social Value of Public Information' (2002) 92(5) American Economic Review 1521;Philip Bond, Itay Goldstein, Edward C. Prescott, 'Market-Based Corrective Actions' (2010) 23(2) Review of Financial Studies 781.

[14] J. Hirshleifer, 'The Private and Social Value of Information and the Reward to Inventive Activity' (1971) 61 American Economic Review 561.

arrangements.[15] Transparency, in this respect, removes the banks' insurance against the risks. As such, *ex ante* deliberation about the welfare reducing results of bank transparency is recommended and the result of greater transparency is seen as a lose-lose situation where the bank and all bank stakeholders end up with less. When the shocks are known in the marketplace, the willingness of peer banks or other markets to provide support decreases due to lack of confidence and liquidity hoarding behaviour. When this happens, interconnectedness and the self-protective behaviour of agents activate a spillover and freeze in a way that propagates deterioration, particularly money and interbank markets, with the potential to endanger financial stability.

Some studies have discussed the role of public disclosures in lessening the possibility of banking crises when banks have control over their risk exposure.[16] This view suggests that when the risk is exogenous, public disclosure is not beneficial *ex ante* as it does not change the bank's risk-taking behaviour but rather triggers bank runs.[17] This transparency-instability view sees some level of opacity as an insurance device against bank runs and the GFC represented an opportunity to revisit the pursuit of greater bank transparency. This re-discussion was motivated by the disagreements that appeared over the disclosure of adverse bank information during a crisis and by the inherent tension between regulators that concurrently regulate banks.

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[15] Itay Goldstein and Haresh Sapra, 'Should Banks' Stress Test Results be Disclosed?' (2013) 8 Foundations and Trends in Finance 1,17.

[16] T. Cordella and E.L. Yeyati, 'Public Disclosures and Bank Failures' (1998) 45 IMF Staff Papers 1.

[17] Wassim Shahin and Elias El-Achkar, *Banking and Monetary Policies in a Changing Financial Environment* (Routledge 2017) 113.

The tension and disagreements referred to here start from the general questioning about whether the pursuit of greater bank transparency is beneficial and optimal in all circumstances. This investigation is about finding how bank disclosures affect the markets, the financial system and the bank itself in normal times and during a crisis. Too frequent disclosure of the liquidity position of banks or disclosure without an adequate time-lag might aggravate the bank's short-term and temporary liquidity problems; especially the information revealing that a bank needs central bank (CB) support has the potential to weaken public confidence and cause market overreaction, information spillovers and contagion during periods of stress.[18] This concerns the natural dialectic between the maximum transparency philosophy of securities markets regulation and the need for a certain level of opacity residing in bank safety and soundness, and financial stability-motivated prudential regulation .

Disclosure provisions of the securities regulation were discussed in terms of whether they would impede the intended secrecy of government interventions that necessitate covert action in order to protect financial stability. In the United Kingdom (UK), the run on Northern Rock (NR) happened right after its need for emergency funds from the Bank of England (BoE) was disclosed. On 13 September 2007, the evening news revealed that the BoE, in its capacity as lender of last resort (LoLR), was to give emergency funding support to troubled NR and the next day depositors began a traditional, panic-based run on the bank as they took this news as a confession of the bank's poor financial standing. A post-mortem examination of the collapse of NR reignited the discussion about an omnipresent element of the banking business, i.e. a lack of confidence on the part of depositors in fractional reserve banking and collective behaviour and the effects of this

[18] Patrick Calver and Jennifer Owladi, 'Pillar 3 Disclosures: Looking Back and Looking Forward' (2017) Q3 Bank of England Quarterly Bulletin 190,191-92.

lack of confidence in both the interbank market and on the public, which are manifested in the form of a bank run and paralysis in the interbank market.

Even if the information was released by the media, not by the regulator or the bank itself, an interesting question arises related to the impact of laws in terms of whether MD of information as a cardinal part of capital markets regulation prevents the government's financial stability-focused measures to forestall runs and panics.

It was art 6 of the Market Abuse Directive (MAD)[19] which requires the public disclosure of inside information as soon as possible. The functionality of existing delay provisions and safe harbours in the law vis-à-vis the most efficient use of stability protective measures, such as receiving emergency liquidity assistance (ELA), in the face of the obligation to disclose inside information that directly concerns the issuer is questioned.[20]

In France, the French authorities opined that the same law, MAD, did not require immediate disclosure of the rogue trading scandal at Societe Generale (SG) due to the highly volatile market conditions emanating from the crisis. This meant that disclosure of information about the discovery of fraudulent positions was delayed.[21]

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[19] Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) (repealed). For the new legislation see Market Abuse Regulation (MAR), art 17. Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC.

[20] See MAD, art 6; MAR, art 17(4) and (5). Competent authorities were in a situation to decide whether delaying information about the ELA was possible in examining if confidentiality of inside information could be guaranteed and whether such delay would not mislead the public.

[21] European Commission(EC),'Call for Evidence: Review of Directive 2003/6/EC on insider dealing and market manipulation' (2009)(accessed May 23,2016)

In the United States (US), the acquisition of Merrill Lynch (ML) by Bank of America (BoA) brought to the fore important and novel questions about whether the deal in the epic acquisition was made as a result of government assistance in order to avert a further meltdown of the capital markets at the expense of not disclosing the severity of problems to shareholders.[22] As such, an investigation into the difficulty in pursuing transparency in the middle of a crisis, taking rapid decisions or withholding behind the scene arrangements to prevent the loss of public confidence and to guard the system against financial instability, systemic risk or a possible contagion vis-à-vis securities disclosure requirements might be necessary to understand how the current laws respond to this problem after the fundamental changes that were applied to the post-crisis regulatory systems.

A meaningful discussion should start with the GFC. The GFC was mostly caused by the tremendous expansion in the scale and complexity of financial instruments that are commonly circulated within the financial industry, augmentation of shadow banking activities in a way that solvency and liquidity of commercial banks were under the threat beyond what conventional approach to commercial bank solvency and liquidity had centred on; and the contagion risk and links between the different financial markets, proving the global and transmissible character of the risks across the borders and implying that the focus on microprudential regulation falls short of the expectations.[23]

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http://ec.europa.eu/internal_market/consultations/docs/2009/market_abuse/call_for_evidence.pdf.

[22] Robert J. Rhee, 'Fiduciary Exemption for Public Necessity: Shareholder Profit, Public Good, and the Hobson's Choice during a National Crisis' (2010) 17 Geo. Mason L. Rev 661.

[23] Anita Anand, Michael Trebilcock, and Michael Rosenstock, *Systemic Risk, Institutional Design, and the Regulation of Financial Markets* (OUP 2016) ch 1.

The resurgence of financial stability as a public good and its dominance over market-based governance has been one of the lessons learnt.[24] However, in the examination of the desired level of bank transparency, what continues to be debated is how the market was unable to address the serious externalities and how the bailouts or emergency liquidity supports have become the response of the state authorities to the troubled banks.

As the post-crisis agenda reveals, transparency has been the key term for spotting a lack of regulatory discernment about unregulated areas of the financial industry or complex and highly linked transactions of regulated parts of the system.[25] That is to say, derivatives transactions on the over-the-counter (OTC) markets have been under the spotlight since the GFC, and the opacity of these private contractual transactions and obscurity of the risks involved throughout the transactions have required transparency and other supportive measures.[26] This is one aspect of transparency in which banks' involvement in the securitisation process as originators of tradable loans and their transferral of risks onto the balance sheets is part of this discussion. This is because originated contracts are in circulation in the market and underlying risks are not known due to the opaque nature of the contracting process and the quality of loans.[27] Banks are deemed inherently opaque institutions as they are informational intermediaries, and

[24] George Soros's speech on the GFC has summarised this approach and become a slogan: 'The prevailing misconception was the belief that financial markets are self-correcting and should be left to their own devices.'(accessed May 17,2017) https://dealbook.nytimes.com/2010/06/10/the-full-soros-speech-on-act-ii-of-the-crisis/.

[25] Mads Andenas and Iris H-Y Chiu, *The Foundations and Future of Financial Regulation* (Routledge 2014) 418.

[26] Such as creation of central counterparty clearing houses and reporting obligations.

[27] From the banks' point of view, securitisation has been a lucrative way of raising funds and their aggression to increase liquidity by providing subprime loans or by concentrating on some particular loans, and therefore making themselves vulnerable to risks concentrated in specific products, sectors or counterparties, was a contributing factor to the GFC.

higher transparency requirements in regulated areas partly motivated banks to shift their business to shadow banks.

This discussion represents the lack of effective oversight, regulation or powers of the responsible authorities to foresee and respond to bank behaviours and their concomitant negative results on the system. The GFC revealed that fundamental weaknesses, gaps and misconceptions both in the regulation and the structure of the system (that banks are subject to) and superfluous market confidence caused banks to engage in opportunistic behaviours to access funds; and that this is an issue that needs to be addressed with prudential regulation and supervision.

The other side of the transparency is about revelation of such information via other channels such as MD of information under securities laws. A recurrent theme of this research is that public disclosure is an important tool for the well functioning of capital markets. Exemptions or safe harbours provided for specific circumstances in securities disclosure regulations might not be responsive for banks when higher public goods like long-term financial and systemic stability outweigh the goals pursued for transparency in capital markets.

The lesson taken from the bank disclosure-specific cases is that it is crucial to have a clear and pre-determined legal framework to manage potential downturns of FIs during times of financial crisis so that financial stability can be protected.[28] This view is based on the idea that banks are special, and they have particular asset profiles, which differentiates

[28] Rosa M. Lastra, 'Northern Rock and Banking Law Reform in the UK' in Franco Bruni and David T. Llewellyn(eds), *The Failure of Northern Rock: A Multi-Dimensional Case Study* (SUERF Studies 2009) 132.

banking from other sectors. The information disclosed to the market as a result of MD requirements is distinctive in that a decision to invest in bank-issued securities requires an investor to seek out bank information. As such, timely disclosure on the strength and solidity of balance sheets, risk levels and future performance of banks to investors is important in giving them fair warning before the transaction. On the other hand, efficient application of prudential goals might necessitate a degree of confidentiality over bank information at a time of difficulty.[29]

The core of the problem can be explained by the substantial differences between the vested interests of regulators. While the safety and soundness of the banks, as an objective of bank prudential regulation, is guaranteed by pre-emptive regulatory intervention via monitoring and supervision, securities regulation is based on public disclosure and *ex-post* enforcement. In this sense, they have the characteristics of a police officer who spots regulatory breaches and enforces the laws without considering the potential drawbacks, whereas another can be comparable to the doctor in his capacity to find and cure a problem in order to prevent any possible difficulty in the future.[30]

While the concurrent application of securities regulation and prudential regulation presents a potential clash, there is another secondary and maybe a subordinated issue that arises as to the bank disclosure of information. This is the status of banks in submitting themselves to public/regulatory authorities on disclosure of information they collected and produced. This represents the tension between private law and public law institutions.

[29] The new MAR in the EU is the official acceptance of the fact that potential adverse outcomes emanating from a temporary reduction in the level of transparency are more manageable compared to a bank that causes systemic stability. Yet, as it will be discussed, there is still room for further improvement.

[30] Howard Davies and David Green, *Global Financial Regulation* (Polity Press 2008) 192.

Regulators act on behalf of the public and they are not completely independent from global and political pressures. This assertion is especially true with regard to transparency initiatives and share of bank information. So, another potential clash triggering the optimal level of disclosure debate is the banks' position against regulatory authorities such that their private relationship with persons can be affected by too much public law intervention and even banks can be the back-doors of the state whenever they need information. Their position as a private firm consisting of private contractual and fiduciary relationships on the face of too much regulatory intervention on the information, which forms the relationship in the first place, should be addressed as a side exploration in addition to any potential side effects of such disclosures on financial and systemic stability.

After all, different sets of laws established on banks, as securities regulation consists of one them, require them to disclose information to the outside, and it raises the optimality problem on two different levels: As one is being the main theme in this thesis, MD of bank information under securities regulation does not always produce the most efficient result for the markets and the economy as whole (as there is mega regulatory objective under which both stability and disclosure of information have to be taken together, not separately); and the second and auxiliary one is that, the other optimality issue emanating from the bank's private law duty of holding information and public law measures asking for the disclosure of bank information. Banks are no longer confidants of their customers but instead are called on to be more transparent in all respects via ever-narrowing boundaries of their private cells. As such, the overall picture illustrates that there is a growing demand for bank information and the autonomy of banks is limited by public policy considerations.

In relation to bank information disclosure, one of the questions is whether there is a trade-off between financial stability and bank transparency during financial distress. In case there is, whether it can be regulated under the present legal environment underpinned by transparency-focused view and in case it cannot, how regulation and transparency policies cooperate and how banking industry should have more prominence in maximum transparency-based capital markets disclosure regulations. The tension highlighted here is based on the dialectic between two regulatory zones with different objectives. Banks' position as a vital information resources both for markets and the state itself to achieve public policy goals generates the question whether bank disclosures are optimal vis-à-vis increasing demand for bank transparency. To answer this question, it is first necessary to address why banks are different from other firms and why the information they collect and produce has specific value for bank stakeholders by linking bank information with interconnectedness and the potential for systemic risk. Bank information, here, means the information that banks collect, monitor and produce, which ultimately becomes information about the bank itself. How can customer information or information about projects be translated into bank information? Bank information is a result of financial decisions that are made based on customer- and project-related information, and therefore bank information is characterised as having a bottom-up structure. Then, with reference to GFC cases and financial and legal reforms, a broader view on the matter is considered with the latest developments in order to find a new balance – which is the balance between private and public law elements of bank information and its disclosure.

Therefore, this thesis examines the application of paradoxical regulatory rationales on banks by investigating the motivations that led to the tension in the first place and by questioning whether there is a functional and ideational solution. It draws attention to post-crisis revisions in financial regulatory thinking and practices in three different jurisdictions: the US, the UK and the European Union (EU). In doing so, it shifts the focus from regulators, policy-makers and supervisors, whose motivations are different from banks, to banks which are the main source of the information in question. It illustrates the arguments not only by questioning the institutional characteristics of banks and their relevance to the negative effects of information disclosure as a result of capital markets transparency requirements, but also by providing a more comprehensive picture of changes in banks' position in terms of sharing information.

1.2. Research Questions and Hypothesis

This thesis establishes that bank information disclosure leads to tensions on both the public law-public law and private law-public law levels. It discusses this from two different positions. The first is that there might be a conflict between regulatory objectives of bank prudential and capital markets regulators over bank information disclosure, and a key challenge this conflict poses is that simultaneous application of these two different regulatory regimes on banks might be inimical to public confidence with effects on financial stability and economic activity. Second, the legal construction embodied in the banker's private law duty of confidentiality is subject to an on-going change due to the shifting balance between private and public interests. The discussion of this initial position motivates several interrelated research questions:

In thinking about the overall goals and strategies of financial regulation, is there a conflict between the maximum transparency-seeking philosophy of capital markets regulation and protecting the safety and soundness and stability of banks and the banking and financial system's philosophy-based prudential regulation?

i) *If conflict exists, does it call for a revision in policy and regulatory thinking so as to prioritise one regulatory goal over another, or to reconcile or combine divergent objectives without undercutting others?*

ii) *Is there a regulatory turf war between bodies simultaneously regulating banks that have distinct regulatory objectives?*

iii) *Do these different goals co-exist, complement or defeat each other? If they cannot co-exist, which of these objectives should have priority over the others?*

iv) *As financial and systemic stability has become the overarching objective of post-crisis regulation, is there a case for less bank transparency in order to achieve it?*

Second, the legal construction embodied in the banker's private law duty of confidentiality is subject to an on-going change due to the shifting balance between private and public interests. The discussion of this second position will address the following question:

Do realities of modern banking and financial environment create a challenge for banks in their disclosures and are there conflicting public and private law requirements that require the optimal level of disclosure of information by banks to be revisited?

The hypothesis of the thesis is that bank disclosure requirements should not be absolute and unlimited and that is difficult to set down a clear-cut and straightforward level of disclosure that can be called optimal due to conflicting divergent regulatory objectives and philosophies between bank prudential regulation and capital markets regulation; and conflicting public and private interests in regulating bank information disclosure.

In order to substantiate the above hypothesis, this thesis values long-term financial stability over the immediate transparency. Financial regulation should not be perceived in isolation but must be recognised in the context of the broader policy objectives, the system of institutions and long-term efficiency and sustainability which should be grounded upon the understanding of how the wider economy runs and interacts with the financial system. Using a macro framework in cultivating a system for reconciliation of competing regulatory objectives and for the accommodation of pluralistic interests, rather than embracing a clear division between regulatory agencies to perform in their technical capacity within its narrowed and pre-defined objectives, responds what the broader purpose of financial regulation is. The tension highlights the need for acknowledgement of normative objective and reasoning of financial regulation, as co-existence of conservative and progressive policy approaches adopted by different bodies has shown the need for ideational shift to reconcile or at least align diversified regulatory objectives in order to provide a diagnostic, expedient and mediating response to this institutional and somewhat political tension. So, if the reconciliation could not be achieved, prioritisation of goals and strategic transparency might be a solution to the conflict.

Rather than setting an exact level that can be termed optimal, this thesis provides valid grounds proving that the application of some regulatory standards to banks should be relaxed and regulators should be given the discretion to adopt a flexible approach to protect systemic and financial stability.

2. Organization of Thesis and Chapter Synopsis

This thesis is organised as follows.

In Chapter 1, a brief introduction to banking is made with regard to why banks are different than other FIs by establishing the nature of banks and their socio-economic place in the financial system. To do that, it explains why banks are regulated and protected and why the information collected and produced in the process of intermediation is important. It submits that, by their very nature, banks have always been susceptible to panic and runs or other strains of systemic risks simply by the fact that they issue liquid liabilities while investing in illiquid assets. It establishes that information is an economic asset of a bank and banks create value by provision of safe and liquid liabilities to depositors, which is possible with their ability to screen and monitor information-intensive loans and to produce information that is unknown to third parties.

This chapter sets the scene for subsequent chapters by linking elements of the banking business with the place and nature of information they produce. It emphasizes the importance of banks, their role in the supply of and demand for credit by asserting that there is a public assumption (not knowledge) about the continuity of the credit extension role of banks. This describes public confidence. Therefore, Chapter 1 answers which information is bank information with an eye to the nature of information banks hold and produce by establishing the initial link between bank information and public confidence. By these observations, it concludes that banks are informational intermediaries and they are still special.

In Chapter 2, two main discussions regarding regulation of the banking sector will be conducted simultaneously: the role of regulators and supervisors in crisis prevention and mitigation; and the concept and the effect of bank transparency within the frame of financial stability and systemic crises. This will be done by explaining why public confidence is a constructing element of the banking business and why the combination of the abstract and impersonal concept of public confidence and the unpredictable, self-interest- and future-oriented, sometimes irrational emotions of certain bank stakeholders is of relevance to the relationship between bank information disclosures and stability. Financial stability is a relatively ambiguous concept and therefore owing to the comprehensive relationships between financial stability elements, bank transparency and its impact on confidence production will be assessed from the systemic perspective. Connectedness, contagion and correlation will be the focus in terms of exploring systemic risk, which is likely to appear after the disclosure of adverse information about the bank.

This chapter submits that instability might come in many shapes and forms and one of the lessons taken from the GFC should be that proactive approach to prudential regulation should seek to solve the bank problem without causing disturbance within the market and the financial system. It submits three conclusions with reference bank disclosure of information: First, financial stability is a vague concept (since it has no clear-cut set of variables to access financial stability as opposed to the price stability) and it encompasses monetary and financial activities, which banks are important players in both of the domains and external changes in these areas are likely to affect the banking sector. Second, owing to the bank's societal role and the mismatch between its assets and liabilities, lack of creditor confidence and the very basic fact of interconnectedness can create bank runs and failures and systemic crises. Third, financial regulation should not only aim to minimise the risk of occurrence of crises, but also it should absorb and deal with the shocks emanating from bank-related problems at the early stages to prevent contagion and the likelihood of systemic effects and it should protect general public confidence.

Chapter 3 starts with the discussion about the place and function of disclosures in capital markets and explores the theoretical foundations of disclosure-based transparency. MD requirement on banks is explained with reference to other disclosure channels to the extent that it is relevant to bank disclosures in capital markets. It submits that the GFC has led to greater expectations from banks in terms of providing more information to the markets and market discipline has become a determinant goal for bank regulation. While the application of market discipline is compatible with the goals of securities markets regulation, inherent obstacles residing in prudential regulation limit the efficient operation of the market discipline. Government safety nets or deposit insurance schemes are prophylactic measures that ultimately undermine market discipline. Having said that, prevalent use of disclosure as a regulatory tool by bank regulators/supervisors has highlighted that bank disclosures have also become the fundamental tenets of bank regulation and imposed transparency within capital markets is complementary to regulatory disclosure/reporting requirements for supervisory purposes established on banks. The premise that 'the more the market is informed, the more financial and securities markets are stable and efficient' is, therefore, underpinned by MD requirements. However, as Chapter 4 discusses, application of mandated transparency residing in capital markets regulation does not always produce the anticipated results that bank or stability regulators expect. The inherent conflict between securities markets regulators and prudential regulators manifests itself during a time of crisis, and therefore Chapter 3, after discussing the theoretical foundations and merits of bank disclosures, carries this theoretical investigation forward to the real-life experiences in Chapter 4.

Chapter 4 is about the application of MD requirements on banks mainly in the US and UK due to the fact that these two important financial centres experienced the dilemma regarding full and timely disclosure of bank information in capital markets and its potential outcomes on the financial stability of the state.

The US part explains that US securities markets regulation is mainly based on enacting stringent laws and having a powerful administrative body. Banks register with their applicable regulatory agencies and the administration of disclosure-related provisions are also transferred to those agencies. From a theoretical approach, the delegation of authority to bank regulatory agencies (BRAs) seems like a preventive measure for a possible instability. In practice, incorporation by reference is used by those agencies in administering the Securities Exchange Act of 1934 (1934 Act) disclosure requirements for banks and the federal system of on-going disclosure still applies to banks. Yet, even the changes implemented as a result of the GFC have not modified such different treatment provided to banks, and it can be explained by the same post-depression logic, which is that BRAs would like to have authority over the bank information and they would like to control the flow of bank information to securities markets.

Having said that, BHCs dominate the US banking sector today and they are directly subject to Securities Exchange Commission (SEC) jurisdiction regarding disclosure. These companies are generally systemically important FIs, and during the crisis, they were considered too big to fail (TBTF). The optimal level of bank disclosure for banks came into question in the US by the conflict between the Fed and the SEC during the GFC (the case related to the merger of BoA and ML) and the same conflict involving the SEC's maximum information disclosure objective and the stability regulator's minimum disclosure goal was seen in a different case involving a systemically important FI (SIFI).[31]

[31] American International Group (AIG).

Investor protection and market efficiency is paramount for the US financial markets and confidential treatment orders (CTOs) given by the SEC and the exemption provided for bank reports at the Freedom of Information Act (FOIA) is interpreted by courts.[32]

The US part in Chapter 4 concludes that the experience from the GFC shows that the absence of a clear measure for such tensions takes the discussion to the political level. The pressure of the Fed on BoA not to disclose adverse information can be taken as the inability of regulators/ government to foresee the situation before the situation comes to that stage by the public. It can undermine the reliability of the state in managing crises. Post-crisis measures do not allow delay or reduction of the bank information to be disclosed in securities markets.

The UK part of the chapter identifies the problem by the EU-specific characteristics of the disclosure requirements that created the tension in the first place. The run on NR and concomitant concerns about the mismatch between law and policy is studied in a way that questions whether policy interventions that the government needed to use, and the immediate and full disclosure philosophy of MAD is reconcilable. This is done by focusing on banks' position in this tension as being subject to two different regulatory zones. The interplay of action and interpretation of laws is discussed with the examples of the run on NR, non-disclosure of the fraud in SG and the merger of Halifax Bank of Scotland (HBOS) and Lloyds TSB which indicate that disclosure does not automatically lead to more stability and resiliency. The capital markets disclosure regime applicable to the EU did not particularly distinguish banks from other firms, unlike the US securities

[32] The wording of exemption 8 under FOIA is not clear and it provides an overly broad interpretation if banks can approach to the SEC for a CTO for financial stability purposes. Courts have interpreted it with reference to stability.

laws. This part first identifies obstacles in the law that caused the tension in the first place, not only by analysing the resulting discourse from NR but also from other cases and practices such as SG. In doing so, the considerations of the various interests in bank transparency, such as the CB, the Treasury, the Financial Services Authority (FSA) (now the Financial Conduct Authority (FCA)), bank stakeholders (including the general public) and the bank itself are discussed. Then, the new MAR and its responsiveness to a potential crisis with a new exception for delaying disclosure is investigated in terms of whether it has been adequately formulated to protect public and peer confidence and provide assurance to markets without placing the banks in a dubious position about their disclosures to markets. It submits that structural changes in the financial regulation and the rise of macroprudential regulation for financial and systemic stability reasons across the EU is designed to address critical gaps and weaknesses, yet the pertinent provision introduced by the MAR, which was primarily designed to serve transparency, accountability and visibility purposes, does not seem well drafted enough as it brings about several legal and political questions even if it serves for macroprudential policies.

Therefore, Chapter 4 illustrates the case for a transparency-fragility view for banks by using different jurisdictions that experienced the GFC based on MD of information under capital markets rules. It presents a discussion about different approaches pursued in jurisdictions which have a similar tension and how banks' situation in being subject to two regulatory zones run by different motives would be affected by the tension.

In Chapter 5, the private law framework of bank transparency will be investigated with intent to explore the limits of bank information disclosures to see if there is a tension on the private law-public law level. From the theoretical angle, legal nature of bank confidentiality can be understood as a legal construction directed at striking the necessary balance between private and public interests situated within the bank-customer relationship and increasing inroads made to the private relationship[33] of a bank and its customers show that banks are ready information sources for the states; yet the interests of the bank might imply a degree of confidentiality over the information produced. One-sided approach to bank confidentiality sees this legal construction in the general discussion about the right to privacy, a basic right of customers or it takes it from the public law's protection of public interest standpoint; but it does not answer in what sense bank confidentiality should be grasped as satisfying both private and public interests.

It addresses that prevention and control of crimes may create concerns over turning the financial infrastructure of banks into police reporting networks by turning bankers into fiscal spies. The duty of confidentiality in its more traditional style is in jeopardy, to the extent that it is seen as opposing public interests. Besides, there is a further consideration regarding whether such disclosures have an effect on systemic and financial stability similar to the case investigated in Chapter 4. It concludes that changing boundaries of bank confidentiality has been narrowed by public law interferences and it is doubtful whether bank secrecy will be able to survive as a sustainable legal concept in the future.

Chapter 6 is the conclusion chapter. As previous chapters establish the theoretical base for the understanding of bank transparency, a central issue to examine is that to what extent protection of financial stability and prevention of systemic crisis residing in prudential regulation should interact with laws imposing full and timely bank

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[33] All relations that banks have are private, but here it means the relations that are subject to private law obligations.

transparency in the face of problems appeared about the information disclosure of troubled banks.

It holds that the traditional approach to bank regulation was protective by nature, but restrictions on bank information disclosure are not compatible with the present market conditions that are founded on transparency. Fragmented regulatory approach is the prevalent one such that the securities activities of a bank and safety and soundness of a bank is regulated by different bodies based on their functions. Simultaneous application of different regulatory objectives on banks has proved that macro approach to regulatory regimes is necessary and regulation should be seen in context, not in isolation. Understanding the corpus of financial regulation in the round is needed, and this approach requires protection of stability to be an encompassing goal.

Therefore, it submits that reconciliation should be based on interactive cooperation between the two regulatory zones regardless of the regulatory structure or disclosure methods. MAR responds to this need by an overarching provision, though it needs further changes, and therefore it is ready to accommodate the opacity needs of banks in times of difficulty.

3. Methodology

This research is mainly analytical. The majority of the arguments used here are derived from the critical use of relevant literature, case law and findings of finance and economics. The research methodology employed is founded in a doctrinal literature survey and on legal analysis from two fields of laws: Banking and securities markets regulation. It seeks to establish a theoretical framework applicable to jurisdictions with democratic and accountable state organizations. To do that, it uses mainly the UK and the US laws as the sources. It makes references to the EU laws to underpin the theoretical discussion.

The analysis presented in this thesis comes from a wide range of sources, including primary and secondary sources, such as laws and regulations, cases, and academic literature. Not only legal literature is considered but reports and studies from supervisory and regulatory institutions of the EU, UK and the US, international or inter-governmental bodies. Legal literature includes EU securities and banking laws as applicable to the UK, directives and regulations, US banking and securities regulation, e-mails used as evidence before courts, expert reports, working papers from different authorities and second-order institutions, communiqués and declarations of regulatory and supervisory institutions.

This research is based on both library-based information and case studies based on the UK and the US laws. Library–based information includes books, articles and online sources. By employing qualitative modes of enquiry, it seeks to point out the function and place of high level of transparency in the banking sector with reference to its private integrity with private contractual dealings as a firm and its role in maintaining the stability in the economic and financial system. In order to highlight the main arguments in the theoretical framework, it takes transparency as a collective output of disclosed information by banks in an interdisciplinary framework. The interdisciplinary approach is used as a contributive, auxiliary method with reference to empirical evidences that are based on the results of researches in finance, economics and accounting and also other fields such as politics.

Additionally, case studies were used for an in-depth analysis of the application of full transparency on banks. In order to clarify the UK (which is based on EU regulations and directives) and the US capital markets transparency requirements, a comparative approach is used when necessary.

CHAPTER 1

THE NATURE AND FUNCTION OF BANKS AND THEIR ROLE IN INFORMATION PRODUCTION

1. The Nature and Specialness of Banks

Banks are a type of financial intermediaries which require implementation of specific rules and particular protective actions by regulatory agencies to ensure competition and minimise their risk of failure. Opponents of this view assert that separation of banks from other financial entities does not bring benefits but inconvenience, and therefore financial services industry should be treated as a single entity which implies that banks are not special.[34] In contrast, those who believe in the special status of banks give various reasons for this, starting from the doctrine of separation, which basically requires the concentration and specialization of FIs, to their ability to offer better services and products. Thus, these two opposing perspectives converge on this simple question: Are banks really special?

Banks can be considered special either because they are subjected to special regulations or simply because regulators have made them so.[35] The difference should lie somewhere else because regulation is subordinate to the special nature of bank, not other way around. The theories arguing that banks are special in a sense such that they serve the public

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[34] E. Gerald Corrigan,'Are Banks Special?'(1982) Federal Reserve Bank of Minneapolis 1982 Annual Report (accessed May 17, 2014)https://www.minneapolisfed.org/publications/annual-reports/ar/annual-report-1982-complete-text.

[35] J. Tobin, 'Commercial Banks as Creators of "Money" 'in Deane Carson(ed), *Banking and Monetary Studies* (Irwin 1963) 408-19.

interest by their importance in the financial system suggest that the state intervention in the forms of regulations imposed on banks might be justified on their quasi-public and socio-economic nature. Considering the application of the theories arguing the nature of the firms to the banks, the origin and the nature of the banking business has developed in a way that positive authority or permission of the state has been necessary, which exercise of the state power in allowing banks to operate in a specific jurisdiction within the determined limits or enabling bank operations with direct state sponsorship stand as external factors that implies a contradiction to traditional form of contract theory where individuals are free to do business without state intervention.[36] The argument which claims that it is the regulation that makes banks unique is based on the idea that rules of reserve requirements and interest rates make them different and thereby restrict the level playing field.[37] Such views leave a question mark over whether this special treatment is justified by the sui generis nature of banks which makes them irreplaceable by different institutions or is grounded in their historical evolution which led them to be differentiated at an early stage.

Various commentators have presented views about what typifies banks in this context. Fama concludes that the divergence of banks can be seen in their roles as suppliers of transaction and portfolio management services.[38] He continues that economies of scope[39] among deposit-taking and lending provide banks with superior 'information' power over

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[36] William W. Bratton,'The New Economic Theory of the Firm: Critical Perspectives from the History' (1989) 41 Stanford Law Review 1471,1989.

[37] Richard A. Werner,'Can Banks Individually Create Money Out of Nothing? The Theories and the Empirical Evidence' (2014) 36 International Review of Financial Analysis 1,6.

[38] Eugene Fama,'Banking in the Theory of Finance' (1980) 6 Journal of Monetary Economics 39.

[39] Section 2.3.

both other intermediaries and finance firms as it furnishes banks with a borrower's very detailed deposit history and credit risk.[40] Goodfriend underlines the unique role of banks in harmonizing information driven lending and payment services.[41] From Corrigan's viewpoint, the economic performance of banks makes them special owing to their standby or back up source of liquidity power in the economy and their pivotal role in the conduction of monetary policy.[42] However, such mentioned characteristics of banks can be considered insufficient to call them special because clearing and settlement services can be substituted by some other FIs in today's world. Moreover, it has been argued that the role of banks in conducting monetary policy is achieved in other ways, such as through security dealers. Such views attempt to show that the historical evolution of banks makes them unique, not their functions. However, today, banks are one of the most heavily regulated sectors and such detailed regulatory interventions must come from a rational basis, which is difficult to explain simply by considering the historical background of banks.

Yet, the arguments about bank specialness are generally classified under three groups. Firstly, banks are susceptible to runs and panics, which shows their relative systemic importance and their fragile relation with trust.[43] Banks are the subject of risk since they provide credit and therefore liquidity for the economy via loans, receive deposits from the public and are closely interconnected with each other which increases the contagion

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[40] Eugene Fama,'What's Different About Banks?' (1985) 15 Journal of Monetary Economics 29.

[41] M. S. Goodfriend,'Money, Credit, Banking, and Payments System Policy' (1991) 77(1) Federal Reserve Bank of Richmond's Electronic Review (accessed Dec 16, 2014) https://fraser.stlouisfed.org/docs/publications/frbrichreview/rev_frbrich199101.pdf#page=5.

[42] Corrigan (n 34).

[43] Douglas W. Diamond and Philip H. Dybvig,'Bank Runs, Deposit Insurance and Liquidity' (1983) 91(3) The Journal of Political Economy 401.

effect and thereby the furtherance of financial crisis. A high level of interdependence in the finance and banking industry emanating from the continuous flow of capital among banks can easily disrupt the rest of the industry and cause financial as well as social turmoil.[44] The fragile capital structure of banks as a result of their services might lay them open to illiquidity and credit risks. Banks as special intermediaries in bridging the trust gap between savers and borrowers could indicate that trust constitutes the most important part of the relationship. If the public loses confidence in the liability side of the banks, this can create a maturity mismatch between short-term liability and medium or long term assets which might ultimately cause a confidence crisis. Lack of confidence emanating from a specific bank can result in endangering the liquidity reserves of safe and sound banks in a self-fulfilling prophecy.[45] Banks are generally at the centre of financial crises in which financial distress in one bank or in the banking industry has the ability to contaminate other banks or sectors and it is explained by the phenomenon of contagion.[46] Small shocks can have a large impact on the financial system and economy as a whole[47] and therefore, a stable banking system is a crucial pillar of a stable, sound and integrated financial system.[48] As Thornton addressed, back in the 19th century, confidence production and maintenance is the real business of a bank:

> Commercial credit may be defined to be that confidence which subsists among commercial men in respect to their mercantile affairs. This confidence operates in several ways. It disposes them to lend money to each other, to bring themselves under various pecuniary engagements by the acceptance and indorsement of bills, and also to sell and

[44] Andreas Busch, *Banking Regulation and Globalization* (OUP 2009) 23-28.

[45] Diamond and Dybvig (n 43); Prasad Krishnamurthy,'Regulating Capital' (2014) 4(1) Harvard Business Law Review 1,14.

[46] Chapter 2, Section 3.1.2.

[47] Allen, Carletti and Gu (n 3) 42.

[48] See Task Group on Regulation of Financial Services, (1984) Blueprint for Reform at 18 (accessed Dec 23, 2015)https://archive.org/details/blueprintforrefo01unit.

> deliver goods in consideration of an equivalent promised to be given at a subsequent period.[49]

When banks extend credit and continue their business as usual, they perform as guardians of trust. As subsequent parts of this chapter explore, financial intermediation is a product of the replacement of a lack of interpersonal trust with impersonal trust.[50] Yet, as Chapter 2 details, trust has behavioural, cognitive and social aspects and it is a portrayal of shared expectations and interpretations regarding future events.[51] It means that the very nature of banking is strongly tied to the confidence produced, as theories explaining bank runs see trust and confidence as pillars of a well-functioning financial system: Banks' role in extending credit, and therefore in providing liquidity to the market with real economic consequences for overall economic activity, is a product of trust generated by indigenous and exogenous factors.[52] It is indigenous to the extent that banks themselves engender trust by protecting their reputation, establishing efficient risk management and corporate governance policies or effective compliance systems. So, a bank can offer its services without disruption and continue to engender trust among the public. Yet, as Seybolds observes: 'The financial world is a theatrical production, abundantly lubricated by that magical elixir of illusionists: Confidence.'[53] This assertion indicates a wider depiction of

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[49] Henry Thornton, *An Inquiry into the Nature and Effects of the Paper Credit of Great Britain* (1802) at 75(accessed Dec 24, 2015) https://mises.org/sites/default/files/An%20Enquiry%20into%20the%20Nature%20and%20Effects%20of%20the%20Paper%20Credit%20of%20Great%20Britain_3.pdf.

[50] Oliver Butzbach,'Trust in Banks:A Tentative Conceptual Framework'(2014) MPRA Paper at 5(accessed March 13,2015) https://mpra.ub.uni-muenchen.de/53587/1/MPRA_paper_53587.pdf.

[51] Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton University Press 2009) xlii.

[52] Chapter 2,Section 3.

[53] Matt Seybold,'Confidence Tricks' (19 Feb, 2018) Aeon Article (accessed March 19,2018)https://aeon.co/essays/the-financial-world-and-the-magical-elixir-of-confidence.

confidence, where banks form a part of it. It is the extrinsic confidence provided by the banking or financial system or the state as a whole. It means that a bank run occurs not only as a response to the deteriorating reputation of a single bank, but also because of a general lack of confidence in the system. It links banks' maturity transformation role with the effect of bank-specific and market-specific information on bank runs.

Secondly, banks are said to be unique because of their role in the supply of money, in creating and destroying money and in their custodianship of the payments system. Banks loan withdrawable deposits to borrowers without passing on any cash or third party liabilities very easily simply by intensifying their liabilities via deposit creation.[54] As such, the special power of banks to produce money and to enhance it by charging interest enables them to control the resource allocation system of an economy. In a similar vein, it makes them decisive actors in both inflation and production. Money creation by banks thus creates a circular flow and new purchasing power and thereby makes entrepreneurs follow new resources irrespective of the changing form of money today. However, this central distinguishing element of banks has been subject to strong objections regarding its financial intermediary function.[55]

In addition to this classic characteristic of banks, the close connection between banks and the CB is said to prove banks' 'transmission belt' role in monetary policy.[56] CBs and other bank regulators can remodel the transmission belt by changing interest rates or the amount of money that banks are required to keep in their reserves, and such changes can be reflected through the bank lending practices in a way that adjustments in lending and

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[54] J. Hicks, *A Market Theory of Money* (Clarendon Press 1989) 58.

[55] Section 3.

[56] Corrigan (n 34).

pricing of loans are made. Banks borrowing money from the CB are required to follow the changes in interest rates which are designated by the CB and reflect those changes to its counterparties due to the increase in their cost of capital. The role of bank reserves in operating as a catalyzer in lending, providing security and confidence to the market is important given the link between monetary policy and banks.[57] The traditional interest rate view is grounded upon the capital requirements where any changes in the monetary policy may culminate in changes in the quantity of money held and produced by the bank. The CB can reduce the supply of money available for investment by raising the amount established as a reserve requirement for banks.[58] Also, it is asserted that shifts in the monetary policy has influence over the supply of bank loans such that decrease in bank loans might disturb economic activity.[59] This argument is produced based on the premise that bank deposits and loans are special in a sense that these features are difficult to be replaced properly by other institutions and therefore it emphasizes the bank-funding as a main source of capital as being a driving power on the overall economy.[60] Overall, interest rate and credit channels of banks apply CB orders to the market in their own particular way.

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[57] Claudio Borio and Piti Disyatat,'Unconventional Monetary Policies: An Appraisal' (2009) BIS Working Paper No:292 at 16 (accessed Nov 18,2015) http://www.bis.org/publ/work292.pdf.

[58] Erik F. Gerding, *Law, Bubbles, and Financial Regulation* (Routledge 2014) 369.

[59] Joe Peek and Eric S. Rosengren,'The Role of Banks in the Transmission of Monetary Policy' (2013) Federal Reserve Bank of Boston Public Policy Discussion Papers No: 13-5 (accessed Feb 24, 2015)https://www.bostonfed.org/publications/public-policy-discussion-paper/2013/the-role-of-banks-in-the-transmission-of-monetary-policy.aspx.

[60] ECB,'The Role of Banks in the Monetary Policy Transmission Mechanism' (2008) European Central Bank Monthly Bulletin (accessed Aug 1,2015) https://www.ecb.europa.eu/pub/pdf/mobu/mb200808en.pdf.

Financial theory has approached the subject of the specialness of banks with caution by examining whether improvements in technology or a large financial liberalization process can be pursued that may form different financial structures as well as different financial devices to challenge banks.[61] Another aspect is the role of banks in the process of putting savings into beneficial activities which is significant for growth and welfare.[62] Economic development and entrepreneurship is strengthened when banks steer the flow of capital through firms which provide the highest probability of social returns and closely observe them in case of default.

In terms of income distribution and poverty, the distinction between well and poorly functioning is made since states with better banks show reductions in poverty whilst poorly functioning banks allocate scarce capital to bad projects, mostly to those with the most wealth or power.[63] Ultimately, this has a negative impact on the poor and on economic improvement. These studies prove the place of banks in the economy, but their specialness can basically be examined according to their role between borrowers and lenders.

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[61] Biagio Bosone,'What Makes Bank Special? A Study of Banking, Finance and Economic Development'(2000) The World Bank Policy Research Working Paper 2408 at 4 (accessed Oct 21, 2015)http://documents.worldbank.org/curated/en/348281468739569626/What-makes-banks-special-a-study-of-banking-finance-and-economic-development.

[62] Ross Levine,'Financial Development and Economic Growth: Views and Agenda' (1997) XXXV Journal of Economic Literature 688.

[63] Thornsten Beck and others,'Finance, Firm Size and Growth'(2004) National Bureau of Economic Research Working Paper No:10983 (accessed Nov 15, 2015)http://www.nber.org/papers/w10983.

2. Banks within the Context of Financial Intermediation

2.1. Case for Financial Intermediation

As the name suggests, financial intermediaries might be thought of as a channel between providers and users of capital[64] due to their roles in mobilizing financial assets from savers and issuing a liability through them and then originating their own assets and liabilities towards borrowers. Their main functions in liquidity and information provision, risk sharing and transformation, lessening the transaction costs and debt renegotiation have made them special in contrast to other firms and have gained them attention in the literature.

The theory of financial intermediation is founded on the issues of transaction costs and asymmetric information which are seen as the basis of market imperfections.[65] Imperfections necessitating the foundation of intermediaries consist of inaccurate severability of financial claims and transaction costs stemming from acquirement, diversification and transformation of the information.[66] Intermediaries enable lenders to obtain higher returns while providing lower costs to borrowers compared to direct finance, and by doing so they provide a ground for savings and investments to deal at the highest optimal level.[67] Thus, the emphasis in the literature on the subject of financial intermediaries has revolved around how intermediaries reduce the transaction costs and

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[64] P. Bolton and X. Frexias,'Equity, Bonds and Bank Debt: Capital Structure and Financial Market Equilibrium under Asymmetric Information' (2000) 108 Journal of Political Economy 324.

[65] M. Dewatripont and J. Tirole, *The Prudential Regulation of Banks* (The MIT Press 1994) ch 5.

[66] John J. Pringle,'Bank Capital and the Performance of Banks as Financial Intermediaries: Comment' (1974) 7(4) Journal of Money, Credit and Banking 545,546.

[67] Ibid.

how information asymmetry is ameliorated via the intermediary channel.

'The perfect market' idea which explains why financial intermediaries remain and which forces preserve them in the system has been asserted by Marshall[68] and Walras.[69] Thus, in a perfect market there is no need of intermediaries since all market parties can reach each other directly without any costs and obtain *ex ante* and *ex post* information about the value of the financial instruments by negotiating at the most optimal prices.[70] In Diamond and Dybvig's model, financial intermediaries are seen as key providers of insurance against liquidity shocks through the transformation of illiquid assets into liquid liabilities.[71] Here, *ex ante* identical depositors are inclined to avoid risks and they cannot guarantee the timing and amount of their future consumptions. Thus, in a world without an intermediary, investors without early liquidity needs are the only ones who obtain high returns in the provided illiquid long-term investments world. However, Leland and Pyle's approach highlights the information sharing coalitions by focusing on *ex ante* information asymmetry in which businesses floating shares to the market are aware of anticipated yields of their own investment yet it is costly to acquire and monitor this information for

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[68] A. Marshall, *Principles of Economics* (8th edn, London Macmillan and Co., 1920).

[69] Their approach reflects the neo-classical market theory which claims that the establishment of intermediaries is simply an outcome of market imperfections. For the discussion about Walrasian equilibrium see Donald W. Katzner, *An Introduction to the Economic Theory of Market Behavior* (Edward Elgar 2006).

[70] This is the general equilibrium model of Arrow-Debreu.K.J. Arrow and G. Debreu,'Existence of an Equilibrium for a Competitive Economy' (1954) 22(3) Econometrica 265.

[71] Franklin Allen and Douglas Gale,'Financial Intermediaries and Markets' (2004) 72(4) *Econometrica* 1023.Also see Diamond and Dybvig (n 43) where banks originate liquid claims on illiquid assets via demand-deposit contracts and even though it provides risk-sharing between the agents which timing of their consumption is not certain, it also makes banks vulnerable to panic-based bank runs.

other agents.[72] Hence, businesses foreseeing low yields from their investments have an incentive to declare high expected returns in an effort to raise their market evaluation, which simply illustrates the moral hazard problem in financial markets.[73] Here, Leland and Pyle's approach takes intermediaries as monitors of the businesses which can help to ameliorate the moral hazard problem that borrower-firms create.[74]

Another view on the existence of intermediaries can be found in the costly task of monitoring loan contracts. Diamond sees financial intermediaries as a result of the technological restrictions on the formation of information that obstructs the accomplishment of contractual contingencies; this asserts that the function of intermediaries is as a delegated monitor for issuing low-risk claims against a diversified portfolio of assets.[75] His view of financial intermediaries as delegated monitors is grounded on the agency problems in financial contracting which might be lessened via monitoring.[76] Here, the financial intermediary needs to find an incentive contract which provides an incentive to acquire and monitor the information, its appropriate use, and provide satisfactory payments to investors to encourage more capital.[77] All of these

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[72] H.E. Leland and D.H. Pyle,'Informational Asymmetries, Financial Structure, and Financial Intermediation' (1977) 32 The Journal of Finance 371.

[73] Iris Claus and Arthur Grimes,'Asymmetric Information, Financial Intermediation and the Monetary Transmission Mechanism: A Critical Review' (2003) New Zealand Treasury Working Paper 03/19 at 10 (accessed May 2, 2015) http://www.treasury.govt.nz/publications/research-policy/wp/2003/03-19.

[74] Borrowers do not necessarily follow their business plans once they borrow from a bank and they might engage in inefficient behaviour or hidden actions.

[75] D. Diamond,'Financial Intermediation and Delegated Monitoring' (1984) 51 Review of Economic Studies 728.

[76] Martin Hellwig,'Banks, Markets and Allocation of Risks in an Economy'(1998) 154 Journal of Institutional and Theoretical Economics 328,334.

[77] Claus and Grimes (n 73) 11.

incentives are costly; diversification within intermediaries may lessen such costs. Other approaches generally examine the foundation of intermediaries through three major points which are high transaction costs, lack of full and complete information in useful time and regulatory factors.

So, a large array of costs of direct finance has led to the formation of centralised agents, so-called intermediaries, engaging under a single roof in activities of monitoring, selection and diversification of risk by supplying credit and liquidity services to the market. [78] The very nature of intermediaries, shaped by the opaque character of investments and their credit, maturity and liquidity transformation roles, reflects the fragility of their operations which make them vulnerable to potential runs, thereby placing them in a socially important place.

2.2. Are Banks Mere Financial Intermediaries?

Chartering restrictions and credit and liquidity warrants by the state create the idea that the classical system of financial intermediation is bank-centred, and risks carried by banks underpin the rationalization of why regulatory and supervisory authorities centre upon banks.[79]

Much has been discussed on the function of banks in the economy but one of the differentiating roles of banks, money creation, has led to new doubts as to banks' ability to satisfy the conditions of financial intermediaries. The debate on the nature of banking

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[78] Nicola Cetorelli, Benjamin H. Mandel, and Lindsay Mollineaux,'The Evolution of Banks and Financial Intermediation' (2012) 18(2) FRBYN Economic Policy Review at 3 (accessed Jun 6, 2015) https://www.newyorkfed.org/medialibrary/media/research/epr/2012/EPRvol18n2.pdf.

[79] Ibid 4.

can be seen as the consequence of an absence of explicit rules and regulations providing banks with rights and power to create and destroy money.[80] There is much debate about the reason why other FIs cannot display the same functions as outlined by Minsky[81] and why there are no specific limits or rules drawing a line between the powers of banks and non-bank institutions. As far back as 1889 Macleod observed that:

> It is commonly supposed that bankers act only as agents or intermediaries between persons who want to lend and those who want to borrow. Bankers never act as agents between those who want to lend and those who want to borrow. Bankers buy money from some persons: and Rights of action from others: exclusively with their own Credit.[82]

In the 1950s, on the matter of the money creation role of banks in the act of lending, Gurley and Shaw offered a new way of thinking about the difference between banks and non-bank intermediaries in that non-banking financial intermediaries also exert major influence on the money supply in the economy.[83] The literature then began to produce counterarguments as to why banks do not need to borrow loanable funds from spending units with surpluses to extend credit.[84] Thus, whether banks are money-creating

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[80] Richard A. Werner,'How Do Banks Create Money, and Why Can Other Firms not Do the Same? An Explanation for the Coexistence of Lending and Deposit-taking' (2014) 36 International Review of Financial Analysis 71,72.

[81] Hyman P. Minsky, *Stabilising an Unstable Economy* (Yale University Press 1986) cited from Wallace C. Peterson,'Reviewed Work:Stabilizing an Unstable Economy by Hyman P. Minsky' (1987) 21(1) Journal of Economic Issues 502.

[82] H.D. Macleod, *The Theory of Credit Vol.2* (Longmans and Green Co 1890) 1889:375 cited from Butzbach (n 50) 3.

[83] J. Gurley and E. Shaw, 'Financial Intermediaries and the Saving-Investment Process' (1956) 11 Journal of Finance 257. Gurley and Shaw's thesis highlights non-bank FIs by acknowledging their ability to generate new assets and liabilities that might influence the money supply due to a decrease of share of banks in the total financial assets. E. Narayanan Nadar, *Money and Banking* (PHI Learning Private Limited 2013) 96.

[84] J. Culbertson,'Intermediaries and Monetary Theory: A Criticism of the Gurley-Shaw Theory' (1958) 48(1) American Economic Review 119,121.

intermediaries consequently leaves a question mark over the relationship among the money and intermediation. Yet, according to Butzbach, if banks are creators of money, 'a single banking transaction implies the very social acceptance of an economy-wide unit of account' and it directly indicates the social dimension of trust – which is also systemic trust. [85]

The literature gives three conventional doctrines to identify the nature of banking business. Fractional reserve theory holds that banks keep only a small percentage of their deposits by reserving part of the money with the CB and loaning the rest to borrowers.[86] Here, the idea of collecting deposits first and investing that money later implies that money is endogenous and deposited money is aggregately provided by the financial system where each bank holds partial control of it. Banks as surplus or excess reserve pools, therefore, act as mere intermediaries. The most prevalent approach to the nature of banks, financial intermediation theory,[87] is based on the rejection of previous theories by asserting that banks neither collectively nor individually create and destroy money.[88] As Tobin observes, banks are not granted 'widow's cruse'[89] power; their ability to expand their liabilities are limited as it is only given to modern CBs.[90] Thus, banks are furnished with the power of intermediation by rendering customer deposits into loans which infers that

[85] Butzbach (n 50) 15.

[86] John Maynard Keynes, *A Treatise on Money Vol:2* (Macmillan 1930) 218.

[87] Diamond,'Financial Intermediation and Delegated Monitoring' (n 75); Franklin Allen and Anthony M. Santomero,'The Theory of Financial Intermediation' (1998) 21 Journal of Banking and Finance 1461.

[88] Werner,'How do Banks Create Money, and Why Can Other Firms not Do the Same? An Explanation for the Co-existence of Lending and Deposit-Taking' (n 80) 71.

[89] The term is defined as 'an inexhaustible supply of something'.Collins English Dictionary (HarperCollins Publishers,12th edn 2012).

[90] Tobin (n 35) 412.

banks have to borrow from individual investors to finance such loans even though they have the power to obtain more from the ultimate borrower.[91] Banks, with their distinctive role as middlemen, focus on consolidating and transforming risks and act as brokers in the credit markets by creating inter-temporal exchange transactions between past, present and future and lessening the costs of transactions between two parties.

However, the debate about banks not being pure intermediaries has become more popular within the context of the credit creation theory. It is grounded upon the idea that banks individually create credit and money out of nothing and this is not limited to any capital, implying that each individual bank is not an intermediary reliant upon deposits or reserves from the CB. Rather, they are the manufacturers of the money.[92] It is asserted that banks, without reducing the amount of money in any other internal or external accounts and sources via transfer or withdrawal, are able to create new money independently.[93] Banks, therefore, are seen as capable of crediting the borrower's account without any reduction in their accounts which implies that there is no need for pre-reserved funds or savings to be able to loan. Proponents of this view assert that modern economies are grounded upon CB money in the form of cash and the bank account money within their balance sheets and double entry bookkeeping.[94] Commercial banks, as the producers of account money, do not redistribute the existing money as other intermediation theories suggest. Rather,

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[91] S.C. Myers&R.G. Rajan,'The Paradox of Liquidity' (1998) 113(3) The Quarterly Journal of Economics 733,755.

[92] Morgan Ricks,'Regulating Money Creation After the Crisis' (2011) 1 Harvard Business Law Review 75.

[93] Werner,'Can Banks Individually Create Money out of Nothing? The Theories and the Empirical Evidence' (n 37) 16.

[94] Joseph Huber,'Modern Money Theory and New Currency Theory:A Comparative Discussion, Including an Assessment of Their Relevance to Monetary Reform' (2014) 66 Real-World Economics Review 38.

as suggested, they add new money to the market through a double-entry accounting process.

Modern theory of banking considers banks as neutral players and facilitators of the smooth transition between consumption, saving and production in the financial system.[95] It should be said that regardless of what banks are called or how they are identified, they have been functioning in a very special way by holding a socially and economically important place in the financial system. Their contracts with depositors together with their role in reducing transaction costs, information gathering, and monitoring functions require particular attention in the mechanics of lending.

In relation to bank information, there are three points should be made regarding to informational asymmetry problems.[96] First, there is an information asymmetry problem between the bank and its investors, lenders and customers. The second one is between the bank and its borrowers or others such as the government or peer banks or those have the counterparty risk in case of bank failure due to its long-term relationship with the bank. The last information asymmetry problem is the one between the bank and all other persons that have connection with the bank. If bank borrowers default, depositors' interests are affected and the borrowers' welfare is disturbed when there is a disruption in bank funding emanating from bank runs or the bank's orderly resolution by the relevant authority. Therefore, this signals a link between information disclosure, confidence and bank runs.

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95 J.R. Collins and others, *Where Does Money Come from?* (2nd edn,Nef 2012) 13.

96 Manuel A. Utset,'Rational Financial Meltdowns' (2014) 10(2) Hastings Business Law Journal 407,418.

2.3. Transaction Costs Reduced by the Emergence of Banks

Coase's article, The Nature of the Firm, was the first to provide insights into the costs of making exchanges in defining the structure of market and non-market economic organizations, and into the question of which factors make markets so expensive that spot exchanges had to be abandoned and had to be substituted by some other institutions.[97] He asserted that the visible hand of the law, in other words, governance mechanisms such as public laws, regulations or business associations, advance economic activities as long as those mechanisms lessen the transaction costs in the system and facilitate trading. As discussed in the literature for many years, transaction costs can be grouped under the costs of search and information, costs of bargaining and decision, costs of policing and enforcement. As a specific type of firm, difference of intermediaries from other firms can be found in their transaction services.[98] Furthermore, costs stemming from such transaction services have been seen as the *raison d'etre* of intermediaries.[99] Transaction costs as a reflection of market imperfections are expected to reduce via some market makers based upon the consumers' interest in maximising the level of utility on their savings and consumptions.[100]

As financial intermediation theory suggests, banks produce new financial commodities by combining two distinct services of receiving funds and granting loans which simply reduces transaction costs to a minimum. Although there are other financing channels as alternatives to banks, bank financing is one of the most common and historical sources

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[97] R.H. Coase,'The Nature of the Firm' (1937) 4(16) Economica, New Series 386.
[98] Xavier Freixas and Jean-Charles Rochet, *Microeconomics of Banking* (MIT Press 1997) 15.
[99] George J. Benston and Clifford W. Smith,'A Transactions Cost Approach to the Theory of Financial Intermediation' (1976) 31(2) The Journal of Finance 215.
[100] Ibid 216.

of external capital, especially for small and medium size enterprises, offering lower costs of exchange for both lenders and borrowers.

Banks achieve economies of scale and economies of scope and these have their roots in transaction costs. Different from individual lenders, banks have the privileges of economies of scope in lending decisions based on their contractual relationships with current and potential customers and this relationship's natural outcome of access to relevant and necessary information.[101] Banks enjoy economies of scope based on their variety of related services through a single infrastructure. The costs of providing each service separately would be much greater than the costs of using a single infrastructure to provide multiple services. Though the extent of scale of economies remains unclear, banks can benefit from economies of scale (meaning reducing the cost by increasing efficiency), for example, by processing customer information to lower credit losses.[102]

To grasp how transaction costs are reduced by banks, it is necessary to conceptualize a world without them. In brief, banks take deposits and grant loans. By doing that, banks place one standard contract to extend loans to various customers and establish standard measures to assess its present and potential customers, helping them to conduct the operations quickly. This means that the relationship with the firms previously contracted

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[101] Munehisa Kasuya,'Economies of Scope: Theory and Application to Banking' (1986) 4 Monetary and Economic Studies 59.

[102] Swedish Competition Authority,'Do Swedish Banks Enjoy Economies of Scale or Economies of Scope?' at 43 (accessed Dec 29, 2016)http://www.konkurrensverket.se/globalassets/forskning/projekt/do-swedish-banks-enjoy-economies-of-scale-or-economies-of-scope.pdf.

in the same line of business may lessen the transaction costs as well as adverse selection[103] and moral hazard problems of the banks.[104]

In the absence of banks, agents have to bear the costly transaction costs by discovering the real prices, and negotiating and concluding contracts with borrowers, in other words, bearing the costs of running the economic system.[105] The transformation of information as a pertinent part of transaction costs imposes a burden on lenders to process, transmit and accommodate the collected information, deal with legal issues as well as selling and supervising.[106] After drafting loan terms and handling other external arrangements like courts and legal issues, agents need to be sure that another party is following the contract terms and agreements. This necessitates monitoring and enforcement measures, in other words, extra labour. Thus, *ex ante* and *ex post* costs of negotiating and enforcing a contract and by doing so trying to protect rights in an exchange economy places great costs on both borrowers and lenders.

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[103] The classic example of adverse selection is the lemons problem depicted by Akerlof. George A. Akerlof,'The Market for "Lemons": Quality, Uncertainty and the Market Mechanism' (1970) 84(3) Quarterly Journal of Economics 488.

[104] Laurence M. Ball, *Money, Banking and Financial Markets* (2nd edn,Worth Publishers 2012) 216.

[105] Kenneth J. Arrow,'The Organization of Economic Activity: Issues Pertinent to the Choice of Market Versus Nonmarket Allocation'(1969)The Analysis and Evaluation of Public Expenditure:The PPB -System, Joint Economic Committee, 91st Congress,1st Session at 59 (accessed Dec 23, 2015) http://www.jec.senate.gov/reports/91st%20Congress/The%20Analysis%20and%20Evaluation%20of%20Public%20Expenditures%20-%20The%20PPB%20System%20Volume%20I%20(444).pdf.

[106] J. Joseph Wallis and Douglass C. North,'Measuring the Transaction Sector in the American Economy, 1870-1970' in Stanley L. Engerman and Robert E. Gallman (eds), *Longterm Factors in American Economic Growth* (University of Chicago Press 1986) 97.

However, banks enable agents to deal with only two acts, which are 'depositing the funds' and 'withdrawing it when needed', without giving them the burden of finding the optimal deal for their investment decisions.[107] Banks with specialized labour employment and expertise make transaction services cheaper and more credible for the agents.

Transactions costs are closely intertwined with information asymmetries. In Thakor and Bhattacharya's words, 'information asymmetries are the most basic form of transaction costs'.[108] Similarly, lack of necessary information related to activities of agents in the financial markets has been seen as the key origin of transaction costs.[109] Banks exist to diminish transaction costs related to search.[110] Banks, in this context, remove the transaction costs and replace ignorance by information, replace distrust by trust and confidence.

Standardized products and services together with expertise through the use of already tested procedures provided by banks relieve individuals and firms from the burden of conducting costly searches about the each other's borrowing/lending behaviours, past and present financial condition and other such detailed information which is very difficult to acquire individually. The informational superiority of banks, therefore, helps to ameliorate the information asymmetry, allowing banks to request a fee for their services in handling risks and asymmetric information, which is the difference between the interest

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[107] Augusto Hasman,Margarita Samartin, Jos van Bommel,'Financial Intermediaries and Transaction Costs'(2010)Documents de Travail de l'OFCE No: 2010-02 at 3 (accessed Dec 17, 2015)https://ideas.repec.org/p/fce/doctra/1002.html.

[108] S. Bhattacharya and A.W. Thakor,'Contemporary Banking Theory' (1993) 3(1) Journal of Financial Intermediation 2,8.

[109] J. Stiglitz and A. Weis,'Credit Rationing in Markets with Imperfect Information' (1981) 71(3) American Economic Review 393.

[110] Benston and Smith (n 99) 223.

charged to borrowers and paid to lenders, ie the transaction fee.

In the case of banks, transaction costs consist of both direct and indirect financial costs that emanate from the costs of searching and gathering the relevant information about agents, and costs of monitoring risk-averse and opportunistic behaviours in order to understand whether they follow the terms and conditions of the contract with the bank. This view suggests that an efficient balance can be achieved by reducing such indirect costs based on frictions both in the flow of information and funds.[111] Banks, therefore, reduce transaction costs first, as a firm, by reducing the costs of many unnecessary transactions, and second by producing information and confidence.

3. Relevance of Information in the Banking Sector

3.1. Implications for Information

The literature has indicated that 'information' is the key component of efficient allocation of lending. Thus, information, as the main pillar of the working mechanism of intermediaries, has formed the substantial part of transaction costs. Having said that, common vocabulary for informational efficiency provides an overarching framework in order to understand how information has implications on regulation and specifically in its role in price discovery and market efficiency.

[111] R. Coase,'The Institutional Structure of Production' Nobel Prize Lecture (Dec 9,1991) (accessed 13 Nov,2015)http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1991/coase-lecture.html.

Information is the basic ingredient of making economic choices and it is 'literally everyone's business and expresses each individual's autonomy'.[112] It is a foundation of the market process where transaction costs and uncertainty decrease through availability of better information. Information is not only related to a specific market and its laws, but it is also related to the actions of others. So, everyone has a substantial level of information about his personal life, and economic decisions made on the individual level have implications on the collective level in a way that information produced is an important factor for efficient allocation of resources either via the government or markets. Resource allocation is traditionally discussed within the realm of whether it is appropriate to let the market find its own solutions both during normal times and stressed times and the debate on this continues.[113]

Information is both a product and process. Liberal and economic views make assumptions about the public domain for information, its use and dissemination.[114] Basic assumptions regarding politics, market, property and privacy generally provide a basis for classification of information. Categorization of information as public or private and the boundaries of designing the information public or private change depending on how one approaches information.[115]

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[112] Ejan Mackaay,'Economic Incentives in Markets for Information and Innovation' (1990) 13 Harvard Journal of Law and Public Policy 867,891.

[113] Helmut Willke,'Transparency after the Financial Crisis' in S. Jansen, E. Schroter and N. Stehr(eds), *Transparenz* (2010 VS Verlag) 67;Gerald P. O'Driscoll,'Hayek and Keynes:What Have We Learnt?' (2011) 27(1) The Journal of Private Enterprise 29.

[114] Steven J. Horowitz,'Designing the Public Domain' (2009) 122(5) Harvard Law Review 1489.

[115] Full ramifications of the economic thoughts' and law' approach in separating public and private are not the main argument here. Duncan Kennedy,'The Stages of the Decline of the Public/Private Distinction' (1982) 130 University of Pennsylvania Law Review 1349.

Information, in the liberal vision, creates a tension between public and private spheres because it takes free access to information as the main base and therefore state restriction on information disclosure is a limitation on freedoms.[116] The notion of private is described with the general perception about the 'justified ability to withhold information',[117] for example, via a right to privacy. The private sphere of information here covers markets vis-à-vis the state, and individuals (both legal and real persons) vis-à-vis markets or the state.[118] So, the level of state intervention to increase production and dissemination of information brings about questions on different levels. Application of this rhetoric to banks provides that collected information by banks create this public and private tension on a customer vis-à-vis bank level, and bank vis-à-vis markets (ie capital markets) and the state (ie exceptions to duty of confidentiality) level.

The economic approach to information emphasizes that information is key for allocation of scarce and rival resources,[119] and price discovery, which is the process by which market traders interact, is possible with information. Information, in its capacity to reduce uncertainty, allows economic agents either to determine the current state of the world or anticipate the future state of the world, and therefore decisions made affect prices and allocations on the aggregate level.[120]

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[116] Ibid 1493.

[117] James Boyle,'A Theory of Law and Information: Copyrights, Spleens, Blackmail and Insider Trading' (1992) 80(6) California Law Review 1413,1440.

[118] Ibid.

[119] Ida Kubiszewski, Joshua Farley and Robert Costanza,'The Production and Allocation of Information as a Good that is Enhanced with Increased Use' (2010) 69 Ecological Economics 1344.

[120] Reinhard H. Schmidt and Marcel Tyrell,'Information Theory and the Role of Intermediaries' in Kalus J. Hopt, Eddy Wymeersch, Hideki Kanda and Harald Baum(eds), *Corporate Governance in Context of Corporations, States, and Markets in Europe, Japan and the US* (OUP 2005) 484.

The financial industry depends on collecting information regarding different units of the economy and acting on that information. This action is not limited to capital markets where securities are purchased and sold but also includes any type of markets where a service or product is priced. For example, the extension of a loan to a firm or an individual is based on information as a result of a two-party contract between the lender and borrower. More information means better pricing of the service.

Effectiveness of price discovery is known as market efficiency or informational efficiency. Informational and market efficiency, therefore, are mutually complementary terms and if mechanisms of a particular market function well, then there is no need of regulatory intervention in order to ensure the availability of information for preventing a market failure.[121] Hayek, in this respect, addresses price mechanism as a setting, which the extent of production, aggregation and transmission of information designates the extent of allocation of resources, and therefore impacts the whole economic system.[122] According to Schmidt and Tyrell, information revelation through prices based on Hayek's approach is information externalisation that is best addressed by Fama.[123] Fama's famous typology of market efficiency (efficient market hypothesis (EMH)) provides that prices in the market rapidly and accurately incorporate and reflect all available information and so that in strong and semi-strong versions of the efficient markets it is argued that there is no need of regulation ensuring information provision under MD regimes since the process of information discovery and information incorporation into prices would remove the need for regulatory arrangements.[124] So, in this setting, market prices are themselves

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[121] Onnig H. Dombalagian, *Chasing the Tape* (MIT Press 2015) ch 2.

[122] Hayek (n 10).

[123] Schmidt and Tyrell (n 120) 487-88.

[124] Roberta Romano, *The Genius of American Corporate Law* (AEI Press 1993) 290-91.

information. There have been other arguments such as chaos and noise theories to develop arguments for an EMH-based approach to markets and its understanding of price discovery.[125] Yet, disclosure of information is an important facilitating factor for price formation and it brings about new discussions as to the terms, level and incentives of disclosures.

Information is intangible and therefore difficult to handle, govern and restrict the access of others. Information is generally characterised as a public good, which means that it can be used by different persons at the same time without depletion. Public goods have two features: non-rivalry in use or consumption and non-excludability. Its non-rivalrous feature means that use and transmission of information by one agent does not prevent others using it and it does not eliminate the benefits of information for the party that transmits or uses it. The non-exclusive feature of information means that once the good is produced it is difficult to prevent others from having access to it. Because of these characteristics of information, an agent that produces or buys information is unable to get the full benefits of that information and it creates an incentive problem. The free-rider, who enjoys the benefit but does not share in the cost, weakens the incentives for production of information. This has forced policymakers to establish a legal or regulatory mechanism to ensure a minimum level of information is available.[126] This brings about a question over the optimal level of information production and the rationale of MD of information and other variations of disclosure theories.

[125] Chapter 3.

[126] Dombalagian (n 121) 28.

3.2. Banks as Producers of Information

The discussion about the importance of information is a continuing one in the literature. The place of information in banking is mostly about banks' roles in collecting and producing information, which is about their intermediary function. Another one is the information about banks themselves, which is built upon banks' financial decisions made pursuant to information collected and produced. It is the information that is reflected in bank balance sheets or other statements, and it is information that forms a collective output based on banks' intermediation function. So, this section approaches bank information both as an indispensable part of running their business (first phase: collection, monitoring and production of information to make and extend loans) and as a value-providing continuance for banks in terms of producing confidence (second phase: information about banks' overall financial standing).

The historical debate related to superiority of banks over market financing implies that financial systems are institutions which lessen the level of information asymmetry and moral hazard among financiers and borrowers.[127] A banking relationship occurs when lenders and borrowers share information with the bank not available to other parties, which matches the financial needs of investors and savers through banks by mitigating asymmetries.[128] Within this framework, banks as the unique source of information help to distinguish between good and bad firms as through the credit relationship or relationship lending, they collect, monitor and produce a great deal of information about the borrower firm's financial prospects and bank lending system collectively eliminates

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[127] Elizabeth Paulet, *The Role of Banks in Monitoring Firms:The Case of the Credit Mobilier* (Routledge 1999) 19.

[128] Alfred M.H. Slager,*Banking Across Borders* (ERIM 2004) 40.

bad firms from reaching bank credit services due to this aggregated data.[129] So, they basically use 'data to create new efficiencies, stimulate demand, build relationships and generate revenue and profit from their services.'[130]

Banks enjoy the reduced costs of information production depending on its brokerage services which necessitates specialist expertise to collect the required information and translate and digest it to make a profit. By finding and interpreting such clues banks re-use the relevant information about customers and enjoy the benefits of temporary re-usability of information.[131]

Since the produced information by market has the features of public good, the first producer of information enjoys the benefits of specializing in the production and distribution of the information which puts banks in a special place given the nature of the information they collect. Banks communicate proprietary information about borrowers and thereby provide re-usability of it through screening[132] and then monitoring[133]. Diversification and specialization of banks requires them to collect some substantial

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[129] However, depending on market specifics, banks might also provide transaction-based loans which are guaranteed by good collaterals and with short maturities and they make these loans decisions based on hard information, rather than soft information. Franklin Allen and Douglas Gale, *Comparing Financial Systems* (MIT Press 2000) ch 1.

[130] World Economic Forum,'Personal Data:The Emergence of a New Asset Class' (Jan 2011) at 8 (accessed March 4,2016)http://www3.weforum.org/docs/WEF_ITTC_PersonalDataNewAsset_Report_2011.pdf.

[131] Y. Chan, S.I. Greenbaum and A.V. Thakor,'Information Reusability, Competition and Bank Asset Quality (1986) 10 Journal of Banking and Finance 243.

[132] D. Diamond,'Monitoring and Reputation: The Choice between Bank Loans and Directly Placed Debt' (1991) 99 Journal of Political Economy 689.

[133] Raghuram G. Rajan and Andrew Winton,'Covenants and Collateral as Incentives to Monitor' (1995) 50 Journal of Finance 1113.

information such as specific information about a borrower's financial condition including very detailed personal and financial information. This is why banks can get involved in both payment services and information-intensive lending.

The lending mechanism in the banking industry requires information related to a borrower's business and his borrowing behaviours in order to evaluate credit standing and remunerativeness of firms. In a world where the investor/lender seeks full and credible information about a borrower, fragmented or missing information on the side of the borrower may result in a mismatch of economic interests between borrowers and lenders, suggesting that this disparity induces credit limitations and deficiency in funds allocated for loans.[134]

Banks gather and preserve the information that is not available to others, only for their own private use. They accumulate and use the information by spreading the cost of collecting it over a number of loans which is in parallel with their confidentiality concerns over that data.

Namely, banks are also special due to their ability to produce soft, private information on their borrowers. While soft information is the qualitative and non-verifiable information acquired by the bank through the credit relationship over time and it cannot be credibly transferred to others since it is not verifiable by anyone other than the one who produced it, hard information is the one contained in balance sheet data and it is quantitative and

[134] I. Kibirige Nalukenge,'Impact of Lending Relationships on Transaction Costs Incurred by Financial Intermediaries: Case Study in Central Ohio' (2003) ETD (accessed Dec 15,2015)http://rave.ohiolink.edu/etdc/view?acc_num=osu1068473959.

verifiable, which means others can obtain and produce it.[135] This means that bank opacity in the first place comes from soft, private information, and hard information is an output derived from soft information. A delegated monitoring function, therefore, means that banks produce information about the debtor's quality and this information is inherently opaque to outsiders. Here, it is possible to mention internalised information where the opaque, granular and soft nature of information that banks possess (in the absence of a specific regulation, a public law compulsion, or of a private law duty requiring banks to disclose information) is shared with only limited recipients such as regulators or supervisors. This aspect addresses the first dimension of bank information.

The second dimension of bank information is the information they produce about themselves and it is the information that has overtones for financial stability and economic activity. It is related to the negative impact of bank information disclosure in such a way that it does not only swipe confidence away and set it to the state of zero; but in fact, bank information can place confidence in a state of sub-zero. So, the literature on banking panics and runs puts emphasis on the nature of information and its negative, reflexive and coordinative effects on individual and collective decision-making.[136] Mainstream theories about the banking crisis distinguish information-based bank runs and panics by emphasizing the cognitive, behavioural and social aspect of bank stakeholder behaviours and they value confidence as a constructing factor in shaping bank stakeholders' decision-making processes. The literature on bank runs addresses random

[135] Masaji Kano, Hirofumi Uchida, Gregory Udell and Wako Watanabe,'Information Verifiability, Bank Organisation, Bank Competition and Bank-Borrower Relationships'(2011) 35 Journal of Banking&Finance 935.

[136] Chapter 2,Section 3.1.1.

events (sunspot explanations),[137] information asymmetries,[138] coordination problems between depositors[139] and a combination of all of these as a general group of reasons for runs. In all of these scenarios, bank-specific information plays a great role in creating or aggravating a banking crisis by spillovers or panics, and this is addressed in the next chapter.

As it will be discussed in Chapter 2, why bank information is of importance can be answered from different angles, but information asymmetry and concomitant problems stand as one of the notable reasons. So, why bank information matters? First, there must be a sufficient level of information to regulate the financial system, and there is an information asymmetry between the regulator and the bank. Second, there must be a sufficient level of information for the protection of customers and investors, which implies that there are information gaps between the bank and its consumers. Third, the market itself needs information for its smooth functioning. Fourth, information asymmetries between FIs themselves have an impact on the smooth functioning of the financial system. Fifth, large FIs that are considered systemically important have internal information asymmetries.[140]

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[137] Diamond and Dybvig (n 43).

[138] C. Jacklin&S. Bhattacharya, 'Distinguishing Panics and Information-Based Bank Runs: Welfare and Policy Implications'(1988) 96 Journal of Political Economy 568.

[139] J.C. Rochet & X. Vives,'Coordination Failure and the Lender of Last Resort' (2004) 2 Journal of the European Economic Association 1116.

[140] Helmut Willke and Eva Becker,'"A Demonstrably Fragile Financial System"- Information and Knowledge Asymmetries in the Global Financial Crisis' in S.A. Jansen, E. Schroter, N. Stehr(eds), *Fragile Stabilitat –Stabile Fragilitat* (Springer VS 2013) 219-42.

4. **Concluding Remarks**

Historical evolution of banks vis-a-vis other FIs has shown the relative superiority of banks' special functions in both financial markets and the economy. Markets are not static and linear organisations. They change, adjust and transform over time and banks as substantial elements of this living organism should be understood in terms of their social foundations and evolving nature.[141] Markets work in a system where participants from households to large-scale firms have confidence in engaging in financial transactions. The social foundation of banks is based on trust where it is not cheap and easy to reach information about others, as in a real-world situation. Under this evolving non-linear financial system driven by information, banks are of importance to establish the needed trust for market participants.

The existence of banks, as debated within the context of financial intermediation, was rooted in information deficits and hazards. Banks hold assets and liabilities with different risks and to a different extent which consist of banks' intermediary side. This intermediary effect can be seen in their asset-liability, capital or risk management skills. However, the arguments that banks are not deposit-taking institutions due to their legal ownership of the deposited money and that they do not lend money but rather purchase a loan contract in the form of a promissory note and therefore invent their own money has gained attraction in order to underpin the idea that banks are not intermediaries as modern theory suggests.[142] However, regardless of how banks are classified, there are some facts that should not be ignored. Banks collect funds from depositors or in the words of credit

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[141] Lena Rethel and Timothy J. Sinclair, *The Problem with Banks* (Zed 2012) 36.

[142] Z. Jakab and M. Kumhof,'Banks are not Intermediaries of Loanable Funds-and Why This Matters' (2015) Bank of England Working Paper No: 529 (accessed Dec 4, 2015)http://www.bankofengland.co.uk/research/Pages/workingpapers/2015/wp529.aspx.

creation theory adherents ‘unsecured creditors’ and offer services to deal with certain typical informational and liquidity frictions as centralised agents. These roles in financial exchange and contracting provide important implications for a large spectrum of costs connected with direct financing. Although these roles run the risk of being inherently fragile given that they do not keep enough balances in their reserves to ensure all sudden withdrawals will be satisfied, the deposit and loan cycle of banks simply describes the functions of an intermediary that run through information.

CHAPTER 2

BANK INSTABILITY AND SYSTEMIC RISK AND ITS RELEVANCE TO CONFIDENCE PRODUCTION AND PROTECTION

1. Protection of Financial Stability as an Overarching Objective

Financial markets are similar to roads, where their maintenance and safety are controlled by governments for the concurrent access of persons and businesses with the aim of establishing the best protection for all participants using those roads and directing them to behave safely.[143] Furthering the analogy, the underlying reasons for regulations imposed on banks have similar characteristics to traffic, based on its intermediating role and accordingly its impact on the aggregate amount and allocation of wealth in society, which also comes with socio-economic effects at the individual and corporate level. However, regulation of FIs, including banks, is explained via uncontrolled private behaviours and their consequences on individual and social levels, where regulation is justified when the social marginal cost of unregulated actions exceeds their private marginal cost.[144] To apply this to banks, the magnitude of the outcomes arising out of bank failures and crises can be indicative of such social costs.

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[143] Edward J. Kane,'Perspectives on Banking and Banking Crises' (2015) Boston College (accessed Feb 25,2016) https://www2.bc.edu/edwardkane/Perspectives%20on%20Banking%20and%20Banking%20Crises.pdf.

[144] R.H. Coase, *The Firm, The Market and The Law* (University of Chicago Press 1988).

Banks, being one of the most vulnerable institutions of the modern economic system, have the capacity to endanger the whole financial system due to the high degree of interdependence between banking and the rest of the financial industry as well as the whole economy.[145] The extent and commonness of banking crises and bank failures, irrespective of the sophistication of banking systems or the economic and financial development level of the country, have motivated lawmakers to exert more monitoring and supervising measures over banks.[146] Determined, extensive and heavy agendas of regulators in order to prevent bank runs and failures have headed towards identification and mitigation of risks in a holistic manner. This means that prevention of systemic risk, a focus on the whole financial system rather than its individual components, and new prudential tools and associated governance, have been the elements of the new financial regulatory approach since the GFC.[147]

The GFC introduced a series of new terms into financial and regulatory terminology and macroprudential regulation. Systemic shock and contagion have become well-known and perhaps over-used terms of post-crisis regulatory agendas.[148] The methods of ensuring the safety and soundness of the financial system and its relevance to the systemic risk have come to the fore and previous concepts, such as the fallacy of composition,[149] have

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[145] Busch (n 44) 24.

[146] Kent Matthews & John Thompson, *The Economics of Banking* (John Wiley&Sons 2005) 161.

[147] The Common Report of IMF-FSB-BIS,'Elements of Effective Macroprudential Policies' (2016)(accessed Sep 1,2017) http://www.imf.org/external/np/g20/pdf/2016/083116.pdf.

[148] Behzad Gohari and Karen E. Woody,'The New Financial Regulatory Order:Can Macroprudential Regulation Prevent Another Global Financial Disaster'(2014) 40(2) The Journal of Corporation Law 403,404.

[149] The fallacy of composition is a concept which contends that the individual parts of the system represent the whole system so that safety and soundness of the whole banking and financial system is the accumulated robustness of all its participating entities. J. Osinski, K.

been re-discussed as the suspicion has been that micro reasoning might not provide true conclusions at the macro level even if that argument might be sound for purposes at the micro level. The asserted idea here is that mere microprudential regulation, while attempting to make each participating institution safe and prudent, might in fact destabilise the whole financial system. Goodhart states this in the following terms:

> … [T]he deeper problem has been that controls and reactions that seem appropriate at the level of the individual financial institution may become seriously damaging at the level of the system as a whole. Thus, faced with adverse financial conditions, the reaction of the individual bank or other financial intermediary is to retrench, to hoard liquidity, to sell assets while the opportunity to do so remains open, and to become far more restrictive in extending credit. Microstructural regulation often reinforces such tendencies, in part by encouraging all the regulated to act in the same way at the same time, as a herd.[150]

As such, since the crisis, a system-wide perspective that considers the interactions within the system has been employed alongside microprudential policies in order to achieve resilience and soundness across the entire system. Correspondingly, new organisations to control systemic risk have appeared and the discussions related to optimal regulatory structure have intensified. In the UK, a shift from the tripartite system to a twin peaks system has been a significant change. The FPC of the BoE (Bank of England) is the new dedicated macroprudential body responsible for identifying, monitoring and responding to risks to the financial system, plus the goal of supporting the economic policy of the government, including its objectives for growth and employment.[151] The FPC

Seal, and L. Hoogduin,'Macroprudential and Microprudential Policies:Toward Cohabitation' (2013) IMF Staff Discussion Paper SDN:13/05(accessed Nov 14,2016) https://www.imf.org/external/pubs/ft/sdn/2013/sdn1305.pdf.

[150] Charles E. Goodhart,'The Macro-Prudential Authority: Powers, Scope and Accountability' (2011) 2 OECD Journal: Financial Market Trends 1,5.

[151] The FPC was established by the Financial Services Act 2012 as a Committee of Court and became a statutory committee of the BoE under the BoE and Financial Services Act 2016.

accomplishes these goals by detecting risks and stresses in its Financial Stability Reports, making recommendations to the Treasury, other regulators and within the BoE, and directing the FCA and PRA on a comply or explain basis in order to calibrate particular macroprudential tools. [152] The establishment of the FPC was particularly important because the new twin peaks system does not provide a single coordinated regulatory structure for financial services, and therefore coordination among the authorities to deliver their statutory objectives for the regulatory structure to work has become paramount. [153]

In the US, the establishment of the Financial Stability Oversight Council (FSOC)[154] and re-discussion of duties and powers of financial regulatory bodies under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) have been the results of this new financial ordering.

The GFC mainly took the form of a banking crisis, although it also included non-bank FIs and shadow banks, which developed out of the traditional banking system.[155] This means that institutions operating outside of the government safety nets or regulatory measures tailored to banks also posed a great danger to the systemic and financial stability. Further developments since the GFC proved that the use of public funds to reinforce the capital status of TBTF banks, both in the US and the EU, was not a sustainable solution to mitigate concerns about banks. The continuous use of public debts for banks triggered a banking crisis that turned into a public debt crisis in the second phase of the GFC. It is

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[152] BoE Act,s 9H-R.

[153] MoUs will be discussed at Section 3.1.3.

[154] FSOC is established by the Dodd-Frank Act in order to identify risks and respond threats to the financial stability.12 USC§5322.

[155] Anthony Elson, *The Global Financial Crisis in Retrospect* (Palgrave Macmillan 2017) 21.

therefore possible to say that banks and financial stability have always been closely intertwined.

During the GFC, it was apparent that large commercial banks were very active in the securities markets and shadow banking activities were dependent on the funding in the capital markets. As such, banking activities, in a traditional and non-traditional way, were greatly affecting the liquidity and the amount of money in the system while the CB(s) could intervene with the bank credits. In other words, they were providing funds to the system by making changes in short-term interest rates in the interbank market for reserves.[156] The timeline of the crises proved that CBs had to step into the complexity more than before through injections of funds into banks, nationalisations, arranged mergers, lowering interest rates, undertaking a series of auctions against a range of collaterals and purchasing toxic assets of the FIs and so on. Unprecedented government support or, under the laissez-faire approach to financial regulation, massive intervention in the markets during and after the GFC highlighted the contours of stability measures in a way that both old-fashioned bank runs (eg NR) and the new type of scenery appeared in the form of withdrawals by interbank market participants (not depositors) are experienced.[157] So, it is possible to mention two kinds of crises where banks were the major actors and CBs and governments were the decision makers on whether to save the institutions or let them fail.

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[156] Ibid 23.

[157] Xavier Vives,'Bagehot, Central Banking and the Financial Crisis' in Andrew Felton and Carmen Reinhart (eds), *The First Global Financial Crisis of the 21st Century Part I* (CEPR 2008) 99-101.

The traditional form of prudential supervision[158] was designed to respond to system-wide concerns. Stress tests, new capital adequacy, leverage levels and disclosure requirements for banks reflect the post-GFC approach. *Ex ante* policies to prevent contagion and spillovers proved that systemic risk is still in the financial system and information disclosure is an important element of public confidence. Protection of overall financial stability has become the prominent goal and the importance of CBs has increased under the macroprudential regulatory approach. While stability has become the overarching objective, the contours of bank transparency and its relation to overall financial stability have been revisited in different ways in different jurisdictions. The importance of market discipline has increased yet capital markets mandated-transparency of banks created question marks about the way that prioritisation of objectives between the financial stability of the state in the long run and investor protection and market integrity in the short term has occurred.[159]

All of these were experienced during the GFC, so the focus will be on the financial environment during the crisis and understanding how the law and theory approached bank regulation and financial stability in terms of disclosure of bank information. Firstly, sources of the GFC that led to a paradigm shift in financial regulation will be explored and then subsequent parts will question the multifaceted relationship between public confidence, bank information and financial stability with an eye to recent regulatory changes in bank regulation.

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[158] These can be grouped as capital, liquidity and disclosure requirements, bank chartering, bank examination, restrictions on asset holdings and activities, risk-based deposit insurance premiums, separation of the banking and other financial service industries, restrictions on competition. Frederic S. Mishkin,*Prudential Supervision: Why is it Important and What Are the Issues?* (University of Chicago Press 2001) 9.

[159] Chapter 5.

2. Brief Summary of the Global Financial Crisis and Its Implications for the Banking Sector[160]

The financial commentators have analysed the underlying reasons for the GFC in different contexts. There have been many interlinked factors given for the GFC which began in the US when various mortgage banks went bankrupt: low interest rates in the early 2000s (easy monetary policy of the Fed)[161] and accordingly acquisition of low-interest-rate mortgages by the American public (housing boom and then housing bubble); [162] complex products circulated in the markets as a result of excessive securitisation and too much reliance on securitisation to reach funds; difficulty of addressing risks underlying the balance sheets of FIs (opacity); reliance on non-updated bank risk models;[163] lax regulations that were not designed for new financial transactions of FIs; absence of regulations for shadow banking activities; greed and opportunistic behaviour of FIs; and supervisors' inability (or rationally bounded regulators) to foresee the risky activities of regulated institutions or to take necessary actions in time to prevent further deterioration of them; structure of the financial regulators;[164] too much emphasis

[160] Since the tension discussed in this research appeared during the GFC, underlying reasons of the crisis will be succinctly considered in as much as it is relevant to main theme of the thesis.
[161] C.A.E. Goodhart,'The Background of the 2007 Financial Crisis' (2008) 4(4) International Economics and Economic Policy 331,334.
[162] Padma Desai, *From Financial Crisis to Global Recovery* (Columbia University Press 2011) 1-20.
[163] Together with Basel II bank capital rules, which allowed banks to replace tangible common equity with subordinated debt and convertible preferred stock, bank risk models came under severe criticisms. The concern about it was that subordinated debt did not hinder failure and it solely absorbed loss after failure. Avinash Persaud,'Why Bank Risk Models Failed' in Felton and Reinhart (n 157) 11-12.
[164] In the US, it was the problem of too much fragmentation at which agencies have separate and also overlapping jurisdictions. In the UK, it was the tripartite model of the UK structure where

on microprudential regulation; existence of a variety of arguments about the FIs that can be abbreviated as too big to fail (TBTF), too many to fail, too important to fail or too linked to fail institutions;[165] flawed investment grade ratings given by credit rating agencies (CRAs);[166] and economic ideologies supporting deregulation, in other words, unrestricted free markets[167]. As Mayntz thinks, financial crises are an aggregate of many events, filtered into a single event as a cognitive construct and all of these factors abovementioned are the causes and effects of each other sequenced in a chain.[168] These components which undergirded the GFC present the most pronounced headings regarding to the underlying reasons of the GFC.

In an environment with generous supplies of credit and with false confidence, bankers developed innovative ways of convincing creditors to make them invest in novel financial instruments such as ABS, MBS, CDS, CDO and other structured instruments that are the

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the BoE, the FSA and the Treasury were blamed not to provide an effective, timely communication and coordination to response to the crisis.

[165] Johan A. Lybeck, *A Global History of the Financial Crash of 2007-10* (CUP 2011) 14-29.

[166] Aline Darbellay, *Regulating Credit Rating Agencies* (Edward Elgar 2013) 93-144.

[167] According to Palley, small government policies in order to liberalise markets spurred privatization, deregulation and light touch regulation, which means detrimental government interference was limited and such policies undermined the rationality of the state. Thomas I. Palley,'America's Exhausted Paradigm' (2009) Institute for International Political Economy Berlin Working Paper No: 02/2009 at 8 (accessed Apr 26, 2015)http://www.ipe-berlin.org/fileadmin/downloads/working_paper/ipe_working_paper_02.pdf. According to Williamson and Mahar, countries that experienced the financial crisis are the ones with high level of financial liberalization.John Williamson and Molly Mahar,'A Survey of Financial Liberalisation' (1998) Princeton University, Essays in International Finance No: 211(accessed Feb 26, 2016)https://www.princeton.edu/~ies/IES_Essays/E211.pdf.See Stuart P.M. Mackintosh,'Crisis and Paradigm Shift'(2014) 85(4) The Political Quarterly 406.

[168] Renate Mayntz,'Crisis and Control: Institutional Change in Financial Market Regulation' (2012) Publication Series of the Max Planck Institute for Study of Societies Vol:75 at 12 (accessed Dec 6,2017) http://www.mpifg.de/pu/mpifg_book/mpifg_bd_75.pdf.

products of the new model of lending. This model, which can be described as securitisation, indicates the changing nature of bank lending from the traditional 'originate to hold' model to 'originate to distribute'.

The change in business model led banks to aggressively issue loans and sell them in the secondary loan market, which ultimately turned their main business of accepting deposits and issuing loans into issuing loans to access funds without waiting for the maturity date for the loan and transferring the risk to the ultimate investors.[169] The new model, which allowed banks to trade their securitized assets via off balance sheet investment vehicles (known as special purpose vehicles), could not produce the anticipated positive outcomes in the financial system of dispersing the credit risk across different asset classes, regions and industries, thus increasing the resilience, efficiency and stability of the financial system.[170] In fact, it has been associated with opacity since it was very difficult to determine where the credit risk related to likely-to-default subprime mortgages or other low quality assets resided. The expected result from securitisation of transferring risks to those investors who were willing to take it or who could bear it was actually not possible as banks were traders themselves and they were holding securitized assets and derivatives. This meant that that the risk never left the banking system as was imagined.[171] The growth of FIs and the rise of their overall riskiness are seen to be closely related to each other and during the GFC banks' funding structure that is in compliance with the pertinent

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[169] Variety of asset classes could be packaged via securitisation such as residential or commercial mortgages, auto loans, corporate loans, credit card debts and trade receivables. Kevin Ingram,'If Securitization is Dead, Why Do So Many Government Schemes Use It?' (2009) 4(4) Capital Markets Law Journal 462, 463.

[170] Hyun Song Shin,'Securitization and Financial Stability' [2009] 119 The Economic Journal 309.

[171] J. Goddard, P. Molyneux and J.O.S. Wilson,'The Crisis in UK Banking' (2009) 29(5) Public Money & Management 277,278.

capital adequacy rules has allowed banks to grow soundly without disturbing depositors.[172]

Given this framework, banks have applied low due diligence standards to issue loans and cut down their monitoring efforts before and during the loan agreement with the borrower. This situation exemplifies the problem of moral hazard and adverse selection in banking where banks relied on the idea that they were transferring the risks to ultimate investors in the securitisation chain. As Gabilondo puts it, 'a value chain had emerged that connected the bank's internal liquidity with trading conditions in secondary markets for securitized credit'.[173] As such, the chain producing value in a systematic way through upstream suppliers to downstream clients linked those participants in several contracts and when the crisis manifested itself, governments had to face it with their outdated credit markets approach.

There has been consensus on the significant role of the shadow banking system in the subprime crisis. Extension of credit to the global financial markets via uncontrolled channels by regulated institutions or from outside the regulated banking sector was the starting point for interbank liquidity seizure which turned into a global credit crunch. The ultimate implication for banks is that banks' production of tradable loans led them to aggressively issue loans to those likely to default. Further, there was another argument

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[172] Simon Sinclair and Michele Crisostomo, 'Tier one Hybrids for Credit Institutions-Is Convergence in Regulation Possible?'(2008) 3(4) Capital Markets Law Journal 458,459. Basel minimum capital rules could not respond to banks' securitisation activities within its capital requirements rules and bank balance sheets expanded greatly while they were allowed to operate with little capital. Frank J. Fabozzi,Henry A. Davis and Moorad Choudhry, *Introduction to Structured Finance* (John Wiley&Sons 2006) 287-90.

[173] Jose Gabilondo, *Bank Funding, Liquidity and Capital Adequacy* (Edward Elgar 2016) 16.

about bank balance sheets; banks sold the good quality loans to SPVs and kept low quality loans on their balance sheets or vice versa. Also, the transfer of risks from banks to ultimate security holders has undermined the banks' incentives to monitor borrowers and caused moral hazard on the part of banks. Banks' dependence on securitisation for raising funds, which was described as 'liquidity through marketability'[174] by Turner, has caused distortions in their main business by leading them to concentrate on specific loans to securitize and transfer the risk to the ultimate ABS purchaser. The shift in traditional bank behaviour from loan and service providers to underlying originators of those securities undergirded greedy and opportunistic behaviours of bankers to lower the standards for the loans and the use of securitisation as one of the main funding sources of the bank. When lack of attention and of allocation of responsibility to non-monetary issues such as systemic risk, contagion, connectedness and public confidence blend in with such a banking environment, changes in prudential and conduct of business regulation and institutional structures were inevitable.

Not all banks became heavily involved in securitisation or invested their sources in derivatives. However, the banking system is closely inter-linked so when a part of it suffers, the whole of it cannot be healthy and the healthy parts are under the threat of infection in different forms. This can be translated to the banking system in the way that transmission of problems is possible via spillover, contagion or collective creditor response to the banks. The link between banks is important for systemic risk in the financial system. This link is not solely limited to the domestic financial system but the connection between banks is related to increasingly global, volatile and integrated

[174] Adair Turner's speech at the Economist's Inaugural City Lecture on Jan 21,2009 (accessed May 11,2017)
http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0121_at.shtml.

financial markets.[175] As will be discussed later in this chapter, macroprudential regulation has been the rising concept in the post-GFC world as a means to oversee the whole system and detect and react to problems in specific parts of the whole before they begin to affect the other parts.

Bank prudential and stability regulators were also the ones to blame for not being able to fully understand, foresee or respond in a timely manner to the risks inherent in the financial system. In a similar way, neither were bankers well-informed about the securitisation and the transfer of risks.[176] The new model left most of the risk somewhere on the balance sheets of banks and bank-like institutions but in a much more complex and less transparent fashion.[177] Opportunistic behaviour was the driving-force as long as continuing liquidity was ensured. CRAs and other securities analysts were also blamed for being part of this illusory confidence production.[178]

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[175] Douglas W. Arner, *Financial Stability, Economic Growth, and the Role of Law* (CUP 2007) 63.

[176] 'After Lehman's collapse, no one could understand any particular bank's risks from derivative trading and so no bank wanted to lend to or trade with any other bank…[N]o one could tell whether any particular financial institution might suddenly implode.'Steve Denning, 'Big Banks and Derivatives:Why Another Financial Crisis is Inevitable', Forbes, (Jan 8,2013) (accessed on May 13,2017) https://www.forbes.com/sites/stevedenning/2013/01/08/five-years-after-the-financial-meltdown-the-water-is-still-full-of-big-sharks/#65935dd13a41.

[177] FSA,'The Turner Review:A Regulatory Response to the Global Financial Crisis'(March 2009) at 16 (accessed Oct 21, 2015)http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

[178] Harry McVea,'Credit Rating Agencies, The Subprime Mortgage Debacle and Global Governance: The EU Strikes Back' (2010) 59(3) The International and Comparative Law Quarterly 701.

The confidence created was not just related to the investment-grade, money safe ratings given by the big three CRAs[179] but also to the size and interconnectedness of the banks. This also means that both the public and the banks believe that the state will prop up individual banks and also the system if something goes wrong. They were right in their belief to some extent because beginning from 2008, governments hurriedly started to announce the measures established to ensure financial stability. This included recapitalization of banks via governmental equity injections, nationalization, heightened deposit insurance schemes, guarantee systems for debt instruments and the extension of CB credit facilities.[180]

The use of new LoLR facilities from CBs (particularly in the US and the UK) proved that significant extension of CB powers in providing liquidity was necessary to deal with the crisis.[181] Liquidity and insolvency of banks, therefore, were crucial elements for the states to decide on whether to follow private, liquidity or capital solutions for those banks. Banks commonly rely on liquidity coming from interbank lending, collateralized by a claim on their financial assets. This means that in case of a liquidity-related problem in the inter-bank markets, valuable assets of banks help to weather the storm. Yet, once the lack of confidence and concomitant general panic materializes, the value of those assets responds to the new panic environment and fire sales are observed. The difficulty of accurate assessment of the real value of toxic assets (such as CDOs or ABSs) created uncertainty in the market to the extent that investors could not distinguish different classes

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[179] Conflict of interest problem that CRAs had by receiving agency fees from issuers to rate for their securities was seen as one of the reasons of those overvalued ratings given to structured products. These ratings created overconfidence in the market.

[180] Boyan Wells and Theo Trayhurn,'The Credit Crisis: How Government Sought to Reopen the Wholesale Markets to Financial Institutions' (2009) 5(1) Capital Markets Law Journal 43,44.

[181] J. Armour and others, *Principles of Financial Regulation* (OUP 2016) 326.

of assets and the likelihood of defaults and recoveries. Ratings provided by CRAs became dubious statements in the eyes of the market.[182] Such an uncertain financial environment has made the distinction between illiquidity and insolvency more vague.[183] So, banks experiencing dramatic decreases in the value of their collateral assets (asset portfolios in general) were on the edge of illiquidity which could turn into insolvency later on. The result was that many banks were either nationalized, rescued, bailed out or at least enjoyed liquidity support from the state.[184]

Overall, the real economy was severely affected starting with the increasing uncertainty of the valuation of structured products and then the sequence of developments filtered into a systemic crisis. Beginning from the birthplace of securitisation, the US financial markets, to the other developed markets involved in the process and policies of governments in interfering in markets, these proved that insulation of SIFIs from the destructive effects of the crisis was necessary.

Pre-crisis political, economic and regulatory ideology did not support the assertion of state powers over financial markets, firms, actors and investors.[185] Yet, neither was the post-crisis approach based on the complete rejection of market forces. Instead, it was

[182] Carlo Gola and Alessandro Roselli,*The UK Banking System and Its Regulatory and Supervisory Framework* (Palgrave Macmillan 2009) 122.

[183] Christopher Mitchell, *Saving the Market from Itself: The Politics of Financial Intervention* (CUP 2016) 4.

[184] Howard Davies, *The Financial Crisis: Who is to Blame?* (Polity 2010) 84.

[185] As mainly influenced by Hayek, the UK and US pursued market freedom and limitation of the authority of the state in the management of the economy in the form of privatization in the UK and deregulation in the US starting in the 1980s. The state's role has been seen to regulate economic activity, not interfere with it as an economic actor itself. Sue Konzelmann and Marc Fovargue-Davies,'Varieties of Liberalism: Anglo-Saxon Capitalism in Crisis?'(2010) University of Cambridge Centre for Business Research Working Paper No: 403 at 11-12.

based on the identification of the dangerous elements that underpinned the GFC.[186] In this respect, private solutions residing in market forces were not possible. Instead, regulatory favouritism,[187] private rescue arrangements by the state and the use of public money in the form of liquidity and solvency support were considered the way to protect the financial stability.

While the crisis is largely considered to have been centred around US bank failures, the UK also had a number of banks fail and the factors leading to these bank failures were not exactly the same as in the US. When delinquencies in the sub-prime market started, the cross-border dimension of poorly structured instruments appeared, and both the FSA and the BoE had flagged fragility problems and potential risks. However, they were late in doing so.[188]

In conclusion, the external contours of the crisis, though the causes still remain contested and so unclear, have been well-examined. Recent years have witnessed the rise of financial stability as a global goal and the dangers of a systemic crisis expedited by lack of confidence and lack of liquidity have been well understood. What these experiences mean for banks and their relevance to information disclosure will be explored in the next section.

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[186] It means state should engage in the markets more to protect the market. Mackintosh (n 167) 408.

[187] For example, in the US, legal status of investment banks could change to BHCs (as Morgan Stanley and Goldman Sachs did). This means that they could reach the Federal Reserve assistance.

[188] Gola and Roselli (n 182) 121.

3. Relevance of Information to the Stability of the Financial System: Production and Protection of Public Confidence

3.1. Financial Stability and Banks as One Generic Source of Instability

The stability of the financial system is a common global goal, especially after the GFC, in order to diminish and prevent the adverse consequences and negative externalities arising from the failures of institutions or markets.[189] Even though the term is used frequently, there is no definite description of it.[190] However, its opposite, instability, provides a general framework for what stability means. Financial instability might be linked with (i) bank failures (or the monetarist approach);[191] (ii) inherent fragility of the

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[189] Chris Brummer,'How International Financial Law Works?' (2011) 99 Georgetown Law Journal 257, 265-68.

[190] Multidimensional characteristics of financial stability entail diversified standpoints such as for some it might be a concern of developed countries whereas others might take it as a universal problem due to spillover risks; or one might see the notion of financial stability as something that should be discussed with TBTF banks and systemic risk; or individual states might assign different meanings to financial stability simply based on cultural variations or different national interests. For example, while the European understanding of financial instability can be explained with a single failure of a FI, the US understanding of financial stability accommodates a more tolerant approach to such failures. Hillary J. Allen,'What is "Financial Stability"?The Need for Some Common Language in International Financial Regulation' (2014) 45 Georgetown Journal of International Law 929,930-31.

[191] One school economic thought, called monetarism is mainly associated with Cagan, Friedman and Schwartz who characterize instability with banking panics that cause or worsen monetary contraction in the end. They characterize banking panics with the loss of public confidence in banks' ability to convert deposits into currency that any collective behaviour towards converting deposits into currency requires, due to fractional reserve banking, which might reduce the stock of money available and cause failures of sound banks.Michael D. Bordo and David C. Wheelock,'Price Stability and Financial Stability: The Historical Record' (1998) 80(5) Federal Reserve Bank of St Louis Review 41,44.

financial system that is affected by any exogenous factors;[192] (iii) asymmetric information and agency costs;[193] (iv) uncertainty; (v) inadequacies in the regulation (such as safety nets that create moral hazard, incentives given to bankers, lack of monitoring of FIs, lack of regulation of CRAs, over-reliance on self-regulation and so on); and (vi) general short-sightedness for the crisis (which means too much confidence or lack of knowledge leads FIs and regulators to underestimate the risks).[194]

Therefore, instability can find its roots in monetary or non-monetary causes, and it might be a purely domestic phenomenon or be spread across states. Some academics such as Mishkin describe financial stability with its opposite: 'Financial instability occurs when the shocks of the financial system interfere with the flow of information, so that the financial system can no longer fulfil its duties to channel the funds to opportunities of productive investments.' [195] This approach to instability is related to information asymmetry and its concomitant outcomes on the intermediation role of the financial system where providing credits to the real economy is severely damaged. As Chapter 1

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[192] The hypothesis of financial instability (known as the Minksy Moment) is expounded by Hyman Minsky where over-indebtedness of borrowers causes them to sell their assets in order to fulfil their other repayment demands. In return, a fall in asset prices and loss of confidence in the financial system occurs and FIs, such as banks, go illiquid due to bank runs. So, the Minsky moment depicts the time when debt levels and lending become unsustainable and after this moment government intervention is required to stabilise it. Overall, it is a theory of the effects of debts on system behaviour and it takes banks as active financial intermediaries bridging surplus funds with deficit agents and they underpin the economy by making loans. Therefore, government interference is needed when necessary. Kim De Glossop,'The Inherent Instability of the Financial System' (2011) 4 J. Bus. Entrepreneurship &L.483,488-92.

[193] Allen and Gale, *Comparing Financial Systems* (n 129) ch 4.

[194] E. Philip Davis,'Towards a Typology for Systemic Financial Instability' (2003) Brunel University and NIESR at 3-4 (accessed Sep 6, 2016)http://bura.brunel.ac.uk/handle/2438/916.

[195] Frederic S. Mishkin,'Global Financial Instability: Framework, Events, Issues' (1999) 13(4) Journal of Economic Perspectives 3,6.

revealed, information is valuable in terms of avoiding adverse selection, information asymmetry and moral hazard but instability is not solely the result of information deficiencies and the harm this does to total economic activity.

A sharp rise in the number of defaults and bank failures can be given as explanation for a systemic banking crisis. It generally starts with an initial failure that sets off subsequent reactions in the banking system through negative externalities and spillover impacts. It is not restricted to geographic borders as the bank contagion can be a global phenomenon.

As such, by placing banks at the heart of the intermediated financial system, Mishkin's definition provides several aspects of banks' role in information-driven markets and their relevance to financial stability:

(i) If banks experience a sudden deterioration in their balance sheets, they need to choose between raising new capital and reducing their lending activity. Raising new capital is costly and especially under stressed economic environment or tightened liquidity conditions of the markets, the expected funds to recover the balance sheets might not always be available. The straightforward choice for a bank is, therefore, to decrease its lending activity which in turn can damage real economic activity. The magnitude of bank balance sheet deterioration has direct links to contagion, systemic risk and panic situations, which explains sudden downturns in bank balance sheets. Its disclosure should therefore be handled with care by the regulators.

(ii) Increase in interest rates might cause adverse selection as the borrowers with the highest default risks will be willing to apply for the credit rather than the prudent borrowers. Bank lending activity will therefore service the riskiest investment projects. Additionally, a rise in interest rates means that the asset-liability ratio of banks will be affected because it decreases the value of bank assets with their longer duration and increases the value of liability with their shorter duration.

(iii) Uncertainty in the political and economic environment can lead to instability. This is directly linked to the term ‘confidence’. Uncertainty stands as a psychological, economic and political element and leads to the authorities responsible for the financial stability of the state and large-sized or small-sized creditors to behave in opposing ways. While the public policy goal of financial stability means that the authorities try to ensure that contractual obligations will be met without disruption, creditors will pursue their interests in saving their funds from a potentially unsound bank. These represent the regulator and consumer approaches. Banks, as lenders to the real economy, are also affected by the uncertainty surrounding the markets. They will be less willing to lend to their peers and borrowers due to an inability to distinguish between good and bad credit risks. Information asymmetry occurring through uncertainty therefore leads to financial instability. Bankruptcies, stock exchange crashes and political instability are causes and effects on each other in the great scheme of uncertainty that causes financial instability. Uncertainty also affects financial innovation where the results of new transactions or behaviours are not seen yet. Hence, uncertainty is closely related to confidence and maintenance of confidence serves the public interest. [196]

[196] Ibid 6-10.

Such an economic approach to financial stability addresses the relationship between financial stability and banks from an information-centric point of view. Having said that, there are other factors used in defining financial stability: monetary or macroeconomic stability;[197] no sudden and fallacious movements in prices of real and financial assets; a high degree of confidence in the financial and political system so that economic actors can fulfil their contractual obligations without outside interference;[198] the state's and FI's ability to absorb or resist shocks, stress situations or periods of important structural changes;[199] stability of the key FIs and key markets;[200] and obviation of systemic risk in the financial system[201]. This indicates that there are many elements that form the causes and effects of financial instability. Financial stability is therefore a dynamic phenomenon.

Financial stability is a public good whose use by consumers does not prevent others benefiting from it and it is in the interests of the state authorities to ensure that an adequate quantity of stability is supplied.[202] Bank instability, within this context, raises public policy concerns as they are either sources or facilitators of financial instability. They can be sources of instability because they deal with the two-sided problem of information

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197 Claudio Borio,'Monetary and Financial Stability: Here to Stay?' (2006) 30(12) Journal of Banking & Finance 3407.

198 Aerdt Houben, Jan Kakesn and Garry Schinasi,'Toward a Framework for Safeguarding Financial Stability' (2004) IMF Working Paper 04/101 (accessed Sep 5,2016)http://www.imf.org/en/Publications/WP/Issues/2016/12/30/Toward-a-Framework-for-Safeguarding-Financial-Stability-17446.

199 Deutsche Bundesbank's Monthly Report (Dec 2003)(accessed Sep 4,2016)https://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Financial_Stability_Review/2003_financial_stability_review.pdf?__blob=publicationFile.

200 Andrew Crockett,'Why Financial Stability a Goal of Public Policy?'(1997) 82(4) Economic Review of Federal Reserve Bank of Kansas City 4th Quarter 5,6-9.

201 Davis (n 194).

202 Crockett (n 200) 14.

inefficiency: banks face difficulties in assessing the default risks of their borrowers (which causes adverse selection) and depositors find it difficult to assess the financial condition of their bank. Information asymmetry transforms into financial instability in the form of bank panics or runs. Therefore, temporal mismatch between loans and deposits can create the grounds for illiquidity problems which is a key component of the first step of a systemic crisis.

In normal conditions, liabilities redeemable on demand at par are not a problem for a bank as it is not usual or expected that all creditors will attempt to withdraw their funds at once. Such *en masse* withdrawals in a short space of time force banks to liquidate their long-term investments at a loss and ultimately leads to a failure. Bank capital, in this respect, serves as a cushion to maintain confidence in the bank by providing liquidity to the bank to cover the risk of loan defaults and to meet withdrawals. Yet, a fractional reserve system does not help when an exceptional situation that disturbs the confidence occurs. Creditors' behaviours can be best explained by the 'first come, first served' logic which puts banks in a more difficult situation than a forced liquidation because fire sales initiated or expedited by creditor behaviour lead to the rapid deterioration of bank assets.

Information asymmetry in such situations means that depositors cannot evaluate the real value of individual bank assets at no cost to themselves and are unable to monitor the performance of banks.[203] Any new information that surfaces, regardless of whether it is incomplete or negative information, inhibits depositors from differentiating healthy banks

[203] Chapter 3,Section 4.

from potentially insolvent ones.[204] The source of new information is not necessarily the bank. It can stem from disinflation, political movements within the state, sudden declines in asset values in another market or some other triggering element that interferes with the behavioural settings of depositors. Overall, irrational and herd behaviour of creditors poses a great danger to the financial system as it encourages a systemic crisis via contagion. This is still related to the maturity transformation function of banks. In addition to the liquidity-confidence link perpetuated through the bank's maturity transformation function, there is a solvency dimension that provides implications for financial stability. Banks can also incur losses through their loans, not just because of liquidity-specific troubles. There is a positive correlation between the lending and vulnerability of a bank because losses must be offset against bank capital. If the default rates of bank borrowers increase, bank losses in turn seriously raise the bank leverage ratio.[205]

Confidence therefore stands as a main theme that affects liquidity and solvency of a bank in different ways. As Bagehot puts it:

> The peculiar essence of our banking system is an unprecedented trust between man and man; and when that trust is much weakened by hidden causes, a small accident may

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[204] Charles W. Calomiris and Gary Gorton,'The Origins of Banking Panics:Models, Facts and Bank Regulation' in R. Glenn Hubbard(ed), *Financial Markets and Financial Crises* (University of Chicago Press 1991) 109-70.

[205] However, there are opposing views supporting high leverage levels of banks based on fostering banks' liquidity provision to markets and allowing them to compete with unregulated shadow banks. Harry DeAngelo and Rene M. Stulz,'Liquid-Claim Production, Risk Management, and Bank Capital Structure: Why High Leverage is Optimal for Banks' (2014) Dice Center WP:2013-8 (accessed Oct 14,2017)https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2254998.

greatly hurt it, and a great accident for a moment may almost destroy it.[206]

So, anything that suddenly reveals the real financial condition of a bank can contaminate the whole banking system. However, apart from the issue of addressing how a solvent bank turns into an insolvent one due to rumours and accompanying loss of confidence, there is another problem when some banks are insolvent, but this fact is not known due to the general economic deterioration. This is the case when there is lack of trust in the interbank market, which was experienced in the form of a credit freeze during the GFC. Yet, a self-fulfilling prophecy, which is one of the sources of a bank run, translates a false conception into a new behaviour. It means that, even if all banks in the system are solvent, once the insolvency of a bank is questioned by a considerable number of persons, then regardless of the objective situation, the subjective meaning attributed to the bank's financial standing has the potential to create a collective damaging outcome for the banking system.[207]

Although the transparency-stability view today dominates the transparency-fragility view, there is still room for a discussion about how financial panics, as products of loss of confidence, develop out of information disclosure.

3.1.1. Understanding the Role of Confidence and Trust in the Banking Industry

'Trust and confidence' stand as common social norms that link social arrangements with economic outcomes. Their ends are not limited to particular exchanges, entities or persons

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[206] Walter Bagehot, *Lombard Street: A Description of the Money Market* (RD Irwin reprinted 1962) 78.

[207] Robert Merton,'The Self-Fulfilling Prophecy' (1948) 8(2) Antioch Review 193,194-95.

and it is a general encompassing element of social organisation of economic life where shared expectations about the economic conduct affect the aggregate behaviour of the public.[208] Financial markets reflect this element in a way that particular exchanges create externalities for the whole economic system, ie financial instability or financial crisis.

Trust and confidence are generally used as synonyms, or they at least share common elements yet from an analytical perspective they tend to represent different sides.[209] Confidence operates based on objective and reliable information, external and independent rules over the conduct and contractual agreements and, therefore, the supply of information and necessary regulations that underpin the provision of information lead to rational and informed decisions. As such, confidence here can be seen as a property fortified or protected by external sources like public or private agents of market governance and is instrumental and calculative. It is the belief founded on experience or evidence (ie information) that particular events will take place as expected. Information and regulatory and supervisory institutions or mechanisms established *ex ante* serve to instil this confidence.[210]

Trust, on the other hand, stands as a subjective concept that is associated with the perception of a person or a collective unit (for example, bank depositors) about the potential risks and doubts and is associated with irrational decisions.[211] Therefore, trust

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[208] Fran Tonkiss,'Trust, Confidence and Economic Crisis' (2009) 44(4) Intereconomics 196.
[209] For more explanation see Richard Swedberg,'The Role of Confidence in Finance' in Karin Knorr Cetina and Alex Preda(eds), *The Oxford Handbook of the Sociology of Finance* (OUP 2012) 529-46.
[210] Timothy C. Earle,'Trust, Confidence and the Global Financial Crisis' (2009) 29(6) Risk Analysis 785,786.
[211] J. David Lewis and Andrew Weigert,'Trust as a Social Reality' (1985) 63(4) Social Forces 967, 968-72.

is associated with endogenous and behavioural content. Lack of information, absence of contractual mechanisms and regulatory sanctions are important sources of lack of trust. However, as trust is a subjective and maybe an animal-spirit driven concept, it might bridge independent behavioural choices with fears on a systemic level. This means that even if there is no lack of information or no regulatory gap in the protection of transactions, contractual obligations etc – namely even if there are external powers to supply and promote confidence – lack of trust on the individual level can affect collective trust. This dimension of trust is a behavioural interpretation of the concept where cooperation and competition between the persons might drive them to behave irrationally. It means that trust is social and relational and is based on shared expectations and knowledge.[212]

How does this differentiation apply to banks? This question addresses banks' specialness and contagion links that banks produce. As such, the answer is related to the importance of trust in the financial services sector in general. Promises or products are generally intangible and therefore evaluation of financial services is difficult before purchase or consumption. As Stiglitz states 'financial markets hinge on trust'[213] and participants allow transactions to take place depending on their perception about actualisation of commitments or promised transactions given by the service provider. In the context of banking, trust stands as a positive feeling that the bank will keep its promises or act accordingly to protect the interests of those that get a service from the bank. So, from this point of view, trust is attributable to consumers and it is not something that banks can

[212] Ann-Marie Nienaber, Marcel Hofeditz, Rosalind H. Searle,'Do We Bank on Regulation or Reputation?'(2014) 32(5) The International Journal of Bank Marketing 407.

[213] He uses the term similar to confidence. Joseph Stiglitz,'The Fruit of Hypocrisy' Guardian (16 Sep 2008)(accessed Oct 26, 2016) https://www.theguardian.com/commentisfree/2008/sep/16/economics.wallstreet.

directly control and manage.[214] In this setting, confidence also includes the institutions, markets or regulatory and supervisory agencies themselves where they can affect the level of public trust. Trust is, therefore, part of confidence and confidence represents the larger framework. Confidence is a precondition of functioning markets and bank stability is linked to market confidence. As such, a socially efficient level of confidence is one that protects the market in general. Prudential regulation and supervision, CB back-up and insurance protection schemes are confidence production measures to preserve public trust in banks and overall confidence within the financial system. It should be noted that not all the trust and confidence come from disclosed information or regulations, policies, supervisory and measures adopted by the state. It can also be based on positive assumptions about the future events. One can describe it as 'ignorance in the market might also mean trust in a way.'

Banks bridge the trust gap between lenders and borrowers by producing an illusion about its liquidity provision and maturity transformation role and therefore provide public confidence. As mentioned in the previous section, financial systems are inherently unstable, and the equilibrium in financial markets is a product of collective trust (public confidence) to the system and its constituencies. This inherent instability means that regulation should support maintenance of confidence.

Disclosure rules on banks, in this respect, fulfil an important role in correcting asymmetrical information flows. Yet, as it will be discussed in the market discipline part, the effect of disclosures is limited to information-receivers' capacity and their exposure

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[214] C. Annew and H. Sekhon,'Measuring Trust in Financial Services:The Trust Index' (2007) 17(2) Consumer Policy Review 62.

to losses emanating from the bank's failure.[215] Large depositors and small depositors have different incentives in their own cost-efficient decisions. Large depositors, those with some part of their funds not protected by deposit insurance, are likely to follow a monitoring strategy than small depositors who enjoy insurance protection. Yet, the result of their response to a downturn in confidence in the bank will be the same. Small depositors' strategy is to withdraw funds immediately when rumours spread about the bank's financial standing, thus actualising what the literature calls a self-fulfilling prophecy. This can also be explained by the concept of the prisoner's dilemma: 'Depositors will be better off individually if they could beat their fellow depositors to the bank and reclaim their deposits whenever there is the slightest uncertainty about the value of a bank's assets.'[216] Large depositors, even if they monitor bank information and know that rumours do not signal a probable downturn in the bank, will also join such a withdrawal move due to a combination of negative information with lack of grounds and general loss of confidence. Therefore, market discipline exerted by large depositors does not help to prevent a depositor-based bank run. In a sequence, security holders and other FIs holding assets in each others' accounts join the movement and help the liquidity crisis.

Confidence is therefore an intangible good that bank stakeholders need; and banks, banking and financial system, markets and the government supply. The type of confidence supplied by an individual bank is intrinsic confidence and the one except individual banks produces is extrinsic. While intrinsic confidence is about capital and liquidity reserves and bank information, extrinsic confidence is *de jure* and *de facto*

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[215] Chapter 3,Section 4.

[216] Jonathan R. Macey,'The Business of Banking: Before and After Gramm-Leach-Bliley' (2000) 25 J. Corp. L. 691,696-97. For the opposite view see Richard H. McAdams,'Beyond the Prisoner's Dilemma' (2008) 82 Southern California Law Review 209,216-17.

deposit insurance system, LoLR and other government support provisions, prudential regulation and supervision of banks.[217] Unless all of the depositors adopt the monitoring approach instead of withdrawal strategy at the first sign of bank difficulty, intrinsic confidence alone does not prevent a bank run and the promotion of intrinsic and extrinsic confidence should be supported by regulation. Collective intrinsic confidence produced by banks completes extrinsic confidence as long as individual banks do not undersupply confidence based on positive externalities emanating from peer banks or based on the classic moral hazard rationale where banks rely on the belief that the government will not let them fail so that they can be risk averse and produce less intrinsic confidence depending on extrinsic confidence. This is one of the arguments used against voluntary disclosure by banks as banks are not willing to disclose information unless they have good news to share.

The MD system, on the other hand, is provided as a remedy for the market's inability to produce adequate levels of confidence on the aggregate. Economic agents should not necessarily fully trust the extrinsic confidence and they need reliable and constant information flow from banks even if they do not absorb and digest the information disclosed. In this sense, the MD system means that agents trust in markets rather than state or state-centric organizations to examine and supervise banks. This suggests that measures that shape the extrinsic confidence are effective as long as there is public trust in regulators and regulations enforced by them and the private law contracting arrangements that ensures adequate stability and certainty in financial transactions during financial turbulence. Another dimension of extrinsic confidence provided by the state is the paradox of the use of those confidence-supporting measures to bolster confidence.

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[217] Albert J. Boro,'Banking Disclosure Regimes for Regulating Speculative Behaviour'(1986) 74(2) Cal. L. Rev. 431,452-53.

Government intervention in banks, for example, through capital injections, the use of LoLR facility or discount windows, decrease public confidence in making new financial commitments or investments, or the readiness of the public to spend in general because it is taken as a signal of the seriousness of the liquidity problem rather than restoring confidence.[218]

As such, the public needs information to trust yet the provision of information and thus the provided intrinsic confidence do not necessarily change their response to a potential downturn in the bank, which is withdrawal. This approach also has implications for state accountability, which means bank regulation and supervision, or state back-up provisions are not enough to give confidence to the public as the public wants to know that the information is already in the public domain.

It is part of the informed citizenry ideal that the new transparency and accountability focused approach is said to represent values of democratic societies.[219] Such a heavy attribution to bank transparency as a precondition or a significant part of democratic values does not provide space and toleration for an opposite view. It is clear that transparency has merits, especially in terms of confidence production. However, information disclosure as a way to ensure intrinsic confidence does not completely refute

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[218] It might also give the impression that the state has been captured by banks themselves.

[219] 'Accountability broadly denotes to the duty of an individual and or organisation to answer in some way about how they have conducted their affairs. Transparency broadly means the conduct of business in a fashion that makes decisions, rules and other information visible from outside.' … 'The word transparency started to become a central doctrine of good governance for both firms and states from the 1990s, and indeed seemed to be reaching saturation coverage by the 2000s.' Christopher Hood,'Accountability and Transparency:Siamese Twins, Matching Parts or Awkward Couple?' (2010) 33(5) W. Eur. Pol. 989, 989-90. See Dennis Thompson, *Restoring Responsibility* (CUP 2004) ch 6.

arguments about the relationship between adverse information disclosure during the time of financial turbulence and the safety and soundness of banks and their privacy expectations vis-à-vis the state's treatment of banks as a quasi-state agency in terms of expecting share of information for its pursuance of wrongdoings or crimes.[220]

Therefore, MD as a tool to exert market discipline on banks is the rising dominant concept supported by global standard-setters such as Basel Committee on Banking Supervision (BCBS), Organisation for Economic Co-operation and Development (OECD) and Financial Stability Board (FSB) as it ensures that the market will eliminate unsound and ill-managed banks and disturbance created by banks will be alleviated by resolution regimes. Again, regulation about the orderly dissolution of banks is part of extrinsic confidence.

As also mentioned in Chapter 1, the relation between banking panics, runs and bank information disclosure is addressed with the notion of trust and confidence. Theories of banking crises provide several models that have implications for bank information disclosure and its inherent links with trust and confidence. In this respect, Breuer addresses four generation of models for banking crises:[221] Banking crises can be related to poor macroeconomic conditions regardless of banks' weak performance, management or risk-taking and this reflects itself consumer defaults and business breakdowns. Such a situation leads to a speculative attack on bank deposits and potentially heralds a system-wide move due to lack of confidence. Another model of the banking crisis is built on the

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[220] There are also other views about the drawbacks of bank disclosures including the traditional discussion about losing the competitive advantages or taking public disclosure as an impediment to effective bank regulation. Boro (n 217) 482.

[221] Janice Boucher Breuer,'An Exegesis on Currency and Banking Crisis' (2004) 18(3) Journal of Economic Surveys 293, 299-305.

self-fulfilling expectations of bank stakeholders. It means that in addition to macroeconomic fundamentals, cognitive, behavioural and relational aspects of trust play a role in escalating a potential downturn. This model puts emphasis on contagion risk and systemic trust in banks. So, a combination of exogenous factors paves the way for bank panics or runs and an endogenous process of trust disruption leads to banking crises.[222] The third model considers banking and currency crises as twins, as they develop simultaneously and hit the monetary and financial system. Finally, the fourth generation model, perhaps similar to Fukuyama's approach,[223] highlights institutional factors, such as private rights, politics, rule of law, enforcement, level of protection of creditors and shareholders and other variables, that might affect the functioning of the banking system and overall macroeconomic performance. This one is related to both extrinsic and intrinsic confidence.

So, the wider picture of banking crises establishes that there are many factors affecting the banking and financial system, with stability implications and confidence always playing a part in it, as either trigger or facilitator. It captures the link between banks and the larger economic system. The dissemination of several kinds of information during financial turbulence, as the asymmetric information theory of bank runs asserts, activates possibilities in the interpretation given to existing information and links individual choices with collective behaviours. Again, it means that depositor confidence is fragile when the reputation of a bank is damaged or when there is so much uncertainty in the

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[222] Such as Washington Mutual and Wachovia in the US. They experienced heavy deposit outflows during the GFC despite the presence of deposit insurance schemes and it was because of deteriorated market conditions and loss of confidence. Jonathan D. Rose,'Old-Fashioned Deposit Runs' (2015) Finance and Economics Discussion Series 2015-111 (accessed May 26, 2017) https://www.federalreserve.gov/econresdata/feds/2015/files/2015111pap.pdf.

[223] Francis Fukuyama, *Trust* (Free Press Paperbacks 1996).

market that there are no indications of capital flight to better quality peer banks. So, extrinsic confidence production by the market and state becomes more important to fill this confidence gap.

There is a delicate balance in interpreting the information in relation to individual banks or the banking system. As mentioned in this section, lack of aggregate information can be translated as bad signals and, in that case, there is a transformation from available public information to individually generated perception-based private information from depositors. Once again, it is one of the main reasons for keeping the market informed. However, a lack of common information might also provide a sense of security to the public and other bank stakeholders because sometimes ignorance is bliss for the market, and this protects the public confidence in another way. Here, public confidence is protected through prevention of the transformation of individual choices into collective market behaviour. Yet again, it is a difficult task to manage.[224]

Collective action has a systemic dimension. It emphasizes a wider portrayal of connections between economic agents: Systemic trust applies to the entire banking system and sees confidence as a product of interwoven links between economic actors that trust each other in their transactions/ interactions. A change in shared expectations about the future, therefore, reflects itself on the systemic level and can be characterised as 'trusting trust'.[225] It connotes an interconnected network of relationships whereby economic agents trust one another's trust. So, the protection of overall confidence is very

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[224] Chapter 4,Section 3.

[225] Niklas Luhmann, *Trust and Power* (John Wiley 1979) 42-62.

important and systemic trust should be supported by an external anchor (extrinsic confidence).[226]

Multifaceted elements of trust and confidence, therefore, suggest that ignorance might be optimal in certain situations. It is reminiscent of Hirshleifer who submits that information disclosure destroys risk-sharing opportunities for weak banks.[227] Dang, Gorton and Holmstrom explain it thus: 'One form of symmetric information is symmetric ignorance.'[228] So, they assert that symmetric ignorance can help to protect liquidity in the markets, and in that sense, it is welfare enhancing.

The moot point for confidence production and maintenance is to strike a balance on bank regulation so that less intrinsic confidence in a bank does not initiate a systemic crisis via contagion or spillover channels and trigger irrational economic behaviour on the collective level. This brings the discussion to the interbank links and the risk of contagion in the financial system.

3.1.2. Contagion Links: One Source of Systemic Risk

Liquidity and insolvency risk of banks, as the two main risks triggered by lack of confidence, can be transmitted from one bank to another bank or FI and this is the basic definition of financial contagion. Financial contagion is a main source of systemic risk, which is the first step towards a financial crisis.

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[226] Butzbach (n 50) 20.See Section 3.1.3.1.

[227] Hirshleifer (n 14).

[228] Tri Vi Dang, Gary Gorton and Bengt Holmstrom,'Financial Crises and Optimality of Debt for Liquidity Provision' (2010) University of Chicago Working Paper at 2 (accessed May 16,2017) https://econresearch.uchicago.edu/sites/econresearch.uchicago.edu/files/ignorance-crisis-and-the-optimality-of-debt-for-liquidity-provision.pdf.

After the GFC, the rhetoric of systemic risk has been the most prevailing and frequent concept to interpret financial stability and also instability. The historical approach to systemic risk accepted that systemic risk was the paradigmatic source of the banking crisis, and the regulation of systemic risk, as part of microprudential thinking, was based on limiting the distress of, and preventing the failures of, individual banks, whereas the modern approach expects non-banks and the market itself to capture systemic risk. Its regulation is not solely based on establishing capital requirements so high in order to forestall the likelihood of bank failures, but instead systemic risk regulation today is about striking a balance between countervailing interests of the social cost of regulation and the prevention of bank failures.[229]

Although the term carries a lot of weight in post-GFC scholarship, systemic risk is not a term of art with a certain and universally accepted description. While one addresses it on the macro-level via exogenous shocks or events that affect most of or the whole economy or a system, and therefore macro-shock hits most or all individual units,[230] other approaches consider it on the micro-level in a way that a single bank is exposed to an initial shock and then the risk is transferred through the bank to another, thus initiating a chain reaction that causes broader financial difficulties.[231] Having said that, there are different viewpoints on this. For example, while it is possible to view the systemic risk as a result of the interconnectedness of claims, assets and liabilities of the banks,[232] it is

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[229] Assumption of non-financial firms do not engender systemic risk is no longer valid and the concept looks beyond FIs. Steven L. Schwarcz,'Systemic Risk' (2008) 97(113) The Georgetown Law Journal 193, 210.

[230] Franklin Allen and Douglas Gale,'Optimal Financial Crises' (1998) 53(4) Journal of Finance 1245.

[231] George G. Kaufman and Kenneth E. Scott,'What is Systemic Risk, and Do Bank Regulators Retard or Contribute to It?' (2003) VII (3) The Independent Review 371,372-73.

[232] It will be further detailed in this part.

also possible to view the interconnectedness from a capital markets perspective in a way that the price of bank stocks are accepted as relative indicators of a bank's real financial status and therefore it is believed that market prices of a bank show a bank's capital shortfall.[233] Perhaps an overarching and general description of systemic risk can be the one that Scott puts forward: 'It is the risk that a national, or the global, financial system will break down.'[234]

This short description does not deal with how systemic risk occurs, how it is spread through units or what level of breakdown connotes systemic risk. Instead, this definition is results-focused, stating that systemic risk is not geographically restrained and thus it addresses contagion links as a source of systemic risk in the interconnected financial environment. Application of this rationale to banking has already proved that banks are directly and indirectly connected with each other, other financial and non-financial firms and with the public as well.

Similar to the case of financial stability and systemic risk, there is also no generally agreed definition of financial contagion. In broad terms, contagion in banking can be defined as the risk that financial difficulties or idiosyncratic shocks at one or more banks spillover to a large number of other banks, FIs or the financial system as a whole.[235] Contagion is differentiated from common shocks that impact all banks simultaneously.

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[233] V. Acharya, L. Pedersen, T. Philippon and M. Richardson,'Measuring Systemic Risk' (2010) Federal Reserve Bank of Cleveland WP 10-02 (accessed Jan 4,2017) https://clevelandfed.org/en/newsroom-and-events/publications/working-papers/working-papers-archives/2010-working-papers/wp-1002-measuring-systemic-risk.aspx.

[234] Hal S. Scott,'Reducing Systemic Risk Through the Reform of Capital Regulation' (2010) 13(3) Journal of International Economic Law 763.

[235] Dirk Schoenmaker, *Contagion Risk in Banking* (LSE Financial Markets Group 1996) 88.

Dissemination of bank contagion occurs through information and credit channels in broad strokes. According to Lastra, at least four (perhaps overlapping) categories detail these channels: (i) inter-bank, inter-institution and inter-instrument channels; (ii) the payment system channel; (iii) information channel; and (iv) psychological channel.[236] The last one is complementary to the information channel.

The credit channel dimension of contagion infers the web of links between banks in the interbank funding market, payment system and OTC derivatives market. As such, this dimension actually represents the connectedness where FIs are directly overexposed to each other and cross-exposures allow the sound ones to become vulnerable to a chain of failures if one of them fails. Direct interconnection between banks occurs through bilateral transactions or relations between banks, with greater interconnection infers greater probability of risk of contagion emanating from a default by one bank.[237]

Credit exposure between banks is the most straightforward one. A bank which lends money to its peer has a direct exposure to that bank and the given amount is listed as an asset on the lender bank's balance sheet. A different scenario might be for the borrowing bank that relies on short-term funds or services provided by another bank in order to continue its daily operations. In case of failure of the lending bank, even if the creditworthiness of the borrowing bank remains unchanged, it will have to seek alternative sources of funding in interbank banking or reduce lending and sell its assets.[238]

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[236] Rosa Maria Lastra,'Systemic Risk, SIFIs and Financial Stability' (2011) 6(2) Capital Markets Law Journal 197,202.

[237] Zijun Liu, Stephanie Quiet and Benedict Roth,'Banking Sector Interconnectedness' [2015] Bank of England Quarterly Bulletin Q2 130.

[238] Stephen Valdez & Philip Molyneux, *An Introduction to Global Financial Markets* (8th edn, Palgrave 2016) 126.

Apart from interbank lending, credit exposures between banks can also be related to activities like securities financing transactions, derivatives or holdings of securities issued by peers whose defaults can have negative effects on the lender bank.[239] Interbank deposits and loans are common in daily operations, while involvement of banks in derivatives provide another systemic risk-related dimension, which was the case during the GFC. The amounts involved in the OTC markets are high and counterparty exposures centre on a few global firms, which makes the rest of the engaging banks fragile if the major counterparty defaults.[240] It is also known as the phenomenon 'too interlinked to fail'. As Chapter 4 shows, the case of AIG exemplifies this concern.[241]

The payment system channel, on the other hand, is more about the clearing and settlement system in which banks transfer funds. A disruption in these transactions is related to operational, legal or liquidity risks that can be transmitted through banks. As such, due to interbank linkages, there can be a domino effect that disseminates systemic risk throughout the banking system.

An indirect means of contagion generally occurs via an information channel. Contagion here is an indiscriminate run by short-term creditors of FIs. Fire sales by a troubled bank can bring about a reduction in asset prices and associated value losses on the balance sheets of other banks since the market will adapt itself to changes and reflect them.[242]

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[239] Sam Langfield, Zijun Liu and Tomohiro Ota,'Mapping the UK Interbank System' (2014) BoE Working Paper No.516 (accessed Dec 27, 2016) http://www.bankofengland.co.uk/research/Documents/workingpapers/2014/wp516.pdf.

[240] Lastra,'Systemic Risk, SIFIs and Financial Stability' (n 236) 202.

[241] Chapter 4,Section 2.2.1.

[242] Mark-to-market (fair value accounting (FVA)) system means that asset prices are changed regularly to reflect market prices. It is severely criticized as in adverse market conditions market prices are difficult to determine due to lack of confidence between FIs; and between FIs and

This pecuniary externality will be more obvious for banks that have similar asset holdings or common exposures to an asset class such as risky sovereign debt or mortgage-based securities[243] or it occurs because banks tend to give loans to similar industries like housing loans. This means that if an exogenous shock hits, for example, the housing market, in which banks are commonly involved in providing loans or it decreases the value of their assets, it is likely that all banks will suffer from losses and it will be a systemic event.[244]

Information spillover is more obvious when financial market investors interpret a problem in a bank as a negative signal about other banks and it provokes a loss of confidence in others. As such, an information channel includes psychological connotations in terms of affecting public perception and triggering panics, which is directly related to market confidence. In a similar way, liquidity hoarding is also a result of a lack of confidence in the system where a default by a bank warns other banks to protect their liquidity. This type of liquidity contagion arises when there is a common fear of liquidity squeeze. The role of disclosure here is a double-edged sword: if the market knows that a bank or some banks have liquidity problems, market participants (including peer banks) might change their behaviour in a self-protective way but not in a way that protects the system.[245] If the market does not know which banks have liquidity problems,

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other market players. Volatility concerns attached to FVA's crisis-neutral system in allowing full revelation of 'large fluctuations in investment values and irregular patterns of loan losses disproportionate to profits' is seen as a catalyzer of loss of public confidence in banks. Mark Billings, 'Financial Reporting, Banking and Financial Crisis:Past, Present and Future' in M. Hollow, F. Akinbami and R. Michie(eds), *Complexity and Crisis in the Financial System* (Edward Elgar 2016) 295.

[243] Inaki Aldasoro, Domenico Delli Gatti and Ester Faia,'Bank Networks: Contagion, Systemic Risk and Prudential Policy' (2017) 142 Journal of Economic Behaviour&Organisation 164,166.

[244] Andreas Krause,'Systemic Risk' in H. Kent Baker and Greg Filbeck (eds), *Investment Risk Management* (OUP 2015) 181.

[245] This behaviour might be individually rational, but not socially optimal.

then it will reflect a lack of confidence and uncertainty in the same way which is, once again, self-protective.[246] If the hoarding behaviour becomes a system-wide behaviour, a liquidity freeze occurs. Contagion therefore spreads through common self-protective behaviours of banks and in turn such collective activities initiate a systemic crisis. As such, contagion hits not just the banks with weaker financial standing but also those in *ex ante* healthy condition that are disturbed through the second-round domino effect and accompanying deteriorated market conditions emanating from banks' capacity to spread panic beyond the banking industry.

So, systemic risk can materialise via bilateral transactions,[247] information and information-related factors,[248] structural commonness,[249] the payment system and reliance on international markets[250]. [251] Therefore, contagion as a source of systemic risk has wider implications for the whole economy either starting from exogenous or endogenous causes. As such, considering how the banking system works, it is realistic to

[246] This behaviour might also be related to imperfect competition where banks purposely restrict liquidity to their peers in order to exploit their failure. V. Acharya, D. Gromb and T. Yorulmazer,'Imperfect Competition in the Interbank Market for Liquidity as a Rationale for Central Banking' (2012) 4(2) American Economic Journal 184.
[247] Such as interbank market transactions or derivative and securitisation-based relationships (off-balance sheet exposures).
[248] It encompasses confidence and behaviour-related factors where information is the key. Herding or irrational behaviour, moral hazard or asymmetric information can lead to fire sales, bank runs and collapse of the whole market.
[249] The situation where asset-liability and funding structure or risk management models of banks are similar to each other.
[250] It highlights the parent-subsidiary relationship or financing from a foreign market in transferring the risks. Financing from a foreign financial market might leave the subsidiary bank fragile when, for example, a crisis hits the market borrowed from.
[251] Pawel Smaga,'The Concept of Systemic Risk' (2014) SRC Special Paper No:5 at 14-15 (accessed May 17,2017) http://eprints.lse.ac.uk/61214/1/sp-5.pdf.

say that systemic risk is inherent in the banking system and this means spotting systemic risk *ex ante* is a difficult task. There have always been measures to control bank risks in addition to those *ex ante* pre-emptive measures (those that aim to contain systemic risk before it materialises as instability, ie such as capital and liquidity regulations and restrictions on short-term funding). Now, revised and augmented *ex ante* measures that are supported by *post hoc* reactive measures (those with the purpose to manage the crisis after the instability occurs, ie resolution policies), forward-looking or early-warning mechanisms such as sress tests in order to spot the level of systemic risk before it breaks out have come under the spotlight.[252] The result has been that overseeing the whole financial system and understanding the links between banks and other economic actors to protect financial stability has led to ample discussions about optimum regulatory and institutional structure to handle systemic risk. In consideration of the foregoing, a specific approach to regulation under which financial markets are regulated based on a higher regulatory objective (ie financial stability) is justified to the extent that it serves the long-term interests of others. In this respect, regulatory objectives of macroprudential and microprudential regulation and conduct of business regulation should be coordinative rather than sharply differentiating themselves based on their main objectives. Thus, it is important how institutional structure responds this need.

3.1.3. Institutional Structure Matters

It is argued that an efficient institutional architecture should establish a collaborative environment and ensure that major conflicts between bodies are resolved in an orderly

[252] Kathryn Judge,'Fragmentation Nodes' (2012) 64 Stanford Law Review 657,665.

and transparent manner.[253] However, distinct policies of bodies bring about inherent conflicts due to the cross-effects of their objectives. The first group is the monetary and macroprudential policies whose ultimate objective is a stable economic system. The second group is the microprudential and the conduct of business/investor protection policies whose concerns do not extend to the stability of the whole financial system. Their goals are distinctive yet microprudential regulation is complementary to macroprudential and policies seeking to establish transparent and competitive markets do not necessarily serve the microprudential and macroprudential policy goals. In this setting, how one manages the demarcation of objectives is a matter of culture, historical development of the financial system, the features of the economic system and the nature of the legal and governmental system.[254]

Much of the potential for managing systemic risk and protecting the stability of the whole system is based on the ability of bodies to cooperate. There have been different approaches to the institutional structure of financial regulation such as integrated, institutional, functional and objectives-based. They all have merits and drawbacks and their merits and demerits are part of an ongoing discussion. Structure matters because each regulatory body's own substantive policy decisions have implications for the banking sector. Whether there is a regulatory framework following the objectives of a

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[253] Dirk Schoenmaker and Jeroen Kremers,'Financial Stability and Proper Business Conduct' in Robin Hui Huang and Dirk Schoenmaker(eds), *Institutional Structure of Financial Regulation* (Routledge 2015) 30.

[254] Ellis Ferran,'Institutional Design for Financial Market Supervision: The Choice for National Systems' in Niamh Moloney, Ellis Ferran and Jennifer Payne(eds), *The Oxford Handbook of Financial Regulation* (OUP 2015) 101. Also, the interplay between environmental factors such as legislation, colonialism, political systems, the sophistication of management, kind and characteristics of business firms and effects of international organisations might play a role in shaping the goals.

hierarchy approach or whether bank regulation is fragmented depending on objectives rather than labels are essential matters concerning the approaches to bank regulation and the weight attributed to specific regulatory turfs such as prudential regulation and conduct of business regulation.

As this thesis approaches bank regulation and stability from an information-centric point of view, it is necessary to provide background information about how the stability concerns have penetrated into the regulatory structures and how these changes have had repercussions in the banking industry by introducing new information disclosure channels or by setting out greater information sharing between different regulatory authorities having a saying in banks and even prioritising one's own goal on the other. Institutional reforms in the UK and the US vary but increased attention to macroprudential regulation to protect stability is common between them.

New or replaced authorities within the EU's institutional architecture epitomise the significant shift in designing institutional architecture. Lamfalussy Level 3 regulatory and supervisory committees have been replaced by the ESMA[255], European Banking Authority (EBA) and European Insurance and Occupational Pension Authority. Also, new bodies have emerged such as the ESRB[256] and European Banking Union. The two pillars of the banking union, the Single Supervisory Mechanism (SSM) and the Single

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[255] ESMA also contributes to financial stability of the EU through sharing information with the European Systemic Risk Board (ESRB) and coordinating actions of capital markets supervisors or adopting emergency measures when a threat to financial markets arises. ESMA (accessed June 22,2017) https://www.esma.europa.eu/about-esma/who-we-are.

[256] The ESRB is responsible for the macroprudential oversight of the EU financial system and the prevention and mitigation of systemic risk. ESRB (accessed May 12, 2016) https://www.esrb.europa.eu/about/background/html/index.en.html.

Resolution Mechanism, provide more profound integration of the euro banking system by establishing initiatives for stronger prudential requirements for banks, improved protection for customers and rules for managing failing banks.[257] The SSM allows national authorities to retain macroprudential powers while empowering the European Central Bank (ECB) to top up national macroprudential measures and act on its own initiative at the request of national authorities.

In the UK, the financial framework consisting of a tripartite system failed and major structural changes were made. In 1997, responsibility for regulation of banks was transferred from the BoE to a new and unified financial regulator, the FSA. While the BoE was the macroprudential regulator, FSA acted as a conduct of business and microprudential regulator with bank supervisory powers, and the Treasury was responsible for legislation. The run on NR made it clear that the memorandum of understanding (MoU) between the organs was lacking necessary arrangements about when and how the LoLR function should be used and thus a coordination problem occurred during the GFC.[258] This problem was also addressed by the FSA's over-emphasis on conduct-on-business regulation rather than prudential concerns that banks posed to the financial system.[259] The Turner Review also acknowledged the FSA focused too much on supervision of individual institutions and the BoE concentrated on the monetary policy of the state, overlooking the responses to the risks identified.[260]

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[257] EC (accessed May 12, 2016) https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union/what-banking-union_en.

[258] Paras 14–18 of the MoU (accessed Sep 12, 2016) http://www.fsa.gov.uk/pubs/mou/fsa_hmt_boe.pdf. See Chapter 4,Section 3.2.

[259] Alison Lui, *Financial Stability and Prudential Regulation* (Routledge 2017) 25.

[260] The Turner Review (n 177).

The regulatory objective of financial stability was given to the BoE[261] and the FSA[262] and, after that, in 2013, a twin peaks regulatory system of the FCA[263] and PRA[264] was set up. Within this regulatory setting, the FPC, with support from the PRA and FCA, is the key macroprudential body responsible for considering all components of the financial system.[265] So, the function of the FPC is a pivotal complement to, but distinct from, other regulators.

The Financial Services and Markets Act 2000 (FSMA) also reflected such changes to be that financial stability has become part of the FCA's integrity objective rather than being a specific duty.[266] The soundness, stability and resilience of the system was not one of the regulatory objectives of the FSA and the new regulatory order now makes them part of the operational objective of the FCA. It is surely a big step as it gives a statutory objective to the FCA to advance its integrity mission.

The above indicates that the BoE has had a clear responsibility for the protection and improvement of the overall financial stability and resilience of the financial system with its microprudential (PRA) and macroprudential (FPC)[267] authorities.[268] From a stability

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[261] Banking Act 2009 added financial stability objective (s 2A) to the BoE Act.

[262] Financial Services Act 2010 introduced a financial stability objective to the FSMA (s 3A).

[263] Section 1B of the FSMA sets out that FCA has strategic and operational objectives. Its strategic objective is to ensure that relevant markets function well. Its operational objectives are grouped under consumer protection objective (s 1C), integrity objective (s 1D) and the competition objective (s 1E).

[264] Microprudential regulator and supervisor for banks.

[265] BoE Act, s 9G.

[266] FSMA,s 1D(2)(a).

[267] BoE Act,Part 1A.

[268] A recent change proving the BoE's amplified role in maintaining financial stability is the new Prudential Regulation Committee (PRC), which ends the PRA's subsidiary status; yet there

point of view, the PRA, FPC and Monetary Policy Committee (MPC) act together to remove or lessen the systemic risks and support the state's economy policy. Therefore, the new regulatory framework in the UK brings bank prudential regulation directly under the BoE and presents an integrated system operated through committees under the BoE.

The demarcation of consumer protection and prudential regulation thus allows them to fulfil their distinctive regulatory objectives as their philosophies differ by nature.[269] However, this new stability-centric and functional regulatory approach accommodates another reform as it gives the FPC powers to make recommendations[270] and directions[271] to the PRA and the FCA in relation to macroprudential measures and instruments. Given the previous experience of regulators operating within an MoU, the relationship among the FPC, PRA and FCA has become particularly important, and the powers given to the FPC reveal that the protection of financial stability is placed at the apex of the regulatory hierarchy.

The balance between macroprudential regulation, microprudential regulation, market conduct and consumer protection is also considered in the face of the predominant role of the FPC. Both the FCA and PRC are members of the FPC board, and this means that the FPC takes these bodies' views into account as regards financial stability.[272] Additionally, the FPC, while accomplishing its overarching goals addressed at s 9C(1),

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are no changes to the PRA's objectives or functions. PRC takes control of the PRA's most important financial stability supervision and policy decisions. See Bank of England and Financial Services Act 2016,s 13.

[269] Chapter 3,Section 5.

[270] BoE Act,s 9O-R.

[271] Ibid,s 9H-N.

[272] Ibid,s 9B.

'must seek to avoid exercising its functions in a way that would prejudice the advancement by the FCA of any of its operational objectives, or the advancement by the PRA of any of its objectives'.[273] From a stability point of view, the UK's regulatory system is highly concentrated, with a stability-oriented (though not clearly established) hierarchical approach being adopted.

The PRA is empowered to restrain the FCA from taking any action against a PRA-authorised firm such as a bank if it thinks that such action can cause a bank's failure, if the adverse consequences may have an impact on the overall financial system or if it considers that such action can threaten financial stability.[274] The new system is established based on cooperation and coordination.[275] A MoU between the PRA and the FCA demonstrates information sharing and consultation between authorities with a view to solving potential conflicts.[276] As different bodies oversee different aspects of the same bank, it makes coordination more important and objectives-based. The so-called twin peaks structure in the UK responds to this cooperation need and takes banks within its sphere of influence.

Considering the significant powers granted to the FPC and the value attached to the protection of financial stability, the new regulatory structure in the UK, with the considerable powers given to the FPC (including the power to give directions to the FCA and PRA requiring macroprudential measures that might contravene specific aims that

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[273] Ibid,s 9F(2).

[274] FSMA,s 3I.

[275] Ibid,s 3D-E.

[276] The MoU between the FCA and the BoE, including the PRA (accessed Oct 20, 2016) https://www.fca.org.uk/publication/mou/mou-bank-pra.pdf.

these regulators are entrusted to promote), appears to constitute a coordinative system that addresses financial stability as its main goal.[277]

In the US, no single authority has sole responsibility for ensuring and protecting financial stability and therefore no stability mandate is particularly given to the Fed. However, the pursuit of financial stability, along with price stability and maximum employment mandates of the Fed, can be traced to its establishment as a result of the Panic of 1907. As such, it is an implicit and more like a traditional duty of the Fed to undertake the promotion, protection and support of financial stability.[278] This was proved during the GFC when the Fed met with some systemically important investment banks even if their primary regulator was the SEC and the Fed assumed responsibility to supervise them and ameliorate their financial standing. The Fed's considerable amount of emergency support provided to FIs became a byword during the GFC.[279] The problem with the US system was that no regulator assumed responsibility for the protection of the whole economic system. While banks operating under BHC structure were the main focus for regulators, the whole firm was neglected. The fragmented regulatory structure continues to be another area of discussion.

Efforts at financial stability embodied in the Dodd-Frank, which enhanced the Fed's surveillance powers, established new restrictions on risk-taking of FIs and changed the

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[277] A. Godwin, S. Kourabas and I. Ramsay,'Financial Stability Authorities and Macroprudential Regulation' (2017) 32 Banking and Financial Law Review 223.

[278] Renee Haltom and John A. Weinberg,'Does the Fed Have a Financial Stability Mandate?' [2017] FDBR Economic Brief No:17-06 at 4-5(accessed Aug 4,2017) https://www.richmondfed.org/-/media/richmondfedorg/publications/research/economic_brief/2017/pdf/eb_17-06.pdf.

[279] Federal Reserve Act 1913,s 13(3).

regulatory model by creating the Consumer Financial Protection Bureau[280] and the FSOC. From a stability point of view, establishment of the FSOC is proof of the change in regulatory philosophy. FSOC was set up as a limited-purpose macroprudential body, which was superimposed on the overall US financial system with an overarching goal of identifying the risks and responding to emerging threats to financial stability. Its duties also include other stability-related tasks such as collecting information from other agencies, facilitating information-sharing and coordination between authorities, and working in harmony with the Office of Financial Research.[281]

FSOC is a collaborative body whose members include federal financial regulators including the SEC and bank regulators. On the face of it, FSOC appears similar to the FPC. One of the similarities is FSOC's power to make recommendations to regulators. [282] Yet, in contrast to the FPC, these recommendations can only be made for limited issues and are designated in the statute.[283]

However, compared to the FPC's power to give directions, the FSOC is a coordination and cooperation forum to strike a balance between microprudential regulators that form the fragmented regulatory system so that the FSOC provides a sense of consolidation in terms of gathering stability-relevant agencies. In this way, it eases the concerns of those who think the Fed should not be the supreme regulator of financial stability.[284] As such,

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[280] It works as a kind of limited-purpose market conduct regulator for most credit, savings and payment functions in the US and it works with bank prudential regulators.

[281] 12 USC§5322.

[282] If the FSOC recommends more rigid regulation or safeguards to regulatory agencies, it is made on a comply or explain basis like the FPC's scenario. It can also make recommendations to Congress about a particular regulation.

[283] 12 USC§5322,s 2F.Also see Financial Choice Act of 2017,s 2.

[284] Godwin,Kourabas and Ramsay (n 277) 243-44.

the post-GFC financial infrastructure of the US does not underpin a regulatory hierarchy that places financial stability at the top. Instead, macroprudential regulation is designed to support microprudential regulation. Though the FSOC collaborates with microprudential regulators, the main responsibility of developing and implementing regulations is still borne by microprudential regulators. The FSOC therefore does not have the power to act on its own; the decentralised regulatory structure of the US has not changed with the establishment of the FSOC, compared to the more concentrated regulatory structure in the UK.

This also means that agencies whose goals are different by nature, like the SEC and bank regulators, will be engaged in the joint exercise of maintaining the nation's financial stability under the FSOC. The legislation for each independent agency restricts its objectives and the reach of its regulations. So, for example, in the case of the SEC which is the agency charged with protection of investors and maintaining transparent and efficient securities markets, how these objectives can be fully compatible with the goals of financial stability is questionable as there is no clear mandate on the SEC to fulfil a financial stability objective. As this change is a post-GFC product, the future will perhaps show how legal and practical challenges of acting in harmony will be handled when a superimposed financial stability goal arises.

Post-GFC US changes, therefore, do not make a striking change in terms of lessening the fragmentation and complexity of the regulatory structure in order to ensure financial stability of the state. Instead, it reinforces the view that its system is like a patchwork that the FSOC has become one of the add-ons in it with its debatable influence on microprudential regulators and lack of authority to deal with jurisdictional disputes.

Both the UK and the US have, therefore, witnessed major changes driven by stability concerns. While the UK established a formal hierarchy by designating financial stability as the overarching goal under the BoE, the US changes do not seem aligned with the calls for a superior mandate of stability. However, this can be explained by cultural differences.

3.1.3.1. Microprudential Regulation of Banks and the Role of Central Banks: Implications for Transparency

Traditionally, financial stability is linked to CBs even if there are other institutions besides the CB.[285] The reason for this is the distinctness of achieving financial stability compared to other regulatory tasks which do not necessitate urgent government intervention as a counterparty to the market transactions.[286] CBs, in this sense, act as a LoLR and they are the source of liquidity and sponsor of financial obligations. This shows that they are naturally and inevitably involved in maintaining the health of banks and safeguarding depositor assets. As mentioned in Section 3.1.1, CB policies are designed to provide extrinsic confidence. CBs inherently assume the role of stabilising expectations about the future and protecting general confidence.

In this setting, microprudential regulation and supervision of banks is necessary to prevent banks from relying on CB assistance. Prudential regulation and supervision is explained by their diversified objectives: regulation is used for policies to protect

[285] Designation of CBs with macro and microprudential powers is not a must for financial stability since, as Swedish system shows, those responsibilities can also be provided to a separate organization, which is solely established for financial stability objectives. Charles Goodhart,'Linkages between Macro-prudential and Micro-prudential Supervision' (2015) 30(10) JIBFL 607,609.

[286] Eric J. Pan,'Organizing Regional Systems' in Moloney, Ferran and Payne (n 254) 192.

financial stability or prevent systemic risks[287] and supervision is used analogous to regular observation and examination of banks by regulators that are authorised with disciplining powers; or prudential regulation simply can be taken as the bank regulation employed by prudential regulators. As such, it is both preventive and protective regulation and therefore prudential regulation allows the regulator to perform a detailed analysis of each bank and thereby thwarting the possibility of single bank failure affecting the whole system. The basic logic argued by Bagehot in explaining why banks should be subject to periodic surveillance in return for access to an LoLR facility and such back-ups is still valid since the contagion risk and concomitant systemic volatility emanating from a failure of a bank might contaminate the whole financial system; but the prudential tools used have changed ever since.[288] Now, banks are subject to a variety of requirements including but not limited to capital adequacy, record-keeping, capital buffers, investment limits or risk-assessments. In simple terms, it is the practice of 'government regulation and monitoring of the banking system to ensure its safety and soundness'.[289]

One of the characteristics of bank prudential regulation can be described by the saying that rules follow the facts. This means rules are designed *post hoc*, after the event occurs and based on the financial reality of yesterday. However, they are intended to have *ex ante* effect, ie to prevent future crises. Regulation, by nature, is an *ex ante* preventive measure compared to private law remedies which are retrospective and *ex post*. Detection

[287] IMF,'Central Banking Lessons from the Crisis' (2010) at 13 (accessed Nov 28, 2016) https://www.imf.org/external/np/pp/eng/2010/052710.pdf.

[288] Bagehot argues that CBs should step in as LoLR as long as banks in distress have sufficient high quality collaterals like performing loans or government securities; so that such an exchange between the CB and the distressed bank does not place the loss on the taxpayers and other banks lacking collaterals of an adequate quality should be doomed to failed.Bagehot (n 206) ch 7.

[289] Mishkin, *Prudential Supervision: Why is it Important and What are the Issues* (n 158) 1.

of causes and results of bank instability and contagion or spillover channels has developed a mechanism within the dynamics and nature of the financial system. This mechanism accepts that the banking system is built on confidence and therefore it implies that it is the confidence that needs to be protected, not the banks. Confidence protection for stability reasons, however, comes with specialties such as deposit insurance schemes, access to the discount window or government guarantees provided to banks and *ex ante* preventive policies (such as capital and liquidity requirements, on-site examinations, stress tests, regulatory reporting requirements or other supervisory tools).

Therefore, the basic arguments for prudential regulation and CB assistance are straightforward. Within this setting, regulatory intervention of banks for higher public interest reasons is contentious as government involvement undermines the notion of market discipline and creates an expectation among banks that they will be protected or saved, thus increasing moral hazard. It also has drawbacks in the competition of the banking sector and further creates political and ethical discussions on whether the intervention is political-interest motivated or not.[290] On the other hand, it is the most basic idea of bank regulation that banks are important for financial stability and so prevention of economy from further deterioration should be accomplished by the state. Mechanisms to control a banking crisis can generally be grouped into (i) blanket guarantees and liquidity provisions during the first phase of the crisis, (ii) capital injections, and (iii) debt

[290] Public interest reasoning to regulate financial markets is criticised by public choice theory (which rejects the notion of reified and independent public interest as a regulatory motivation) and a revised version of public interest as a result of philosophical change in defining regulatory behaviours, approaches regulation of and intervention to financial markets, FIs and transactions as a necessity to control systemic risk, maintain financial stability and correct information asymmetries in the market. Constantinos Tokatlides, *Retail Depositor and Retail Investor Protection under EU Law* (Routledge 2017) 3.

structuring mechanisms like asset management companies. The fourth one that this thesis suggests is the information management mechanism.

In this setting, government intervention to prevent a crisis occurs in different ways. It can be a group of systemic measures applicable to all banks regardless of their status or it can be a single policy instrument to save individual banks.[291] Whether CB involvement responds to an idiosyncratic or a systemic need, the purpose is not to save all banks from failure; but only those that are solvent but illiquid.

Stability measures surely have merits from a stability point of view but in terms of bank information disclosure the way measures are applied to banks has implications. Again, the argument is about the correlation between the level of public confidence and disclosure of government support.

A good example is the Troubled Asset Relief Program (TARP) in which the US government used its Capital Purchase and Assistance Programs to provide capital and ameliorate the financial standings of banks.[292] TARP was a voluntary scheme when it was first designed. Yet, the fears about negative signalling to the market due to receiving liquidity support from the Treasury alerted the Fed about a potential market collapse based on loss of public confidence and its corresponding results in withdrawing funds from banks. Even if depositors of commercial banks were covered by the FDIC guarantee, investment bank counterparts were suffering heavy losses. Once those sophisticated

[291] Emmanuel Farhi and Jean Tirole,'Collective Moral Hazard, Maturity Mismatch, and Systemic Bailouts' (2012) 102(1) American Economic Review 60.
[292] TARP is a product of Emergency Economic Stabilization Act of 2008 (Public Law No. 110-343).

investors who had a relationship with the investment part of the banks became aware of the illiquidity problems, the common concern of general depositors, who are not assumed to have specialised financial risk management skills, deep understanding of market signals or the ability to insulate themselves from bank failures, started to appear and they suddenly began to withdraw funds.[293] Therefore, the US policymakers decided to make TARP funds mandatory for the nine top FIs. This was an acknowledgement of the fact that receiving support from the government gave out negative signals to the market. Due to this, healthy banks, as well as troubled banks, were also required to get TARP funds to provide a common sense of security to the markets.

Information disclosure about government support became an issue when the Fed was asked to release the identity of the banks, amount provided, collateral pledged, interest rate charged, the terms of the transaction and other relevant information to provide transparency about the use of its powers.[294] Even though most of the banks repaid TARP shares at the first opportunity, some voiced their fears about losing their creditors after the Fed disclosure due to being perceived as unsafe by the market.[295] Concordantly, cases

[293] Mitchell (n 183) 140-98.

[294] The Fed had to make unprecedented disclosure about its support facilities with detailed information about the identity of the borrowers after losing the FOIA-based lawsuits in 2011. Even if the Fed strongly argued that such release undermines the financial stability and creates stigma by damaging the very existence of CB support, Dodd-Frank Act s 1103 made it clear that the Fed must disclose information on discount window loans, emergency lending facilities and open market operations after a 2-year lag. See 12 USC§248(s). See Bloomberg L.P. v Board of Governors of the Federal Reserve System 601 F.3d 143(2d Cir. 2010), cert denied sub nom. Clearing House Ass'n L.L.C. v. Bloomberg L.P.,US(2011).

[295] A historical example during the Great Depression about this concern could be the one involving a financial firm that publicly disclosed which banks it had provided loans with. Borrowers banks experienced runs after the disclosure. Marc Labonte,'Federal Reserve: Oversight and Disclosure Issues' (2017) CRS Report R42079 at 13(accessed June 18,2017) https://fas.org/sgp/crs/misc/R42079.pdf.

about the disclosure of federal bailouts noticeably cited exemption 8 of the FOIA and the courts were more inclined to withhold such information rather than allow disclosure,[296] and one court even decided to use other exemptions rather than exemption 8 as a basis for non-disclosure.[297]

Disclosure about bank lifelines by CBs has been an ongoing discussion across the EU and the UK as well. CB support had been shrouded in secrecy, but transparency initiatives after the GFC also bite the ECB and national CBs, as attacks about CBs making political or industry-interest decisions damages the reputation and credibility of the state. As such, the ECB decided that beginning from 16 September 2015 CBs have the choice to communicate publicly regarding the provision of the ELA to banks in their territory, which means that disclosure of ELA is optional and not mandatory.[298] As the BoE stated, 'considerations of policy effectiveness and transparency have the potential to conflict with each other … but … with a sufficient lag, disclosure that a firm had received temporary liquidity support from the Bank should not undermine confidence in that firm or the financial system as a whole'.[299] It is therefore possible to say there is more

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[296] See *Judicial Watch, Inc. v. US Dept. of Treasury, 796 F. Supp.2d 13* (DDC 2011) (where the information regarding the receivership of the TARP funds was covered by exemption 8.); *Public Investors Arbitration Bar Association v. SEC*, 771 F.3d 1,3, Fed. Sec. L. Rep.(CCH) P 98240 (DC Cir.2014).

[297] *McKinley v. Board of Governors of Federal Reserve System*, 647 F. 3d 331(DC Cir 2011).

[298] ECB,Press Release on Sep 16,2015 (accessed on May 14,2017)https://www.ecb.europa.eu/press/pr/date/2015/html/pr150916.en.html.The ECB also announced 'Agreement on Emergency Liquidity Assistance' (17 May 2017) See part 8 of the Agreement (accessed May 19,2017) https://www.ecb.europa.eu/pub/pdf/other/Agreement_on_emergency_liquidity_assistance_20170517.en.pdf.

[299] BoE,'Changes' to the Bank's Weekly Reporting Regime'(2014) 54(3) BoE Quarterly Bulletin at 2 (accessed Jan 21, 2017) http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb300614.pdf.

flexibility provided to European CBs compared to their American peer. In the EU, especially after the case of NR, national and international liquidity disclosure regimes by banks have been under the spotlight in terms of the importance of not risking a state's financial stability policies in supporting banks.[300]

This means that CB transparency and accountability measures are also linked to bank transparency in a way that bank liquidity information might be revealed by the hand of CBs. This creates a non-borrowing stigma because, so the classic argument goes, such disclosures that signal a potential weakness of a bank might induce reduced lending and avoidance of approaching the CB for support.[301] If banks believe that disclosure of support affects decisions of investors and counterparties, escalates their cost of funding, or restricts their ability to borrow from interbank funding, then banks might search for another liquidity source or different methods to fulfil short-term liquidity needs, thus avoiding the adverse consequences of CB support.

Safety nets provided to banks, either as part of a higher goal of financial stability or in the normal course of bank transactions, give rise to arguments about the judicious mixture of ambiguity and transparency. Constructive ambiguity exists to the extent that banks do not know whether a CB will provide liquidity assistance and therefore it is decided on *ad hoc* basis. Transparency here means a rules-based system in which the conditions and responses are designed by the law and pre-commitment to support is made.

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[300] BoE,PRA's Supervisory Statement,'Compliance with the EBA's Guidelines On Disclosure' (Sep 2017) SS6/17 at 6 (accessed Oct 21, 2017) http://www.bankofengland.co.uk/pra/Documents/publications/ss/2017/ss617.pdf. See Chapter 4, Section 1.6.

[301] Hal S. Scott, *Connectedness and Contagion* (MIT Press 2016) 106.

Constructive ambiguity is about policy choices of CBs in applying some sort of discipline to banks by leaving them in uncertainty or providing them with *ex ante* information about the terms so that banks can discipline themselves. Yet, the existence of TBTF banks proved that if a bank perceives itself as systemically important – not just because of the magnitude of its asset and liabilities but also its connections with other economic agents – it will have the belief that CB assistance will be available for them to protect the system. This is one of the classic examples of moral hazard by banks and in both of the systems it addresses the importance of efficient microprudential regulation and supervision to minimise the likelihood of accessing CB assistance. Though regulatory scholarship typically values transparency and accountability, conditions of how these goals are satisfied need to be considered as well. For example, constructive ambiguity is consistent with the idea that CB operations should be outside the public gaze and *ex post* transparency is more preferable.[302] So, stability concerns are ranked higher than immediate transparency needs.

Disclosure of bank support is generally supported because extra information regarding banks' asset quality and liquidity positions are consistent with the goal of market discipline. It also leads to a change in *ex ante* behaviour by banks in a way that banks will be more prudent in their borrowing and lending behaviours and their liquidity positions as it is the public authority making the public announcement about a bank. Yet, even if disclosure by the CB or prudential regulator is *prima facie* beneficial to markets as it supports further transparency, this straightforward thinking ignores the irrational

[302] Charles Enoch, Peter Stella and May Khamis,'Transparency and Ambiguity in Central Bank Safety Net Operations' (1997) IMF Working Paper WP/97/138 at 10 (accessed Oct 24, 2016) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=882699&rec=1&srcabs=227474&alg=7&pos=5.

behaviour-driven aspect of public confidence and bank interconnectedness which ultimately engenders suboptimal *ex post* market externalities during financial turbulence. However, considering that such disclosure is not done immediately after the support is granted, it is evident that there is still a strong case for upholding a transparency-fragility view. This indicates that, stability policy effectiveness is based on some level of opacity and it creates a question mark over whether banks should be allowed to disclose similar information by other disclosure channels established by law.[303]

4. Concluding Observations

Overall, the shift in financial regulation reflects the systemic focus as the correlations and interdependencies in asset holdings and funding of both bank and non-bank organizations have encouraged a holistic view of the entire system. The discussions about microprudential regulation and supervision to minimise the likelihood of receiving government support and key challenges that CBs face in order to design a financially and socially optimal response to idiosyncratic or systemic bank problem are ongoing. Banks, in this scheme, are passive quasi-public institutions in their capacity to follow microprudential and macroprudential regulation and authorities.

[303] Chapter 4.

CHAPTER 3

FOUNDATIONS OF DISCLOSURE OF INFORMATION BY BANKS

1. General Remarks

As discussed in the previous chapters, banks are inherently opaque organisations and public confidence element residing in the banking business has long been asserted as a reason for underpinning bank opacity. Both banks and prudential regulators have sound reasons to keep bank information away from the public sight; yet, concerns emanating from bank disclosures have not been effective enough to prevent legislators from subjecting banks to disclosure requirement for, for example, company law, conduct of business or BCBS disclosure guidance reasons.[304]

Considering banks as publicly traded companies requires one to analyse the legal framework established consisting of both the securities regulation and company law, and then reach a conclusion as to whether banks should be considered without the exertion of authority within the financial and economic system in general. However, as previously stated, the quasi-public nature of banks distinguishes them from other publicly traded companies and, historically, they are heavily regulated and are subjected to supervisory and prudential control. As discussed in Chapter 2, these controls are intended to prevent banks from destroying the confidence they created, and the disclosure of information, whether voluntarily, recklessly or due to mandatory regulation, could contribute to the destruction of this confidence which is a public good and also the backbone of the banking

[304] Roel Theissen, *EU Banking Supervision* (Eleven Publishing 2014) 677.

system. So, the links between transparency and bank riskiness and disclosure of such risks to the market present an important question to explore.

Substantive regulation is paternalistic in nature, and it might be contradictory to investor autonomy, in the sense that investors' choices are limited in terms of allowing them to assess the risks and benefits of the transaction before deciding to proceed with their individual choice.[305] However, securities markets are the output of private ordering, and they are also the exchange grounds with greater public interest; in this respect, banks, already subject to governmental intervention in their economic activities, are subjected to both a public-oriented and private-ordering view of capital markets like any other public company.

Public-oriented regulation, with its aim to protect actual and potential investors and public confidence and prevent fraud in the markets, underlies the disclosure philosophy. The conventional laws and economic models of disclosure have gradually moved towards greater transparency and assumptions about the reasons behind corporate failures have pointed to inefficient markets in different forms; disclosure regulations have been the traditional panacea for accurate price formation of shares, reflecting all available information.[306]

Regulatory developments on the global and national levels have mentioned that the regulations were weak before the crisis, particularly in banks, whose increased exposure

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[305] Susanna K. Ripken,'The Dangers and the Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation' (2006) 58(1) Baylor Law Review 139,190.

[306] Jonathan R. Macey,'Efficient Capital Markets, Corporate Disclosure, and Enron'(2004) 89(2) Cornell Law Review 394,418.

to securitisation and credit derivative activities, together with the increasing intricacy of ABSs and the surrounding complexity, have been the primary concern for regulators in terms of foreseeing and gauging the level of risk taking by banks.[307] When the complexity of the new financial environment and investor protection and the difficulty of monitoring such activities are considered, both securities and banking regulations are seen to rely on the concept of enhanced transparency to evaluate banks. However, the question of whether enhanced bank transparency via MDs makes banks more vulnerable to systemic shocks might not be answered in all respects, and it is yet an open question after the GFC.

Traditionally, there has been much debate about bank disclosures in terms of the premise that banks should be immune from the market discipline compared to other companies, which means that banks should not be subject to the same disclosure requirements as other firms. Over-protective bank regulations, together with depositor protection and safety net schemes, have created question marks in people's minds as to why taxpayers have to bear the loss emanating from bank failures and why the state fails to monitor and foresee such failures in the first place. Therefore, an examination of the role of disclosure in present-day regulations and its relationship with market discipline and efficient markets is necessary. In an attempt to present the general picture pertaining to bank disclosures, it is useful to set out the interest groups in establishing applicable disclosure policy. The broad array of public disclosures is mandated by the coercive power of the state and there are always some interest groups affected by those disclosures. Therefore, the rest of the thesis will make references to those interest groups.

[307] P. Iren, A. Reichert and D. Gramlich,'Does Bank Transparency Matter?'(2014) 9(1) Bank and Bank Systems 75.

As discussed in Chapter 2, the years 2007-9 are characterized as one of the worst periods experienced both in the US and the UK. Application of securities laws MD requirements on FIs with systemic importance during the GFC and the government's need for certain level of opacity to maintain or protect financial stability of the state brought about different cases in these two financial centres. As next chapter will examine in details, while the epic acquisition of the ML by the BoA and the AIG bailout led to discussions about the political calculus due to CB support and its role in the non-disclosure; in the UK disclosure dilemma was more severe as the run on the NR directly established a strong case for the transparency-fragility view.[308] The cases implied that content and timing of bank disclosures are still capable of facilitating negative externalities opposed to new world's mainstream and maybe enshrined transparency-stability view.

The purpose here is not to resubmit the classic arguments related to the pros and cons of disclosure regulations in the context of criticism of MD but rather to try to bring out the questioning of the disclosure requirements which are relevant to banks as issuing their own securities in the capital markets.

2. Banks Revisited: Banks as Publicly Traded Firms

2.1. Presence of Banks in the Capital Markets[309]

Capital markets are an important source of funding and banks, as other firms, can finance their activity by raising capital in capital markets as issuers of their own securities. For a

[308] Chapter 4.

[309] The relationship between the capital markets and banks can be discussed under various headings, as banks actively issue shares and debts to finance themselves; they hold shares in other publicly traded companies; and they underwrite, trade and sell securities (depending on the regulatory concept). The separation of investment and commercial bank activities for the

long time, in many jurisdictions, most banks were not affected by securities regulation because banks' activities vis-à-vis depositors and other creditors were not subject to disclosure rules or rules of conduct designed for investor protection.[310] The new approach of seeing banks as any other company developed quite late and security supervisors now treat banks as any other listed or limited company.[311]

It is mentioned that the issuance of securities depends on the prospects of the firm, which means that a firm with poor prospects will be expected to issue stocks to split its disadvantageous circumstance to new claimants, while a firm with good prospects will be expected to issue debt securities with the intention to keep the upside for itself rather than sharing it with new claimants.[312] The application of this approach to banks suggests that capital adequacy requirements established for banks might refute such assumption because banks might simply issue securities to satisfy the regulatory capital requirements and such an involuntary issuance might give negative signals to the market with concomitant low bank-share prices.[313]

Though the reasons make banks issue securities differ, banks go public like other companies and it has been found that banks that go public become larger within a short period of time, employ higher leverage, derive more profits, and increase the assets by

protection of private capital and public interest after the GFC is another discussion and it is not the main focus. So, this chapter will not discuss banks' involvement in securities activities other than when issuing their own securities.

310 Tommaso Padoa-Schioppa, *Regulating Finance* (OUP 2004) 35.

311 Ibid.

312 Stephan A. Ross, 'The Determination of Financial Structure: The Incentive-Signalling Approach' (1977) 8 Bell Journal of Economics 23.

313 Marcia M. Cornett and Hassan Tehranian, 'An Examination of Voluntary versus Involuntary Security Issuances by Commercial Banks' (1994) 35 Journal of Financial Economics 99,100.

investing in more loans.[314] However, this brings risks and, of course, less managerial autonomy described as an exchange among the liquidity and corporate control.[315]

Issuing equities provides a more permanent type of financing compared to liability funding. Equity shares provide confidence to creditors who understand ordinary stocks and retained earnings as a financial buffer against loss.[316] Since the stockholders come after other creditors on the list of those whose claims will be honoured, it might be said that bank stock is the proxy for its ability to absorb losses. Dynamics in bank funding are of great importance to the state to ensure the stability of the bank. As governments become actively involved in increasing the bank's capacity to absorb losses via deposit insurance schemes, they also force banks to comply with capital cushion rules and provide rules regarding bank equity capital.[317]

It is true that the banking business has been subject to considerable transformation within the time, but one of the core questions about whether banks are shielded from market discipline has remained as a theoretical one. The ability of market forces in assessing and pricing the bank's riskiness forms one pillar of disclosure-based problems in the banking sector. Debates on the reasons for bank failures have addressed two issues in particular. First, market discipline does not work because of the inability of stakeholders to sufficiently screen the bank's activities; and this means enhanced disclosures by banks is necessary for the prevention of rumour or imperfect information causing the failure in the

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[314] Richard J. Rosen, Scott B. Smart and Chad J. Zutter,'Why do Firms Go Public? Evidence from the Banking Industry' (2005) Federal Reserve Bank of Chicago Working Paper No:2005-17 1,2.

[315] Ernst Maug, 'Large Shareholders as Monitors' (1998) 53 Journal of Finance 65.

[316] Gabilondo (n 173) 13.

[317] Ibid 14.

first place. Second, inadequate market discipline is asserted because banks are provided with safety net protections, which encourage them to take higher risks. Therefore, the principle of disclosure and its application in the banking sector will be addressed first, and then its relevance to market discipline will be discussed.

2.2.The Application of Mandatory Disclosure of Information in Securities Regulation

2.2.1. Objectives of Disclosure Regulations

The mainstream company law is generally private law surrounded with various contractual relationships with the aim of ensuring that business can be created and can function conveniently. The goal of securities laws can be explained in the same way as other financial regulations and from this respect they show the prevalent presence of the state within the appearance of regulations as they facilitate the productive running of the capital markets and provide the necessary degree of investor (including unsophisticated ones) protection for promoting confidence and economic growth and for facilitating capital raising.[318] These goals are possible with smooth transfer and exchange of property rights across demographic cycles, which means the rules of the game should be set on the grounds of optimality.

The premise that investors of public companies are subject to a more severe information asymmetry problem throughout the manager–investor relationship than the investors of a private company might be true because private firms have fewer shareholders than a public one and therefore shareholders of a private firm might exert more power and

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[318] J. Lowry and A. Reisberg, *Pettet's Company Law:Company Law and Corporate Finance* (4th edn,Pearson 2012) 383-84.

control on the controller/managerial team of the company.[319] Further, a necessity of a certain degree of investor protection is related to the interconnectedness of the companies traded in the stock exchanges where a fraud in a firm might have spillover effects over the other firms.

Therefore, the endogenous differences between public and private companies establish that outside investors need information about the product they might want to invest in and the state becomes involved at this stage to ensure such protection. For that reason, securities law comprises the policies that facilitate private contracting and then assure the enforcement of such contracts by establishing the most productive grounds for efficient and competitive markets designed for specific consumer protection and market stability.[320] Disclosure regulations, in this context, are one of the principal instruments in terms of providing protection for shareholders and creditors, decreasing the opportunistic behaviour within the agent–principal relation and supporting market efficiency by reducing information costs for investors and accommodating market participants with information about the firms and the market itself.[321]

The philosophy of disclosure is generally described as a system intended to distribute material information to investors, who in turn will be in a position to make an informed and prudent judgment whether or not to buy the security. Regulatory schemes take disclosure as a way to achieve their goals since disclosure-based regulations are alleged

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[319] Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policy* (2nd edn, Hart 2015) 487.

[320] John C. Coffee and Hillary A. Sale, *Securities Regulation* (11th edn,Thomson Reuters 2009) 1-10.

[321] Zohar Goshen and Gideon P. Ovsky,'The Essential Role of Securities Regulation' (2006) 55(4) Duke Law Journal 711,737.

to provide practical and political satisfaction. The basis of this view is twofold. First, to issue substantive rules has been seen as more difficult than to just impose some disclosure requirements. Conventional types of government response by regulating substantive rules might be out of keeping with future risks and actions and also carries the risk of being out of date in a short period of time in changing public demands or in an innovative environment. Second, the concept of command and control regulation might not work properly and extra information from the market can show what and how to regulate.[322] Apart from these views, it is said that disclosure-based systems have brought a shift of roles from the governments to businesses and individuals in the decision-making process[323] and therefore direct intervention of government is covered by this soft touch by allowing market participants to decide on what is more efficient for them. In other words, disclosure is offered as a civil regulatory system shaped by society with its developing economical dynamics, rather than a government-made system, and thereby citizen-regulators are expected to be more successful than the government by demanding the necessary degree of qualitative and quantitative information via disclosure.[324] Thus, disclosure as a tool of targeted transparency is rooted in individual choices by disclosers and users who interact to organize risk levels as well as developing the organizational performance.

On the one hand, this view can be justified by asserting that individuals or businesses can see the whole big picture depending on the released information without a direct

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[322] Paula J. Dalley, 'The Use and Misuse of Disclosure as a Regulatory System' (2007) 34 Florida State University Law Review 1089,1092.

[323] Bradley C. Karkkainen, 'Information as Environmental Regulation: TRI and Performance Benchmarking, Precursor to a New Paradigm?' (2001) 89 Geo LJ 257,293.

[324] John Parkinson, 'Disclosure and Corporate Social and Environmental Performance: Competitiveness and Enterprise in a Broader Social Frame' (2003) 3 J Corp L Stud 3,4.

government intervention and therefore may follow their best interest freely. On the other hand, it carries the danger of regulatory failure in drawing an optimum level of disclosure regulation which not only changes the entire free-decision-making process of individuals/businesses; but also undermines the system which it is based on. Further, to take disclosure as a civil-based system may generate new arguments related to the non-necessity of substantive regulation since market participants will be armed with information and they will protect themselves against any misconducts or misuses, which essentially means that the government does not need to take part in more substantive regulation.[325] Yet, as Posner addresses, the choice is rarely between a free market and public regulation.[326]

Disclosure as a policy tool has become highly prevalent together with its relatively demanding regulatory aims but concerns about how individuals or firms process the released information have been raised in the context of both economics and psychology.[327] There have been various behavioural approaches asserted in an effort to mitigate such concerns including heuristic bias concept, rational choice, bounded rationality, and herd behavioural theories. Those financial behaviour propositions reflected different aspects of the behaviours of individuals or firms in the face of disclosed information and show that when investors or other market actors meet with complicated disclosed data, they choose to 'satisfy' instead of to 'optimize'.[328] In other words, with reference to Brandeis's terminology, publicity may not be just one of the best

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[325] William O. Douglas, 'Protecting the Investor' (1934) 23 Yale Review 521,523-24.

[326] Richard A. Posner, *Economic Analysis of Law* (4th edn,Little Brown and Company 1992) 367.

[327] Dalley (n 322) 1090.

[328] Herbert Simon, 'A Behavioural Model of Rational Choice' (1955) 69 Q J ECON 99.

disinfectants; it may also cause blindness to market participants by exposing them to too much information.

Such behavioural researches offer that an increase in the quality and quantity of disclosed information does not necessarily lead individuals or firms to make more rational choices. Thus, researches call the question of whether disclosure-oriented regulation, which is mostly motivated by the acceptance of 'more information is better than less', is sufficiently useful.[329] Today's disclosure laws necessitate two things to be effectual: information has to be released, and receivers of the information have to make rational choices by using that disclosed information. One expects a regulation to have substantial goals and to succeed in satisfying a need by performing such aims. However, disclosure-oriented regulatory concepts use 'enhancing transparency and protecting individuals or firms' as a goal, but they fail to clarify the answers of 'why extra information is of value or why increased information is supposed to lead effectual changes in information receivers' actions'.[330] Those questions under the heading of overload information and market responses in behavioural finance still await answers because rapidly changing financial environment, technology, and financial innovation may also affect the behavioural responses of market participants.

It is also noteworthy that legislated transparency in the form of disclosure in a market-based economy is still debatable in economic theory. The debate revolves around 'information asymmetries', which come with both moral hazard and adverse selection problems. The overall view of such problems is that information is likely to be in underproduction in markets and that operations in real-world markets are very different

[329] Ripken (n 305) 148-49.

[330] C.R. Sustein, *Laws of Fear: Beyond the Precautionary Principle* (CUP 2005) 123.

from the world in which the access to information imposes no cost. Furthermore, it might be important to approach the problem from the standpoint that individuals and firms have distinctive and idiosyncratic incentives to come up with a solution for information asymmetries.

No markets are perfect. In fact, they are subject to severe information asymmetries with a low level of transparency. Positive theories based on the main objectives of financial regulation in protecting the integrity, resiliency and stability of the market, approach disclosure from both price and trade transparency and several trade-offs coming with it. The literature, therefore, provides a consistent and cohesive framework to address information-specific problems and the role of disclosure. Provision of information in the markets through disclosure has intrinsically engendered several problems regarding the cost of such disclosures, issues related to conflict of interests, and promotion of information to stakeholders.[331]

A firm, or in Jensen and Meckling's term, a nexus for contracting relationships, accommodates several relationships where each contracting party pursues the maximisation of its own interests and these interests do not necessarily match with those of others.[332] As such, the agency problem embodied as the conflict of interest between stakeholders (principal) and the management (agent) could be ameliorated by disclosures.[333] Further, other stakeholders such as employees, the general public, peers and other interest groups such as governments have an interest in the firm and stakeholder

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331 P. Latimer and P. Maume, *Promoting Information in the Marketplace for Financial Services* (Springer 2015) 10.

332 Michael C. Jensen and William H. Meckling,'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3(4) Journal of Financial Economics 305,310.

333 Ibid.

theory, thus highlighting a conceptual framework for information disclosure that is not solely directed to investors but to a broader group.[334] However, as will be discussed in the market discipline section, the motivations of each stakeholder are different and a firm might be required to prioritise stakeholders and strike a balance between stakeholders' interests as not all disclosures are beneficial to shareholders.

Returning to Chapter 1, 'the lemons problem' arises due to the very existence of information asymmetries between the firm and markets, ie adverse selection, where the seller knows more than the buyer. Signalling theory posits that firms that believe they are more profitable and better than other firms signal this to markets in order to distinguish themselves from the weak ones and attract investment.[335] Signalling here implies the incentives of the firm to voluntarily disclose positive information while staying quiet is understood as bad news by the public.

The proprietary cost approach to disclosure employs a broad definition of costs. Cost can be related to collection, production or provision of information or can be about proprietary costs, those related to costs occurring after disclosure, such as loss of competitive position after disclosure.[336] The political cost approach to disclosure, on the other hand, focuses on the level of disclosure desired by political groups, such as governments, and consumer or environmental groups. According to this perspective, firms with a high political profile, such as banks or large corporations, tend to disclose more information voluntarily to escape from government scrutiny and extra regulations or lobbies establishing

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[334] R. Edward Freeman and others, *Stakeholder Theory* (CUP 2010) ch1.

[335] Robert E. Verrechia, 'Discretionary Disclosure'(1983) 5(1) Journal of Accounting and Finance 179.

[336] Ibid 181.

pressure.[337] Legitimacy theory approaches disclosures from a management and ethical point of view. It sees legitimacy as 'a process by which a firm seeks approval or avoidance of sanction from groups in society'.[338] The firm, in this respect, cannot survive if its values are not perceived as matching the norms of acceptable behaviour at large and therefore transparency is key for firms to keep their social license to operate.[339] As such, this theory postulates that expectation of society and political approval needs of firms stimulate firms to voluntarily disclose information or follow MD regulations so as not to be discredited in front of the public.

The above indicates that theories related to disclosure provide different determinants that arise from different motivations and constraints. As Chapter 1 mentioned, information is produced privately and therefore there is a cost to produce it. The difference between the cost of creation of information by the issuer and the benefits that the stakeholders get from the disclosure is a determinant of supply of information. Market failures based on underproduction of information is therefore addressed with MD regulations, which also help to weaken the self-interests of the management in not releasing adverse information to the markets.

MD of information is generally addressed as the necessity of market discipline and as a reaction to market failures emanating from lack of production of information that people are ready to buy. The discussion includes its advantages over the potential drawbacks of its absence, and the benefits and costs analysis of MD regimes has produced other

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[337] J.L. Zimmerman, 'Taxes and Firm Size' (1983) 5 Journal of Accounting and Economics 119.

[338] Steve E. Kaplan and Robert G. Ruland, 'Positive Theory, Rationality and Accounting Regulation' (1991) 2(4) Critical Perspectives on Accounting 361,370.

[339] John Dowling and Jeffrey Pfeffer, 'Organizational Legitimacy: Social Values and Organizational Behavior' (1975) 18(1) Pacific Sociological Review 122.

arguments such as non-disclosure, voluntary disclosure, and selective or one-on-one disclosure.[340] As discussed in Chapter 1, public-goods nature of disclosed information cuts down private incentives to produce it and therefore available information is assumed to be less than socially optimal. One of the justifications of the MD regime includes positive externalities produced via individual firms' information provision to capital markets such that disclosure gives signals about other firms' securities and gives other firms incentives to disclose and enhance the competition.[341] Other justifications are about agency problems[342] and the need for standardization.[343] These discussions about limits, pros and cons of MD regimes are indeed to be continued.

The conceptualisation of transparency via the MD regime therefore requires different arguments to be considered. The first is that there is a cost to transparency. This includes direct costs such as production, storing, certifying or authorisation of information. Moreover, some activities in finance might require opacity rather than transparency because the expectation of greater transparency might reduce the willingness of financial intermediaries to produce information.[344] A further argument is that, as Chapter 2 established the base, transparency can be disruptive to financial stability. First, this happens when the economic agents who process the information do not have the same

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[340] For the discussion see Coffee (n 9); Frank H. Easterbrook and Daniel R. Fischel,'Mandatory Disclosure and the Protection of Investors' (1984) 70 Virginia Law Review 669.

[341] Michael D. Guttentag,'An Argument for Imposing Disclosure Requirements on Public Companies' (2004) 32 Florida State University Law Review 123,140-65.

[342] The problem is between the managers and shareholders mentioned previously in this section. Jensen and Meckling (n 332).

[343] Luca Enriques and Sergio Gilotta,'Disclosure and Financial Market Regulation' in Moloney, Ferran, and Payne (n 254) ch 17.

[344] Augustin Landier and David Thesmar,'Regulating Systemic Risk Through Transparency' (2011) National Bureau of Economic Research WP: 17664 (accessed May 17, 2015) http://www.nber.org/papers/w17664.pdf.

level of sophistication to grasp it. This means there is a negative correlation between the complexity of the released information and the level of information asymmetry between the agents. Second, public disclosure can create coordination failures, such as in the case of bank runs. Agents collectively become more susceptible to common noise. Its relation to financial stability can be seen in their coordinated response to certain information.[345] Third, regardless of the underlying reasons for the fire sales, disclosure of holdings of distressed firms might exacerbate fire sales and predatory trading which can end up producing systemic disruption of the whole financial system. The final one is on disclosure by confidence-driven firms, ie banks, and agents' reaction to adverse information on which is scattered across different parts of this thesis.

Academic literature has adopted the philosophy of MD regime as it facilitates informed investment decisions, prevents fraud, lessens information asymmetry and boosts confidence in the capital markets. Investor protection, market fairness, allocational-, institutional- and operational- efficiency and transparency in market operations are therefore ensured via MDs. Yet, lengthy and complex disclosures, investors' inability to understand disclosed information, and reliance on flawed assumptions of investors' rational behaviour have been general criticisms by those stating MD does not efficiently deliver anticipated results.[346]

3. Implementation of Disclosure Policies in the Banking Industry

Bank disclosures as means of providing transparency have gained more importance in the

[345] Morris and Shin (n 13).

[346] S. M. Solaiman,'Revisiting Securities Regulation in the Aftermath of the Global Financial Crisis' (2013) 14 The Journal of Investment & Trade 646.

world since the late 1990s[347] and a large number of studies have focused on different aspects of information disclosure in the market.[348] Whether the market remunerates disclosures of banks has been set out since the BCBS made public disclosure requirements an inbuilt part of the capital adequacy system.[349]

Lack of transparency of banks has been seen as one of the reasons of financial crises[350] and transparency is largely taken as the main component of an efficient and stable banking and financial system.[351] According to this view, the underlying reason for the non-performance of financial markets is bank stakeholders' (including the government) lack of information to gauge the bank's financial situation during financial stress. The main cause of the collapse of interbank markets during the subprime crisis was defined as the asymmetric information, which rationalizes the prolonged nature of interbank market

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[347] Karl Dayson, Pal Vik, Dory Rand and Geoff Smith, *A UK Banking Disclosure Act: From Theory to Practice* (Friends Provident Foundation 2012) 10.

[348] For example, R.E Verrecchia,'Essays on Disclosure' (2001) 32 Journal of Accounting and Economics 97; P. M. Healy and K.G. Palepu,'Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of Empirical Disclosure Literature' (2001) 31 Journal of Accounting and Economics 405. Also see Goldstein and Sapra (n 15) 12.

[349] BCBS, 'Public Disclosure of the Trading and Derivatives Activities of Banks and Securities Firms' (1995-6-7); 'Enhancing Bank Transparency' (1998-99); 'Sound Practices for Loan Accounting and Disclosure'(2000);'Public Disclosure by Banks'(2001-2-3); 'Financial Disclosure in the Banking, Insurance and Securities Sectors: Issues and Analysis' (2004); 'Revised Pillar III Disclosure Requirements'(2015).

[350] Financial Stability Forum, 'Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience' (2008);OECD, 'The Financial Crisis: Reform and Exit Strategies'(2009); International Bar Association, 'Task Force on the Financial Crisis' (2010); Financial Crisis Inquiry Commission,'The Financial Crisis Inquiry Report'(2011); BCBS, 'Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems'(2011).

[351] Enhanced transparency is the main recommendation of the de Larosiere Report that analyses the organization of supervision of FIs and markets in the EU. Comparable recommendations are also set forth by the UK's Turner Review and the Group of 30 Report.

tensions.[352] In the same vein, most of the bank runs in the US starting from the 19th century were accepted as the outcomes of insufficient depositors' information about the solvency of the banks.[353]

Here, disclosure and transparency may be thought as synonymous or interchangeable terms, but actually there are some subtle differences between them.[354] For instance, there is no direct guarantee that released information is received and comprehended in the correct way by the market.[355] As O'Neill states: 'Transparency counters secrecy, but it does not ensure communication.' [356] Disclosure might therefore provide higher information but not automatically higher transparency because transparency should be supported by analytical placing of information into useful and purposeful contexts.[357] Further, considering the intricate transactions and high-risk exposures of banks, the mere provision requiring extra information might not necessarily lead the bank to be more transparent.[358]

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[352] Florian Heider, Marie Hoerova, Cornelia Holthausen,'Liquidity Hoarding and Interbank Market Spreads:The Role of Counterparty Risk' (2009) ECB Working Paper Series No: 1126 at 6 (accessed March 16,2017)https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1126.pdf.

[353] Gary Gorton,'Banking Panics and Business Cycles' (1988) 40 Oxford Economic Papers 751.

[354] 'Openness might therefore be thought of as a characteristic of the organization, where transparency also requires external receptors capable of processing information made available.'David Heald,'Varieties of Transparency' in Christopher Hood and David Heald(eds), *Transparency: The Key to Better Governance?* (OUP 2006) 26.

[355] Nicole Allenspach,'Banking and Transparency: Is More Information Always Better?' (2009) Swiss National Bank Working Papers 2009-11 at 2 (accessed May 23, 2016) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1524702.

[356] Onora O'Neill,'Ethics for Communication?' (2009) 17 Eur J Phil 167,170.

[357] Remarks by former Fed Chairman Alan Greenspan (accessed July 12, 2016) http://www.federalreserve.gov/BoardDocs/speeches/2003/20030508/default.htm.

[358] Mohamed A. Elbannan and Mona A. Elbannan,'Economic Consequences of Bank Disclosure in the Financial Statements before and during the Financial Crisis: Evidence from Egypt' (2015) 30(2) Journal of Accounting, Auditing & Finance 181,186.

Policy proposals such as Basel Accord III have offered new disclosure rules and increased quantity of information given by the banks for several purposes such as preventing a possible crisis based on a contagion effect, protecting depositors and shareholders of the bank, increasing market discipline in the market, and so on. Though the aim of disclosure regulations can be justified on those grounds, there remains the question whether these initiatives have been useful, since a variety of causes can be asserted to approach overly detailed bank disclosures with suspicion.[359] Greater transparency in banking may not be as apparent as seen in other sectors.

The availability of all information does not necessarily mean transparency, because parameters designing the efficiency of transparency are also related to content, timing, accessibility, and the perception of market participations to see that information. Disclosure is not an end itself to provide transparency, which suggests that the quality of the information disclosed is also relevant such that it must conform with economic reality, be comprehensible, be explanatory about the risk profiles and risk management, and follow the high accounting standards.[360] Further, such meaningful disclosures must be supported by statutory liabilities with credible sanctions. Therefore, the premise summarized as ‘if it is disclosed, it is transparent’ might oversimplify the meaning of transparency.

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[359] Ursel Baumann and Erlend Nier,‘Disclosure, Volatility, and Transparency: An Empirical Investigation into the Value of Bank Disclosure’ [2004] FRBNY Economic Policy Review 31.

[360] Andrew Sheng,‘Disclosure Regulation:The Role of Intermediaries’ in Asia Pacific In-House Counsel Summit’ (accessed July 14, 2016) https://www.iosco.org/library/speeches/pdf/disclosure_regulation_role_of_intermediaries_mar05_as.pdf.

According to Baumann and Nier, bank transparency can be measured by three indexes.[361] First, a publicly traded bank has to comply with the stock exchange's binding rules on transparency, so transparency here is warranted by such binding rules based on maximum transparency. Second, bank ratings are important indicators of transparency. It is suggested that if a bank is estimated by a well-known CRA, then this can be taken as a credible indicator of transparency as there is a constant information flow from bank to the CRA. Last, financial statements related to the bank's risk analysis (including interest rate risk, market risk, credit risk, and liquidity risk) in the bank's annual reports show the level of transparency. [362] It is interesting that the last measure does not regard the non-financial information of banks as criteria of transparency and ignore other factors such as periodicity, accessibility, and completeness of information as in the case of disclosures directed to investors. If one accepts that any piece information of FIs is classified as financial information, then all kinds of information of banks must be considered as financial by nature. In the same work of Baumann and Nier, financial information is accepted as the mere information in the bank's annual reports and therefore the rest of the information, which is non-financial in nature, is not taken as a factor which may affect transparency of a bank.

Moreover, other researchers have formed different factors to evaluate the transparency of a bank. For instance, Tadesse suggests different variables to measure bank transparency: the quality of disclosure, disclosure of private information, and director liability (strong auditing measures).[363] The frequency, lag and granularity of disclosures might also be

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[361] Ibid.

[362] U. Baumann and E. Nier,'Market Discipline and Financial Stability:Some Empirical Evidence' (2003) 14 Bank of England Financial Stability Review 134.

[363] Solomon Tadesse,'Banking Fragility and Disclosure: International Evidence' (2005) William Davidson Institute Working Paper No:748 (accessed June

indicators of transparency. As seen from those empirical studies in finance, there can be various criteria to measure transparency of banks and disclosure itself is not the only criteria for transparency.

The support of disclosure is fed by a very straightforward view, which is based upon the idea that more disclosure provides more information regarding to the bank's risk exposures and liquidity position (which is taken as one of the most important disclosure items for a bank to reveal its true financial standing) and therefore the market price of the bank reflects its true value in the market. In terms of price efficiency, bank disclosure is said to help allocate the resources more wisely and correspondingly discipline insiders of the bank. To give an example, in the case of risky operations, such risks would be impounded in the bank's debt and equity claims and market prices of the bank would be automatically oriented into the new information and this is a desirable feature of efficient markets. Thus, under these conditions, price formation of a bank share will depend on the nature of the news, which means that any information that can be considered bad by the market will cause the bank to raise fewer funds and behave more prudently, as well as make less risky decisions. In the same vein, it has been asserted that the absence of information will cause depositors/lenders to require higher deposit rates on their agreements with the bank.[364] This is the very basic idea of market discipline.

It has been found that disclosure practices affect both the capacity of the financial system to absorb shocks and the bank structure so that in cases where there is information asymmetry between the investors or where bank managers keep more information

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18,2016)https://deepblue.lib.umich.edu/bitstream/handle/2027.42/40134/wp748.pdf%3Bsequence=3.

[364] Jensen and Meckling (n 332).

compared to outsiders, the rise in the cost of issuing equity becomes more apparent.[365] The increase in the cost of issuance of equity suggests a more leveraged bank, which is associated with a less robust financial system. So, disclosure appears to be a necessity from this angle.

On the other hand, the problem of excessive risk taking of the bank, which is – as widely accepted – suppressed by disclosure regulations, is still of importance even though the sufficient information related to the financial situation of the bank is released to the market, since the existence of deposit insurance schemes or other such guarantees provided by the state creates a moral hazard problem.

Thus, from the positive side, disclosure practices in banking are seen as a tool to reduce agency problems occurring among bankers and creditors and thereby lessening the threat of expropriation, strengthening the confidence of market participants in the banking sector, and providing stability and competition to the financial community. So, provision of information is well acknowledged and the rationales underpinning MD as opposed other disclosure regimes are manifold.

Specific to bank MDs, two observations should be made based on the very nature of the banking business. First, banks – as public companies – issue securities and invest in assets with values generally unknown to outside investors.[366] This is one of the features that

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[365] S.C. Myers and N.S. Majluf,'Corporate Financing and Investment Decisions When Firms Have Information That Investors do not Have' (1984) 13(2) Journal of Financial Economics 187 cited from R. Sowerbutts,P. Zimmerman and I. Zer,'Banks' Disclosures and Financial Stability' (2013) Bank of England Quarterly Bulletin Q4 326,327.

[366] Mikail Frolov,'Why do We Need Mandated Rules of Public Disclosure for Banks? (2007) 8(2) Journal of Banking Regulation 177,181.

makes banks different from other publicly traded companies because bank assets are financial assets (mostly loans) and therefore banks might quiescently shift risk to the investors. Second, the inherent nature of bank assets provides that bank assets informationally opaque. Bank loans are privately negotiated and borrower-tailored agreements in spite of the increasing prosperousness in the quality and quantity of the information about the price and trading activity and the risks residing in bank loans, therefore, are difficult to be captured and managed.[367]

Commercial banks provide loans to borrowers of a publicly unknown quality and, in the case of non-tradable loans, the quality of the loans is only available to the lender bank due the fact that collection, monitoring, and production of borrower information is performed by the bank. Consequently, one might think that a bank with assets which are centred upon loans might be riskier due to the opaque nature of the assets.[368]

MD of bank information might therefore be more important under inherent opacity that the functioning of the bank offers in the first place. On the other hand, there is one more argument should be pointed out. As discussed, credit decisions of banks are accomplished through the use of private information that is not accessible by the general public. So, financial contracts and other loan information cannot be interpreted properly with the

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[367] Alan Greenspan's speech delivered at Financial Markets Conference of the Federal Reserve Bank of Atlanta on Feb 23,1996 (accessed May 12,2015)https://fraser.stlouisfed.org/scribd/?item_id=8561&filepath=/files/docs/historical/greenspan/Greenspan_19960223.pdf&start_page=1.

[368] D.P Morgan,'Judging the Risk of Banks: What Makes Banks Opaque?' (1997) FRBNY Report No: 9805(accessed May 1,2015) https://www.newyorkfed.org/medialibrary/media/research/staff_reports/research_papers/9805.pdf.

information disclosed on public statements.[369] Accentuated point here is that greater emphasis should be given to reliability and accountability of bank supervisory agencies so that private information utilised for loans might truly be represented on bank disclosures. Regardless of the disclosure regimes, mandatory, voluntary or selective, as long as it is not supported by the supervisory agencies, the core information about the main artery of the banking business might remain opaque.

It can be said that the main business of commercial banking might be interrupted to the extent that MD regulations apply to information that causes such opacity in the first place because the information of loans is a product of private collection, screening, and other such efforts associated with large costs. The costs argument is not bank-specific, but the content of the information and the time and sources spent on acquisition and production of such information might be significant simply because it is the main job of a commercial bank. Accordingly, removing the lending incentives of the bank via MDs is not just related to private costs; the nature and type of the information that the bank keeps is of importance.

MD regulations, in this respect, might serve as a minimum ground for the effective flow of information between market participants. The costs and benefits of mandated disclosure are complex, and they involve the classic argument between scholars and regulators as to efficiency or legitimacy and also whether they are a central doctrine of ensuring transparency in the market. That is, current regulations suggest that the language

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[369] Eric Rosengren,'Will Greater Disclosure and Transparency Prevent the Next Banking Crisis?' (1998) Federal Reserve Bank of Boston Working Papers No: 98-8 (accessed March 16, 2015)https://www.bostonfed.org/publications/research-department-working-paper/1998/will-greater-disclosure-and-transparency-prevent-the-next-banking-crisis.aspx.

of transparency is communicated through MD regulations and in this respect the rationale of MDs should be revisited prior to the examination of such rules for the banking industry.

4. The Relation between Bank Disclosures and Market Discipline

As a desirable and necessary part of the today's regulatory disciplines, the term market discipline generally describes a situation where the stakeholders of the firm who are at risk of financial loss as a result of the firm's decisions can discipline the firm by the application of their market monitoring and influence functions.[370]

Market monitoring means that bank stakeholders monitor changes within the bank and, more specifically, those changes related to the riskiness of their claims and then proceed with their transactions depending on the information collected via monitoring. Market influence, in this respect, means that firm's risk taking is affected and consequently is changed based on the investor's behaviours and choices so that investors bring about risk management motives.[371] Depositors are not investors in a sense that they have no voting power to change the management of the bank and therefore to change the bank's behaviour towards its risk taking. Depositor reaction to bank management might be withdrawing the funds from the bank. Depending on the circumstances, and as it will be discussed in detail here; the magnitude of the result of such depositor reaction differs. For example, the risk of moving funds might be unrealistic in a market with weak competition because in such an environment, withdrawing funds from one bank and placing in another might not mean that depositors might effectively control the risky activities of banks; and rather, in these cases it is the regulators to control and prevent exposures to risky activities

[370] Robert R. Bliss and Mark Flannery,'Market Discipline in the Governance of US Bank Holding Companies: Monitoring vs Influence' (2002) 6(3) European Finance Review 361.
[371] Jochen Kuhn, *Optimal Risk-Return Trade-Offs of Commercial Banks* (Springer 2006) 52.

of banks. The circumstances of the market, that banks operate in, might be relevant to the level of regulatory discipline exerted by regulators and capital standards or safety and soundness regulations are just part of the variables affecting the bank's risk taking.

The public interest in maintaining a stable banking system has offered different views such that incompetency of regulatory discipline in exercising regulatory good than public good has highlighted the market discipline both as complementary and as individual regulatory tool.[372]

The confidence of depositors is of importance for the market so that depositors can act in the way that the exercise of market discipline requires: to control the risk taking of the bank and therefore discipline them into operating with the optimal risk. Here, regulation plays an important role to establish the optimal grounds for depositors to apply disciplining effect.

It has been stated that depositors and uninsured debt-holders in particular have a large impact on such risk management motives: a bank's riskiness is highly influenced by depositors because of the potential bank runs that may emanate from sudden and frequent withdrawals or other behaviour affecting the bank's risk-taking behaviour such as depositors refusing to rollover funds or asking for higher-risk premiums or collateral.

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[372] John A. Allison,'Market Discipline Beats Regulatory Discipline' (2014) 34(2) Cato Journal 345.

A bank's level of risk is also affected by debt-holders holding large debt claims because they have the capacity to worsen the bank's refinancing ability and terms.[373] Those groups with a high degree of monitoring incentives resulting from a fear of bank failures and the existence of deposit protection schemes do not help subordinated debt-holders and shareholders whose claims are not subject to state-backed protection schemes. Therefore, both private sector agents and regulatory authorities that monitor banks are the main pillars of market discipline. Particularly after the GFC, market discipline has been the hot topic based on the premise that state intervention in banks could be experienced by way of the government's backup of banks in the form of blanket guarantees, liquidity support, or other such failure-prevention devices, and the application of such bank-protection measures has weakened the market discipline.[374]

The application of the modern theory of corporate finance on banks reveals the contradictory interests of depositors and shareholders.[375] Shareholders of a bank have one main aim, which is to boost the value of the firm reflected in the market share, stock price, or profitability of the bank. For this reason, they tend to support high-variance (and necessarily risky) activities that are essentially funded by the depositors' money. Depositors, on the other hand, are not residual claimants and their incentive in monitoring the bank's activities is to protect the money credited to the bank and to ensure the

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373 CW Smith and RM Stulz,'The Determinants of Firms' Hedging Policies' (1985) 20 Journal of Financial and Quantitative Analysis 391.

374 Viral V. Acharya and Nirupama Kulkarni,'Government Guarantees and Bank Vulnerability during the Financial Crisis of 2007-09' (2014) NYU Working Paper (accessed July 7, 2016)http://pages.stern.nyu.edu/~sternfin/vacharya/public_html/pdfs/IndianBanking_AcharyaKulkarni%20(2).pdf.

375 Daniel Fischer, Andrew Rosenfield and Robert Stillman,'The Regulation of Banks and Bank Holding Companies' (1987) 73(2) Virginia Law Review 301,314-17.

performance of fixed claims.[376] Thus, contradictory approaches desired by depositors and shareholders at some point merge on the need to monitor the bank's final disposition in the event of failure.

Borrowers, as one of the stakeholders, also have interests in the general healthiness of the bank with which they have a relationship. One may therefore say that they might have a portion in disciplining banks. Borrower-related data, which covers a variety of items such as past borrowing experiences, deposit flows, repayment habits, or information pertaining to management, control, or quality/quantity of products, is held by the bank to assess risks and to decide whether to extend or renew a loan. Therefore, durability of the communication patterns and experience evolved through the course of the lending relationship will be interrupted if a bank fails and the borrower will ultimately be affected by such losses.[377] Considering the firms without having access to public debt markets, borrowing from banks stands as an important source of funding and, for those firms, the soundness of the bank is of great significance since any failure of the bank might place the company at risk of bankruptcy by cutting the main artery of its liquidity.[378]

In consideration of attracting funds from depositors, bank management might voluntarily limit its risk taking and this might suggest that market discipline is sufficiently competent to be an alternative to bank regulation.[379] Advocators of a system based on market

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[376] Ibid 314.

[377] Myron B. Slowin,Marie E. Sushka and John A. Polonchek,'The Value of Bank Durability: Borrowers as Stakeholders' (1993) 47(1) The Journal of Finance 247,249.

[378] Diamond,'Monitoring and Reputation:The Choice between Bank Loans and Directly Placed Debt' (n 132).

[379] A.D. Mathewson,'From Confidential Supervision to Market Discipline: The Role of Disclosure in the Regulation of Commercial Banks'(1986) 11(2) The Journal of Corporation Law 139.

discipline exerted by depositors highlight the importance of bank disclosures to enable depositors to act upon the risk level of the bank and therefore they disregard the overreaction and possible irrational behaviours of depositors.

The possibility that the government covers the loss incurred by the depositor in the event of bank failure is an incentive for banks to invest in risky projects, which serves the purposes of bank shareholders, and this situation is described with the famous phenomenon of the problem of moral hazard. Intervention by the use of regulatory devices such as deposit protection measures appears to be an impeding factor in terms of achievement of market discipline; but even in the absence of such state backups, depositors might not in practice provide the disciplining effect on the bank's riskiness.[380] According to Garten, in a world without deposit protection or other safety net systems, depositors still do not provide a disciplining influence over banks because depositors do not consider risks in the same way as investors do because they are more interested in factors whereas depositors concerned about risks are the ones with large sums of capital.[381]

Further, the disciplining influence that depositors provide would be generally so severe that catastrophic consequences such as bank runs are highly possible and therefore market discipline exerted by depositors is negative and disadvantageous.[382] This view suggests that the responsiveness of depositors towards bank risks does not necessarily mean that market discipline exerted by such sensitive depositors will provide positive influence in

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[380] Helen A. Garten,'Banking on the Market: Relying on Depositors to Control Bank Risks' (1986) 4(1) Yale Journal of Regulation 129,130.
[381] Ibid 131.
[382] Ibid 132.

controlling the riskiness of the bank because the pure idea of market discipline emanates from the premise that depositors are sensitive to bank risks and a high level of riskiness will lead to them demanding a risk premium and a necessary degree of compensation in proportion to risks involved.

The depositor-based capital of a bank comes from the depositors with short-term deposit accounts or with small amounts of money who are under the protection of deposit insurance schemes. Those holding large amounts of money in the bank accounts tend to be sophisticated depositors and can be considered as depositor-investors. However, deposit size, as a criterion of market discipline might also be illusory because those depositors might simply be unconcerned about the bank's riskiness and might view the bank as a substitute safe box. Yet, deposit size might be relevant if adverse information of the bank is released and depositors holding funds under the specified limit of the deposit insurance react to such information by immediately withdrawing their funds without notice, particularly where they are unsophisticated and cannot tell the difference between true information and market rumour. This supports the premise that those depositors are highly likely to exert market discipline *ex post*, which means market discipline would be experienced in the form of bank runs. On the other hand, depositor-investors, who are supposed to exercise market discipline *ex ante*, consider the risk and the return as deciding factors to deposit money in a bank and in this sense; deposit accounts might be investments for them.[383] It means bank information disclosure is important for these groups.

[383] G. Benston and others, *Perspectives on Safe and Sound Banking: Past, Present and Future* (MIT Press 1986) 131-176.

Depositors with credits exceeding the maximum specified amount for the deposit insurance divide their deposits into smaller (and therefore insured) amounts so that there is an application of market discipline by those uninsured depositors, but this type of market discipline does not serve the expected purpose of market discipline.[384] Therefore, the funding of the bank is important here because if the size of the retail deposits is larger than wholesale deposits, holders of small deposits will be the driving force in stressful times. So, when investor-depositors are relatively less in number and amount, it might mean it does not provide as much as disciplining effect as one thinks.

It should also be noted that their behavioural reflections to the negative news about the bank might be exactly the same as other depositors in removing their money from the bank or banking system or in liquidating their investments instantly. However, it should be borne in mind that demand accounts generally consist of the initial, and maybe the only, source of liquidity for the depositors and the assertion that depositors protected by a deposit insurance system are not concerned with the financial healthiness of the bank during the relationship might be unsound. The assertion that those small holders of the bank's liabilities lack resources, technical skills and incentives in monitoring is one of the on-going debates; but the effect of the adverse information in the market shows itself in sudden withdrawals by depositors and the risk of systemic risk and bank runs. Empirical studies on the private agent monitoring of bank riskiness are dissenting, but the negative effect associated with 'first come, first served' is obvious when adverse information is released during stressful times.[385]

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[384] Stephen K. Huber,'Mandatory Disclosure of Information About Banks' (1987) 6 Ann Rev Banking L 53,69.

[385] R. Sowerbutts and P. Zimmerman,'Market Discipline, Public Disclosure and Financial Stability' in E Haven and others(eds), *The Handbook of Post Crisis Financial Modeling* (Palgrave Macmillan 2016) 42-64.

Investors, on the other hand, would like to control the management to assure the well-being of their shares and bonds, and this causes inevitable agency costs, which can be mitigated by disclosures, and therefore investors can influence the management in taking decisions. The premise establishes that investors are more detailed-oriented since they are expected to interpret the bad loans and low earnings of the bank compared to depositors that only responds to institutionally life-threatening information might be useful for designing the appropriate extent of public disclosures.[386] As a distinction made between the depositors and shareholders, another division between shareholders and debt-holders should be set out in terms of understanding the source of market discipline coming from different motives. Based on the nature of risk linked to their investments, stockholders and debt-holders might expect different perspectives from the bank management as a consequence of inherent conflict of interests among the residual and fixed claimants.[387]

The contract between the bondholder and the bank is not formed depending on the level of risk per se; rather, it is made by using the overall view of transparent and foreseeable information related to the risks that the debt-holder takes as base.[388] A bondholder's position as a fixed claimant means that they supply capital to bank capital for a fixed term at a fixed rate or at a rate subjected to short-term market interest rates. Because the rate of return is already designated, there are no further advantages; but depending on the decisions taken by the bank, there are always potential downsides associated with the risk because there is always a possibility that the bank can invest in riskier projects compared the time that the bondholder had invested in. Therefore, a debt contract does not involve

[386] Stephen K Huber (n 384) 71.

[387] Respectively shareholders and bondholders.

[388] Bliss and Flannery (n 370) 367.

benefits depending on the bank's financial success but rather it might cause the bondholder to bear the risks in case of loss, and this situation highlights the importance of risk transparency so that bondholders can see the risks and price them accurately using coupon rates before investing. Following changes in the credit and market risk of the bank is reflected in the coupon and increases in the level of risk disturb the value of the bondholder's claim. Accordingly, there is a connection between the information and the cost of a debt since bondholders look upon the accounting information in pricing the bond.

Conventional corporate finance theory also applies to banks where both shareholders and bondholders expect contradictory investments from the bank. The assumptions made for the firms such as '… a production plan that maximizes shareholder wealth does not maximize bondholder wealth, or vice versa'[389] or the premise that shareholders do not consent to lucrative investments if the return only satisfies bondholders, might be applicable for the banking industry with one exception –its financial soundness is generally a matter of the financial healthiness of the whole system.

While shareholders, as previously mentioned for the case of depositors, aim for high-risk investments, which present high returns above the fixed debt charges,[390] bondholders demand the promised return, and therefore low-level riskiness is desired. This situation represents the incompatible investment strategies by investors such that shareholders pursue a pushing and dynamic way of influencing the bank management and bondholders search for the optimal degree of riskiness, which seems more compatible with the goals

[389] E.F. Fama and M. Miller, *The Theory of Finance* (Holt 1972) 179 cited from Clifford W Smith and Jerold B Warner,'On Financial Contracting: An Analysis of Bond Covenants' (1979) 7 Journal of Financial Economics 117. It applies to depositors, too.

[390] Helen A. Garten,*Why Bank Regulation Failed* (Quorum Books 1991) 26.

of market discipline. The existence of debt-holders in the first place might be the reason for the aggressive approach of shareholders towards high risk taking based on the fact that shareholders are paid depending on the profits after debt charges paid. They are also different in terms of the management of assets of the bank, so that in the event of a bankruptcy, bondholders have priority over shareholders and this means that, bondholders' interests in the bank's assets maintenance and dividend policy might be higher than shareholders.

The legal obligation putting debt-holders above shareholders in bankruptcy might also suggest that the burden of market discipline is on the shoulders of the shareholders as well. Further, another conflicting interest could be seen in the divergent approaches concerning leverage because the issuance of new additional debts by the bank suggests the dilution of the position of the present debt-holders. An increased number of payments made to the new debt-holders are also undesirable for shareholders, but the capital gained from new debt-holders means greater financial power for risk taking and therefore shareholders may take advantage of the leverage, particularly if the newly issued debts consist of inexpensive financing.[391]

Bank exposures in the interbank market lead to another type of discipline exerted by peer banks. This type of interbank discipline is part of market discipline that implies banks have strong economic incentives to monitor their counterparties because they have myriad links with other banks that expose them to credit risks. As such, banks themselves are disciplinarians in the sense that they react to other banks' risk profiles and respond accordingly.[392] However, the response of peers to adverse market conditions (liquidity

[391] Smith and Warner (n 389) 118-122.

[392] Kathryn Judge,'Interbank Discipline'(2013) 60(5) UCLA Law Review 1.

scarcity or unwillingness of government to support weak FIs during difficult times) does not necessarily serve the goals of discipline because, as discussed in Chapter 2, liquidity hoarding and interbank freezes are a commonality of distressed markets with a lack of confidence.

4.1. Relationship between Market Discipline and Deposit Insurance

In the light of this information presenting the inherently contradictory interests of shareholders and debt-holders and different motives of other bank stakeholders such as depositors, borrowers or peer banks in monitoring banks' standing, one can see how information regarding the bank's risk exposure is important, even if they pursue conflicting strategies for their own interests. However, as mentioned, the presence of deposit insurance schemes is a distortion on the incentives of monitoring and therefore it cuts down the need of information for those. The deposit insurance system, as a safety net element, is a part of the social mechanism concerned with distressed banks and accompanying social costs emanated from bank failures and as a matter of principle it is designed to prevent spillover effects and systemic risk by accommodating a degree of risk sharing in the financial system.[393] Safety nets are augmented or extended specifically during a period of banking instability[394] to make depositors respond to a 'wake-up call' in a less vigilant and more unruffled manner.

The numbing effect of explicit deposit insurance schemes or *de facto* government backups implies a trade-off between market discipline and the protection of public confidence via

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[393] A. Demirguc-Kunt and E. Detragiache,'Does Deposit Insurance Increase Banking Stability? An Empirical Investigation' (2002) 49 Journal of Economics 1373.

[394] Asli Demirguc-Kunt, Edward Kane and Luc Laeven,'Determinants of Deposit Insurance Adoption and Design' (2008) 17(3) Journal of Financial Intermediation 407.

depositor protection schemes, because measures taken to mitigate bank failures and runs actually weaken other forces supporting the stability of the banking system.[395] As the theory of market discipline allows some bank failures based on the elimination of badly managed and unsound banks from the financial system, the augmentation effect of systemic failures on the bank crisis has created such safety net provisions. The conventional discussion about the deposit insurance systems, namely the problem of moral hazard, has been addressed with strengthened monitoring of banks by the regulatory authorities in order to prevent excessive risk taking disadvantageous to interests of depositors and investors.[396] Accordingly, prudential initiatives of regulators to monitor banks and implement enhanced disclosure standards have made it possible to mention the disciplinary role of the supervision. Greater transparency in risk taking and financial reporting has therefore been one of the main pillars of BRAs.

Existence of deposit insurance schemes allows banks to raise capital from persons who have lack of monitoring incentives, and as a classic argument to safety net arrangements, deposit insurance systems not only cause moral hazard by encouraging banks to take more risks than optimal (based on the view that while they can enjoy the benefits from risky activities since the government will cover the failures) but also might create a TBTF problem because the bank's ability to lower the cost of funding based on safety nets might incentivize banks to become larger and maybe more systemically important.[397] Therefore,

[395] Charles Calomiris,'Building an Incentive-Compatible Safety Net' (1999) 23(10) Journal of Banking&Finance 1499.

[396] H. Osano and T. Tachibanaki, *Banking, Capital Markets and Corporate Governance* (Palgrave 2001) 140.

[397] Robert R. Bliss,'Market Discipline: Players, Processes and Purposes' in W. Hunter, G. Kaufman, C. Borio and K. Tsatsaronis(eds), *Market Discipline Across Countries and Industries* (MIT Press 2004) 37-53.

the successful application of market discipline is discussed with the elimination of the TBTF problem and lack of transparency. A global regulatory agenda has provided some solutions to limit moral hazard including risk-adjusted deposit insurance systems, rules requiring banks to issue certain numbers of subordinated debt,[398] or more intensive monitoring by the prudential and supervisory agencies.[399]

Managers, in this scheme, have to deal with such contradictory interests including their self-interests. Both bondholders' and shareholders' interests accord with bank profitability, and poor management and poor investments are the reason for the need of information about the management and its activities. Regulators, on the other hand, also have incentives in the application of market discipline as agents of the public interest, such that the raison d'être of supervisory mechanisms is to ensure the stability and soundness of the banks and financial system. Regulatory monitoring and examining form an important part of prevention of bank failures or systemic risk; in this respect, collection and verification of the screened information by the regulators is a part of regulatory discipline.

The combination of regulatory discipline and increased transparency, therefore, can be seen as the combination of market monitoring and supervisory monitoring which might relieve the regulator's burden in monitoring if market discipline is effectively exercised.

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[398] It is discussed that the level of discipline in capital markets could be enhanced by making issuance of subordinated debt mandatory with regard to support regulatory capital because holders of the subordinated debts are junior claimants with exposure to maximum possible loss. So, they come before depositors and shareholders to assert disciplining effect over banks. A. Afzal and N. Mirza, 'Market Discipline in Commercial Banking:Evidence from the Market for Bank Equity' (2011) 16 The Lahore Journal of Economics 233,252.

[399] Heidi M. Schooner and Michael W. Taylor, *Global Bank Regulation: Principles and Policies* (Elsevier 2010) 64-67.

Ex ante market discipline is curtailed by elements such as bailouts or deposit insurance schemes, which are the products applied as a result of regulatory discipline. Coexistence of *ex ante* and *ex post* market discipline is therefore an arduous task for regulators, and disclosure is taken and enforced as a complementary and viable solution to the application of market discipline.

As it is also highly supported by the BCBS, basic idea of market discipline asserts that surveillance of banks is deemed a mechanism to encourage banks to behave prudently. Nevertheless, it is argued that the BCBS concept of market discipline is different than the conventional thinking as perceived in securities law, which takes the market discipline as a pressure to change the management behaviour for the benefit of shareholders and rather, the BCBS has used the term market discipline for highlighting the well-being of the bank itself and stability of the financial system as being different from conventional understanding.[400] Though underlying philosophies differ, application of market discipline is generally seen useful overall. So, the idea of confidential supervision is outdated as disclosure is supported both by bank supervisors and securities markets regulators.

The bank's risk profile can be affected by the screening activities of its market signals. By way of example, disclosure of a high level of counterparty risk by the bank might cause its counterparties to limit or stop their transactions with the bank, and in a similar vein, bank supervisors might urge the bank to lessen its risk taking based on such information.[401] Updated bank information, in this context, has the power to change market prices of bank-issued securities by creating both market and regulatory pressure

[400] Henry T.C. Hu,'Disclosure Universes and Modes of Information: Banks, Innovation and Divergent Regulatory Quests' (2014) 31(3) Yale Journal on Regulation 565,606.
[401] Ibid.

on bank management. However, it is still a debatable issue whether the theory of market discipline satisfies real-life practices.[402] It has been asserted that the securities issued by banks reveal the bank risk taking precisely, but this sort of market discipline is not seen as being sufficient to have effect on the whole risk taking of banks because the bank might still have a high level of risk as long as the bank and its depositors are accordingly compensated for bearing those risks.

Overall, market discipline in the banking industry has a prominent place and, as the BCBS highlights, 'the provision of meaningful information about common risk metrics to market participants is a fundamental tenet of a sound banking system. It reduces information asymmetry and helps promote comparability of banks' risk profiles.'[403] The modern regulation of banks is therefore supported by the link among the disclosure and bank's risk taking and the subsequent risk-adjusted performance of banks, which is also beneficial to regulatory agencies so that they can reduce the costs of bank monitoring in the increasing complexity of large banking firms.

Application of effective market discipline depends on the fulfilment of three conditions. First, banks must be obligated to perform prompt and full disclosure of material information regardless of its adverse effects. Second, elimination of weak banks from the market should be allowed and therefore banks should know the potential danger(s) of failure. Last, stakeholders including depositors must bear the loss emanating from bank

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[402] For example,Bliss and Flannery investigated the real effect of market forces over bank decisions and they asserted that stock or bond investors do not have strong effect on the bank managerial behaviour. Bliss and Flannery (n 370).

[403] Revised Pillar 3 Disclosure Requirements (Jan 2015)(Accessed July 18, 2016) http://www.bis.org/bcbs/publ/d309.pdf.

operations.[404] Though the proposals suggesting the change for the deposit insurance and safety net schemes (such as risk-based insurance system) have been contentious areas of discussion, bank information disclosure as a pillar of market discipline is globally given overriding support. Therefore, the argument pertaining to those enumerated three conditions is closely tied to the deposit insurance system and a drastic way to accomplish market discipline is the removal of such system which allows banks to operate on equal grounds as other public companies. Yet, as next chapter will further discuss, the GFC revealed that there are subtle concerns about the efficiency of market discipline.

5. Regulatory Battle between the Capital Markets Regulators and the Bank Prudential Regulators in terms of Bank Information Disclosures

A specific challenge facing the architects of market discipline and disclosure lies in the different motivations of regulators that concurrently regulate banks. A meaningful discussion about the different objectives of bank regulatory and prudential agencies and the capital markets regulator should start from the general understanding of the overall design of the financial regulatory system such that the traditional prudential regulation (protecting the safety and soundness of banks and financial stability in general) and the regulation related to goals of 'investor protection, maintaining fair, orderly and efficient markets and facilitating capital formation'[405] present a bifurcation in terms of objectives pursued and utilised techniques to discharge these aims.

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[404] James C. Treadway,'A Seamless Web: Banks, New Activities and Disclosure' (1983) Keynote Speech, Third Annual Seminar on Securities Activities of Banks at 11(accessed Aug 5,2016)https://www.sec.gov/news/speech/1983/092983treadway.pdf.

[405] See the SEC's website regarding its objectives (accessed June 1,2015)https://www.sec.gov/about/whatwedo.shtml.

Financial stability regulator[406] and the securities regulator, in this respect, might represent the two sides of this distinction. Here, such a segregation of bodies is an abstraction and even though they share common elements such as market integrity, share of responsibilities and their different main goals under the traditional regulatory paradigm might still accommodate such bifurcation.[407]

Maintaining the soundness of the financial system in general and safeguarding consumers and investors from imprudent operators, as common goals of financial regulation, require input from other special agencies empowered with supervision or rule-making authority. The efficient operation of the whole mechanism involving the CB and other institutions necessitates coordination in such a way that regulations created based on the objectives of each regulatory or supervisory organisation should not lead to major conflicts between the organisations that cause uncertainty, confusion and concerns about the enforcement of laws.[408] Instead, the structure of the system should accommodate the deliberation or cooperation grounds for the application of public interests which allows taking the right actions at the right time. Accountability and transparency might be associated with clear lines of responsibility of each regulatory and supervisory body. Though clear-cut and certain designation of responsibilities between the bodies is desirable, depending on the facts of the case, it might cause exertion of pressure by one body over another whose

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[406] Here the term financial stability regulator is used as a generic term implying that both micro and macro prudential regulation also serves for the financial stability especially on the face of redefinition of prudential regulation. Daniel K. Tarullo,'Rethinking the Aims of Prudential Regulation' (2014)(accessed June 11, 2016) https://www.federalreserve.gov/newsevents/speech/tarullo20140508a.pdf.

[407] Chester S. Spatt,'Regulatory Conflict: Market Integrity vs. Financial Stability' (2010) 71 U. Pitt. L. Rev. 625.

[408] Chapter 2,Section 3.1.3.

established rules might be temporarily and underhandedly suspended for higher public interest reasons.[409]

The debate regarding designing optimal supervision and regulation is a well-known one but the mere focus on the structure itself might be mistaken since there are also other factors that form the regulatory concept. According to Taylor, organizational structure is also relevant to other factors:[410] the first one is public policy goals that designate the extent of the trade-off between financial stability and consumer protection; the second is the administration of regulatory rules emanating from those public policy goals, which means the basis, kind and nature of the powers provided to regulatory bodies; the final one is related to the particular methods that each agency uses to conform to their duties. The financial stability regulator and conduct of business and consumer protection regulator follow those three patterns in discharging their duties.

Regulatory goals in providing safety and soundness of the financial system mostly subsume three main headings as financial stability, prudential regulation and market conduct regulation.[411] Thus, efficient banking regulation connotes the simultaneous guarantee of protection of depositors and investors, as well as maintenance of financial stability and the payment mechanism.[412] Within this context, approaches of the bank and securities regulation might stand in stark contrast to each other during times of crisis. As will shortly be discussed, the fundamental divergence might lie in the level of exposure to risk that they put the state generally in if they do not function properly.

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[409] Chapter 4.

[410] Michael Taylor,'The Search for a New Regulatory Paradigm' (1998) 49 Mercer L. Rev. 793,794.

[411] Pan (n 286) 190.

[412] Chapter 2.

Pre-emptive regulatory intervention is a feature of prudential regulation of banks such that banks are monitored and supervised, which is *ex ante* by nature. Securities regulation, on the other hand, is based on general rulemaking and *ex post* enforcement. It is also propounded that, banks have necessary incentives in operating in due care to lessen the possibility of borrower-related credit risk for their commercial interests;[413] while on the other hand, the securities regulation is directed at buyers or customers who are exposed the risks (as different from bank customers) due to their disadvantageous position in reaching information or in asking for more information.[414] So, the consumer/investor protection approach residing in the securities regulation is premised on disclosure in a way that what information, to whom, in which ways and in which format are all regulated rather than controlling each members one by one, as it is the case of bank regulation. This divergence is illustrated by Davies and Green as:

> (T)his is sometimes characterised as the difference between the "doctor" role of the prudential regulator- temperamentally inclined to seek to cure a problem when he finds it, rather than to discipline those who might have been responsible for it- and the "cop" characteristics of the traditional securities regulator, inclined to reach for the enforcement tool whenever a regulatory breach is seen.[415]

Having said that, such bifurcation between the prudential regulation and securities regulation might also be seen as something hypothetical and artificial which can be

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[413] Michael T. Cappucci,'Prudential Regulation and the Knowledge Problem' (2014) 9(1) Virginia Law & Business Review 1,8.

[414] Langevoort asserts that the capital market regulator's focus and capabilities are based on the concept of average investors, not the institutionalised investors as the marketplace witness today.Donald C. Langevoort,'The SEC, Retail Investors and the Institutionalisation of the Securities Markets' (2008) Georgetown Law Working Papers No: 80 (accessed Nov 21, 2015) http://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=1082&context=fwps_papers.

[415] Davies and Green (n 30) 192.

explained better in theory rather than in practice due to the fact that both prudential and securities regulators keep rule-making and supervision powers to some extent.[416] So, the difference between these two can be found in their primary purposes rather than their application. Also, it is noted that such apartness presented for those two regulatory fields might be exaggerated due to the fact that over the long haul, they are compatible with each other in terms of production and protection of confidence in the system. One of the eventual results based on healthy and prudentially well-structured and disciplined FIs is a well and fair functioning of the system which in turn those FIs can provide services and opportunities to persons that can use them with confidence.[417] This ultimate goal-based approach therefore takes the mentioned bifurcation as a short run thing.

Capital markets regulator is more interested in the protection of investors and in preserving fair, transparent and organized markets.[418] By Hu's words, it can be addressed as:

> The SEC's primary goal is more long-term and diffuse in nature: ensuring efficient, fully-informed financial markets driven by decision makers in the private sphere. The dynamic nature of such markets may well cause short-term pain, but that may be the price one has to pay for efficient markets and efficient allocation of resources.[419]

On the contrary, bank regulators are concerned with spotting unsafe and unsound bank practices for potential failures, which has been made possible by the provided authority to intervene and limit banks from taking excessive risks. Safety and soundness of the

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[416] For instance, the SEC rules a net capital requirement on registered broker-dealers. Cappucci (n 413) 9.

[417] Davies and Green (n 30) 192.

[418] M. Jickling and E.V. Murphy,'Who Regulates Whom? An Overview of US Financial Supervision'[2010] Congressional Research Service, Report for Congress No:R40249 1,18.

[419] Henry T.C. Hu,'Too Complex to Depict? Innovation, "Pure Information," and the SEC Disclosure Paradigm' (2012) 90(7) Texas Law Review 1601,1699.

banks and the whole system have been supported by measures such as extensive supervisory powers with regular on- and off-site examinations to solve such problems in private, without disturbing the market. Bank agencies have therefore historically believed in non-public regulatory procedures. Banking regulation, in this context, supports a coordinated and advisory relation between the banks and the regulators; the securities regulation, on the other hand, builds upon the warning impact of capital markets regulator's enforcement actions.[420]

Therefore, in plain terms, the capital markets regulator does not provide anything related to quality of the security, whether it is good or bad; it simply asks for registered and listed firms to disclose necessary information to investors in the belief that capital formation and investment will be promoted and expedited via disclosure. Both the capital markets and bank regulators seek to protect investors, but in paradoxical ways. The contradiction relies on the philosophical differences between them since the former aims for investor protection (establishing minimum grounds of disclosure by considering particularly small and unsophisticated investors) and market efficiency, while the latter aims for soundness of the banks themselves and the system in which they operate. Disclosures demanded by those two divergent universes are related to the well-being of investors for the one, and the well-being of the banks and financial system for the other.[421]

As Chapter 2 discussed, institutional models, supervisory performance and financial stability link with each other, but issues related to regulation should not be oversimplified by mere organizational-based approach. There is an inherent conflict between the

[420] Eugene F. Maloney,'Banks and the SEC' (2006) 25(1) Annual Review of Banking & Financial Law 443,455.

[421] Hu,'Disclosure Universes and the Mode of Information' (n 400) 574.

prudential regulator and securities markets regulator and institutional organisational divergence is a result of this. At the heart of the debate, there might lie a political decision-making process that blurs the lines of the jurisdiction of each regulatory and supervisory body. So, accountability, legitimacy and independence are important factors for a regulatory system so that bodies do not exercise influence over each other based on political decisions. It is very relevant to production and protection of public confidence such that political moves towards obscuring or delaying the disclosure of real loss of banks might undermine transparency and accountability of the organisations.[422]

In this sense, the GFC provided a fertile ground to discuss the inevitable or natural dialectic between these two regulatory zones by revealing the cases about MD of bank information as a result of securities markets transparency regulations and the stability-driven concerns attached to those disclosures during a crisis time. The conflict summarised here was experienced in leading financial centres with different cultures: While the pre-emptive and public interest-based regulation in protection of systemic financial stability has been the result, both the US and the UK had provided substantial case studies that show the need of subordination of market efficiency-investor protection (and other attendant benefits of public disclosure) in favour of financial stability. MD of information as the traditional aspect of capital markets has brought new challenges about the intersection of market efficiency, systemic risk and government. It was the cases related to the merger of BoA and ML and the bail-out of the AIG in the US. In the EU, it

[422] For example, in the 1990s, Japan's policy of regulatory forbearance towards banks in not forcing them to disclose their losses can be seen as a political decision made for the overall financial stability which later on it turned out to be the loss of confidence of market participants in Japanese markets. Benjamin Nelson and Misa Tanaka,'Dealing with a Banking Crisis: What Lessons Can Be Learned from Japan's Experience? (2014)(Accessed Dec 1, 2016) http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q104.pdf.

was epitomised in the infamous case of NR, rogue-trading scandal at SG and the merger of HBOS and Lloyds TSB. The animating regulatory philosophy of capital markets regulators such the SEC and the FSA has always been pure and rich informational environment based on disclosure and not the correction of market decisions.[423]

So, experiences regarding to the SEC and the FSA (now FCA) vis-à-vis financial stability and their treatment to banks as a listed company under national laws should be discussed. Therefore, without drawing a short conclusion here, this chapter directly links to the chapter regarding the application of this regulatory battle in different jurisdictions.

[423] Henry T.C. Hu,'Efficient Markets and the Law:A Predictable Past and An Uncertain Future' (2012) 4 Annual Review of Financial Economics 129.

CHAPTER 4

EXAMINING DISCLOSURE OF BANK INFORMATION UNDER NATIONAL SECURITIES LAWS

1. Regulatory Landscape of US Bank Securities Disclosure Regime

1.1. The Synopsis of US Securities Disclosure Regulations

Federal securities laws have traditionally been based upon the principle of disclosure instead of direct regulation and despite the extensive generation of experience with the merit-based approach.[424] Since 1933, companies going public for the first time have been asked to furnish investors with specific information regarding the company's assets, risks, funding, past performance, management compensation, and transactions among the company and its insiders; and since 1934, disclosures made in the primary markets must be renewed both quarterly and annually and also those results must be audited by independent accounting organizations.[425]

One of the purposes of the 1933 Act was therefore to reveal the truth in securities in relation to public offerings. The Act is applicable to any company on the mere purpose of offering and selling securities. The second purpose was to provide rules against misrepresentation and fraud in the securities markets. Before the 1933 Act, the sale of securities was generally a matter of state laws and, as the first leading piece of federal

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[424] Jickling and Murphy (n 418) 6.

[425] R. Daines and C.M. Jones,'Truth or Consequences:Mandatory Disclosure and the Impact of the 1934 Act'(2012) Stanford Law School Working Paper at 3(accessed Nov 16, 2017) https://law.stanford.edu/publications/truth-or-consequences-mandatory-disclosure-and-the-impact-of-the-1934-act/.

regulation on the sale of securities, the 1933 Act highlighted the disclosure philosophy such that the sale of bad securities is not illegal as long as the investors are fully and fairly informed about the character of the security.[426] It therefore accommodates the disclosure of both positive and negative information.

The 1933 Act provides exemptions from the registration for certain types of securities; but it does not mean that they are also exempted from the anti-fraud provisions, and those exempted securities might be treated as security in the 1934 Act. The Sarbanes-Oxley Act of 2002 (SOX) and Dodd-Frank established a significant shift from the 1933 Act's disclosure standards since the role of the SEC was changed through the established trust on the fields of corporate governance which were previously under the liability of the states and the self-regulatory organizations like FINRA and, further, the SOX placed the SEC into the accounting profession based on its oversight authority over the Public Company Accounting Oversight Board.[427]

The 1934 Act was established for the securities dealers and brokers and for the market they transact, and it set out comprehensive disclosures about the securities traded in the market. The 1934 Act therefore applies to the issuers whose securities are listed and traded in the stock exchanges.[428] It establishes that those issuers named s 12 issuers and the issuers offer and sell securities by virtue of the 1933 Act named s 15(d) firms are

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[426] C.J. Johnson, J. McLaughlin and E.S. Haueter, *Corporate Finance and the Securities Law* (5th edn,Wolter Kluwer 2015) 1-17.

[427] Ibid.

[428] It also applies the issuers having active investor interest in the OTC market by satisfying the threshold levels as holding minimum 500 holders of a class of equities and minimum $10 million in assets.

required to file periodic, quarterly, and annual reports, and other documents to the SEC in accordance with the relevant accounting standards.[429]

Together with the integrated disclosure system, combination of the disclosure regimes in order to eliminate duplicative disclosures by decreasing the burden of issuers has been possible.[430] Regulation S-K for non-financial information and Regulation S-X for financial information, therefore, reflect the harmonized regulatory disclosure system, which applies to filings by issuers in both respects. Different from the European approach, general principles of disclosure do not impose an affirmative duty to disclose all material information except when it is required by registration statement, periodic reports and other filings, when the company is required to correct inaccurate disclosure or to avoid insider trading and when the company purchases its own securities. Yet, such an affirmative duty to promptly disclose any material information is rather imposed by securities exchanges themselves (such as the New York Stock Exchanges and NASDAQ).[431]

Under this concept, the materiality principle embedded in federal securities regulation, as a fundamental tenet of the federal securities laws, has always been argued as being a subjective and vague standard.[432] Application of materiality is relevant to the facts and circumstances of each public company and in each case the assessment as to materiality

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[429] 15 USC§78m(a),(b) and 78o.

[430] SEC Release No. AS-306.

[431] Regulation FD and Regulation G.

[432] Standard of materiality that is generally used today was designated at *TSC Indus. Inv. v. Northway, Inc. 426 US 438 (1976)*. Here, the materiality standard is articulated as '… there must be a substantial likelihood that the disclosure of omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information available.' at 449. For the legal definition of the term material see 17 CFR§230.405.

might require an investigation of the public company's sector, products, services, structure, size, and other such information.

The law provides SEC registrants with the opportunity to ask for a CTO if specified conditions are met. They need to support their requests with an applicable FOIA exemption.[433] Most common ground for a CTO is exemption 4, which protects information that is a trade secret or business or commercial information that is obtained from a person and is confidential.[434] Yet, if the information is required under the 1933 and 1934 Acts and other related rules and regulations or if it is material information, then it has to be disclosed.

SEC, as the principal authority to oversee and regulate the US securities markets, interprets and enforces these disclosure laws and regulations in order to pursue its objectives of protecting investors, maintaining fair, orderly and efficient markets and facilitating capital formation. Yet, the GFC proved that the SEC was involved in stability-related measures under the wider rhetoric of protection efficient markets in the long term.

1.1.1. Securities Exchange Commission and Financial Stability: Restrictions on Short Sales of Financial Stocks

The SEC's traditional identity is based on protection of investor and facilitation of capital formation, which MD of information forms the main tenet of these objectives. So, 'the

[433] There are nine exemptions provided under the FOIA.5 USC§552(b).
[434] Kara Karlson,'Check and Balances: Using the FOIA to Evaluate the Federal Reserve Banks' (2010) 60 American University Law Review 213,250.

SEC is first and foremost a disclosure agency.'[435] Yet, the SEC intervened in the market place at the height of the crisis by banning short sales of bank stocks for market confidence and financial stability purposes.

The SEC chairman Christopher Cox claimed that the order was issued as a result of intensive pressure coming from the Fed and the Treasury in order to mute or prevent market declines and so, it was a move towards the protection of FIs and overall financial stability.[436] So, governmental price neutrality, as rooted in securities laws, was therefore temporarily suspended via government intervention in increasing securities prices for overall financial stability of the state.[437] Here, market confidence was the determinant for the stability because sudden price declines in bank securities would urge the market to examine the underlying financial standing of the issuer and the result of such questioning would cause a crisis of confidence with potential severe outcomes.[438] Considering the previous approach of the SEC's on short sales (relaxing short sale restrictions and its established stance regarding to less restricted markets for setting the prices)[439]; such a move might be addressed with the conflicting regulatory interests or the domination of the more powerful government actor over the less powerful one; or it might be related to superiority of the objectives in the specific point in time where assuring the short-term stability overrides the maintenance of longer-term and more nuanced goal of market

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[435] Daniel M. Gallagher,'The Importance of the SEC Disclosure Regime' (2013)(accessed Dec 27, 2016) https://corpgov.law.harvard.edu/2013/07/16/the-importance-of-the-sec-disclosure-regime/.

[436] http://www.washingtonpost.com/wp-dyn/content/article/2008/12/23/AR2008122302765.html?sid=ST2008122302866&s_pos= (accessed March 26,2015).

[437] Hu,'Too Complex to Depict? (n 419) 1688-1701.

[438] SEC,(accessed Dec 11,2016)https://www.sec.gov/rules/other/2008/34-58591a.pdf.

[439] Hu,'Disclosure Universes and Modes of Information' (n 400) 657.

efficiency which the SEC pursues for.[440] This emergency SEC intervention in the securities markets proves that severe market distress can lead SEC to prioritise financial stability over market efficiency.[441]

It is true that SEC's restriction on short selling financial stocks is not directly related to the potential battle among bank prudential supervisor or the Fed and the SEC, but it shows that the SEC might act as a stability determinant agency in a non-prudential sense. As mentioned in Chapter 2, the SEC has no explicit legal duty to go after financial stability or lessen the probability of future crises.

Yet, the establishment of the FSOC, a council of regulators created for financial stability purposes, has introduced new mandates to its members.[442] Post-crisis agenda tacitly assigns the SEC the responsibility about financial stability as being one of the members of the FSOC. This indirect responsibility includes production of necessary annual reports about the risks and threats that the SEC considers important for the financial stability[443] or it can be the FSOC's power to advise increased standards or protections for activities or practices that endangers the financial stability and in return this advice might require the SEC to oversee the financial industry from stability point of view[444]. So, even if the legal boundaries of the SEC in financial stability are still not clearly defined even after the Dodd-Frank, one can say that the SEC can find this responsibility per se. According to Allen, s 2 of the 1934 Act, which establishes the grounds for securities regulation, provides a legislative direction for the SEC and it compasses a general responsibility for

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[440] Hu,'Efficient Markets and the Law:A Predictable Past and Uncertain Future' (n 423) 193.

[441] Or it can be prioritizing the political over the important.

[442] Chapter 2,Section 3.1.3.

[443] 12 USC§5322(b).

[444] 12 USC§5330.

the SEC to regulate and behave in way that economic outcomes of securities markets failures on the financial system should be at a minimum.[445] Further, she thinks that the SEC has indirect liability of pursuance of financial stability based on its investor protection mandate. Investors with diversified stock portfolios are the ones that most likely to be affected by the instability or crisis in the aggregate compared to individual cases of fraud or misconduct.[446] For this reason, which is simply based on collective harm that the investors face, prevention of market failures is part of the duty of the SEC as part of its investor protection objective. Yet, this approach takes financial stability as an overarching objective for agencies regulating the financial markets and it accepts that protection of financial stability (although not in a prudential regulation sense) can be conceptualised as part of investor protection. So, financial stability regulation here does not only encompass prudential regulation, it also includes investor and consumer protection regulation tacitly.

The Treasury and the Fed are strong governmental actors in terms of having bargaining powers regarding economic issues (compared to the SEC), and the concern here is the potential clash between the ideas of unruly but efficient capital markets in short-term and safe-and-sound financial system in the long term. Yet, the political economy of the SEC's administrative powers and its independence should not be overshadowed by uncertainty about the extent to which market efficiency and investor protection are required to be renounced for financial stability. So, the law must address the smooth functioning of public policy goals in different regulatory ends and means.

[445] Hillary J. Allen,'Financial Stability Regulation as Indirect Investor/Consumer Protection Regulation'(2016) 90 Tulane Law Review 1113.
[446] Ibid.

The next section will discuss the legal framework of the US federal securities law in terms of the jurisdiction dealing with bank disclosures with reference to disclosure requirements established by BRAs.

2. Bank Disclosure Schemes under the US Securities Laws and Regulations

Structuring of the banking regulation in the US is based on the intellectual background derived from the Great Depression experience and the philosophy of the New Deal.[447] The paternalistic concept of bank regulation has been founded upon the prevention of bank failures by reason of greater public interest in maintaining a safe and sound financial system. For example, this approach could be experienced in the veiled application of confidential supervision as means of achieving regulatory policies.[448] The premise that depositors cannot be the facilitators of surveillance of banks due to their potential negative reaction to any adverse information pertaining to the bank's financial condition or riskiness of banks was the main concern of regulators in not supporting public disclosures by banks.[449] US legal history pertaining to banks witnessed disclosure-related problems during the Great Depression and Savings and Loan Crisis (S&L).[450] So, the established mechanisms are generally result of such experiences and should therefore be

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[447] Fischer, Rosenfield, Stillman (n 375) 302.

[448] Confidential supervision was not particularly mandated by the regulation, but the practice was supporting the non-disclosure of bank information to outsiders and there was no general law requiring confidentiality of bank information over public disclosures. Boro (n 217).

[449] Mathewson (n 379).

[450] For example, in a case involving Manufacturers Hanover Bank, the news about the physical condition of the bank building turned out to be a market rumour about the shaky financial standing of the bank and the stock prices of the bank experienced sudden and sharp declines and the bank consequently came close to collapse. Daniel L. Goelzer,'Current Developments in SEC Regulation of Depository Institutions'(1990)(accessed May 2,2016)https://www.sec.gov/news/speech/1990/020590goelzer.pdf.

interpreted in their dynamics.[451] As the discussion concerning market discipline addressed, the argument stating that the majority of bank assets is supported by a small sized, but great number of depositors and the depositors having particular interest in the soundness of the bank consist of the minority with lesser amounts of deposits mean that public disclosures are not as necessary as one might think and rather, confidential supervision might be complementary.[452] Maybe based on this view, confidential supervision was provided as a safeguarding measure to prevent bank runs, and the bank's general immunity from market discipline by the availability of the information to only regulators rather than the public has been one of the failures in causing opaque financial markets.

Banks subject to securities disclosure regulations had long been linked to the post-Great Depression approach of transparency-fragility view and the law still accommodates a bifurcated jurisdiction system pertaining to disclosure by banks and BHCs. It means that under the present regulatory system, while the SEC regulates BHC disclosures, the disclosures made by individual banks are enforced and administered by the relevant bank regulators. This bifurcation, as a product of the Great Depression, creates academic questions about its necessity, efficiency or bias towards banks; yet the overall disclosure regime forming the whole picture provides that bank information disclosure is a tenet of bank regulation as it is also a regulatory tool used by bank supervisors/regulators.

[451] Jane W. D'Arista, *The Evolution of US Finance Vol II* (Routledge 1994) 337. Especially the monumental collapse of the Continental Illinois National Bank and Trust Company supported the initiatives towards bank transparency in the US.
[452] Chapter 3,Section 4.

The development of the parallel disclosure universe for banks as a product of BCBS-related exercises has been a major step towards bank transparency in the US.[453] Further, for large and complex banks operating under BHCs, mentioned opacity and its concomitant consequences in inaccurate risk pricing in the market have pioneered the arguments about the public disclosure of stress-tests information and further risk and capital-related information.[454] Risk-related provisions of the SEC disclosure system do not particularly ask for public disclosure of stress-testing results; but on the regulatory side, the discussions related to greater access to regulatory information by the public and the use of market information for supervisory purposes is not new[455] and the developments on the public disclosure of stress-testing are the products of the GFC and its accompanying trend towards more transparency.

Both the domain of BRAs and the SEC disclosure system share common elements related to capital adequacy and major risks; but enforcement mechanisms and the amount of information required are different. For instance, while BRA disclosure provisions require more financially complex and demanding data from banks about risks, the SEC disclosure system is not.[456] Also, bank regulator disclosure system, as underpinned by the BCBS, has developed beyond disclosure of market risks as being supplementary to capital adequacy rules.[457] The money raised from issuing stocks is not repaid and therefore it constitutes a portion of the cushion against potential vicissitudes. Large and complex

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[453] Section 2.1.2.

[454] 12 USC§5365(i)(1)(B)(v) and §5365(i)(2)(C)(iv). The relevant provision applies to BHCs with total consolidated assets equal to or greater than the amount specified at 12 USC§5365.

[455] Mark J. Flannery,'The Use of Market Information in Prudential Bank Supervision: A Review of US Empirical Evidence' (1998) 30(3) Journal of Money, Credit and Banking 273.

[456] Hu,'Disclosure Universes and Modes of Information' (n 400) 612.

[457] The US Basel III Adopting Release,78 Fed. Reg. 62,018 (Oct 11,2013).

banks, which are generally deemed systemically important, in this respect, are required to disclose highly detailed information on their capital adequacy.[458] BRA disclosure requirements, as revised at regular intervals based on the guidance of the BCBS, are prospered on the face of negative externalities emanated from bank risks. So, while discussing the bank disclosures, one should bear in mind that those mentioned two disclosure universes are undergirded by different goals even if they both serve for bank transparency and public interest.[459]

Considering the overall disclosure scheme for bank disclosures, there will be two main arguments in the subsequent subsections: The first is one about the impracticability of relevant bank-specific provisions in 1933 and 1934 Acts, which stands as an academic questioning; and the second one is about the tension emanating from BHC disclosures and financial stability concerns occurred during the GFC.

2.1. The Jurisdiction of the SEC and Application of Securities Information Regulations Towards Banks

2.1.1. Banks as Individual Organizations

The 1933 Act establishes that securities issued[460] by a national bank or any banking institution organized in a US jurisdiction are exempted from registration and delivery of prospectuses pursuant to s 3(a)(2).[461] However, the federal bank agencies[462] have the

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[458] Ibid 62,021.

[459] Chapter 3,Section 2.3.1.

[460] ‘or guaranteed’

[461] 15 USC§77c(a)(2),(5) and 15 USC§78c(a)(5)(C).

[462] The OCC is the authority that charters, regulates, and supervises all national banks together with federal branches and agencies of foreign banks. The FDIC is the authority for state banks

authority to establish disclosure requirements for bank-issued securities under banking laws.[463]

The SEC frequently advised Congress that such an exemption provided to banks should be changed with a rule that requires banks to register with the SEC by providing authority to the SEC to arrange exemptions for banks.[464] While the purpose of such an exemption was not clearly described, the underlying reason of the exemption of securities issued by banks from registration is the premise that regardless of their charter, either state or federal, they are already highly regulated in a sense that even though there is no registration requirement, regulations that banks are subjected to require them to disclose sufficient information to investors regarding their finances. Another reason for such an exemption was the fear of bank runs emanating from the public disclosure of bank financial data.

One may think that if a bank has concerns about releasing its financial information to the public, which might worsen its financial position, it should not go public in the first place. However, this way of thinking also establishes a paradox such that the decision to go public is basically made to be able to reach the capital in funding the bank. Therefore, the existence of exemption from registration only provides the exemption for new offerings

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and state-licensed branches of foreign banks with insured deposits. The Board of Governors of the Federal Reserve System is the primary regulator of the state-chartered member banks.

[463] For the OCC regulation see 12 CFR§16 and 12 CFR§11.2-3, for the FR Board see 12 CFR§208.36, for the FDIC see FDIC Statement of Policy regarding Use of Offering Circulars in connection with Public Distribution of Bank Securities (1996),12 CFR§335 and 12 CFR§350.

[464] For instance see 'The Report by the United States SEC on the Financial Guarantee Market:The Use of the Exemption in Section 3(a)(2) of the Securities Act of 1933 for Securities Guaranteed by Banks and the Use of Insurance Policies to Guarantee Debt Securities'(1987)(accessed May 2, 2016) https://www.sec.gov/about/annual_report/1987.pdf.

of bank securities and the discussion related to the spectre of bank runs should also be directed towards the bank securities traded in the secondary markets. Also, the capital adequacy requirements to which banks are subject suggest that banks have sufficient funds for timely principal and interest payments to be given to the holders of their debt securities.

The arguments about the exemption should be interpreted vis-à-vis the regulatory environment, such that disclosure requirements applicable to banks under federal supervision were mainly directed to protection of depositors and other creditors, not stockholders.[465] This exemption was seen as a reflection of the protectionist approach so that bank regulation did not require public disclosure of income statements, earnings reports, or dividend information because this information was presumed confidential for banks.[466]

Therefore, the characterization of bank regulation by safety and soundness motives, intentionally or inadvertently, presented anti-investor behaviour. The concerns related to the protection of the bank investors were addressed within another law, which set out public disclosure of some certain information via local newspapers and circulars; but bank stockholders still did not have access to the same level of information as other investors holding securities under the SEC.[467] Consequently, the discussion about bank disclosures under the 1933 Act centred on whether the application of anti-fraud and misrepresentation provisions provide indirect but sufficient protection to stockholders, whether bank supervision on both federal and state levels is adequately and fully accomplished, and

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465 H.D.M. Jr.,'Banks and Securities Act of 1933' (1966) 52(1) Virginia Law Review 117,118.

466 109 Congressional Record 9312 (1963) cited from Ibid 125.

467 National Bank Act of 1864,s 34.

whether the management of information to protect investors is efficiently handled by those agencies which are familiar with bank operations and problems, so that placements of banks under the SEC by registration is not essential to protect investors. The existence of this exemption today provides that the rationale behind the exemption still survives regardless of the post-depression conditions that the acts were passed back then.

In terms of the continuing disclosure requirements, s 12(i) of the 1934 Act establishes that the regulatory enforcement of the regulations about bank securities, as specified one by one under s 12(i), is under the charge of bank regulators.[468] The intention of Congress in the 1934 Act was not to exclude banks from the registration reporting rules as it could be seen in the original version in the Act and the SEC implemented a provisional exception for banks to be excluded from registration of their securities listed on the exchange; but such an exception was never invalidated.[469] The amendments made in 1964 established new provisions about disclosures regarding securities in the OTC markets including banks which satisfied the specified threshold levels of shareholders and assets; but the same amendments also eliminated the jurisdiction of the SEC for the enforcement of reporting and disclosure requirements and handed over the administration of such provisions to the BRAs.[470]

The exemption provided by the 1933 Act is therefore not the end for the banks, and bank regulators were thought to perform the relevant functions of the SEC under the 1934 Act. Even though bank-issued securities are not subject to the 1933 Act, they might be subject

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468 15 USC§78(l)(i).

469 Louis Loss&Joel Seligman, *Fundamentals of Securities Regulation* (5th edn,Wolters Kluwer 2004) 483.

470 D'Arista (n 451) 338.

to the 1934 Act if they satisfy the registration requirements such as satisfying the threshold limits.[471] This means that bank securities issued at initial public offering are generally exempted from the federal system of securities regulation[472]; yet the federal system of continuous disclosure applies to those securities as part of the secondary market for securities.[473] From the beginning of the implementation of the 1934 Act banks were subject to the requirements of the 1934 Act simply because trading (and therefore listing) on a national securities exchange requires registration of the securities; but the 1934 Act had not had a big impact on banks since they had already been delisting their securities in practice.

In 1974, as a response to criticisms appearing on the differences between the level of disclosures established for public companies and banks, the criterion of 'substantially similar' to SEC regulations was established and therefore the tendency of the bank agencies in providing time and space to banks to deal with their financial problems and minimize the content and the number of disclosures rather than reflecting such difficulty to the market was hoped to diminish. However, expectation from those bank agencies to make public disclosures as being contradictory to their working principles under confidentiality has been the matter of debate.

[471] Under the JOBS Act, the threshold limit is specified as minimum $10 million in total assets and a class of equity security (other than exempted security) held of record by minimum 2000 people. 15 USC§78l(g)(1)(B)(as of Nov 2018).

[472] Michael P. Malloy, *Banking Law & Regulation* (2nd edn,Wolters Kluwer 2016) ch 7.02.

[473] Michael P. Malloy,'The 12(i)'ed Monster: Administration of the Securities Exchange Act of 1934 by the Federal Bank Regulatory Agencies' (1990) 19(2) Hofstra Law Review 1,9.

In short, the 1934 Act refers to BRAs as federal authorities to administer and enforce specified sections of the 1934 Act and some enumerated sections of the SOX.[474] In terms of the responsibility of such agencies, it is stated that 'in carrying out their responsibilities under this subsection, the agencies named in the first sentence of this subsection shall issue substantially similar regulations and rules issued by the Commission …' and it continues:

> … unless they find that implementation of substantially similar regulations with respect to insured banks and insured institutions are not necessary or appropriate in the public interest or for protection of investors, and publish such findings, and the detailed reasons therefore, in the Federal Register.[475]

This statement is important because it is the snapshot presenting the philosophy of the securities regulation in investor protection and the philosophy of the regulators to accommodate safe harbours that provide the cases for non-disclosures with intent to prevent bank runs and preserve efficient bank regulation. However, as it will be explored later, this discussion now appears academic.

Since 1974 the two values (that are generally declared as opposing each other) of safety and soundness and public disclosure have been dealt with by the provision (s 12(i)) in the 1934 Act ordering BRAs to issue substantially similar regulations to those delivered by the SEC as long as it is conforming with the public interest. Yet, most of the banks in the US formed under BHC structure and the number of individual banks is low. So, the US regulatory architecture for banks is complex with different BRAs and rules and the

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[474] For the OCC see 12 CFR§Part 16.3 and 16.5;for the FDIC see FDIC Final Rule, 59 FR 67166 (Dec 29,1994);12 CFR§335.

[475] 15 USC§78l(i).

discussions pertaining to institution-based and functional-based regulations are still valid.[476] Section 12(i) of the 1934 Act supports the institution-based regulatory approach; but there have been disparities between the BRAs in their regulatory philosophies and actions in terms of their application of those relevant provisions.[477] However, those inconsistencies between the BRAs still present a single uniform standing compared to their variations from the SEC.

BRAs have the authority over banks, and yet the SEC has not made any particular recommendation as to the extent of necessary disclosures for highly regulated establishments including banks, and this area is governed by the rules and guidelines established by relevant BRAs, not the SEC.

It was experienced that those BRAs at one time had such regulations as can be seen from the earlier versions of the OCC disclosure regulations or FDIC disclosure circular; yet, at present such regulations require banks to disclose information on the forms required by the SEC for other public companies as regulated in the 1934 Act.[478] Disclosures about the financial condition, loan loss activities, profitability, and lending activities of banks were criticized as being not sufficiently detailed compared to the SEC disclosure requirements.[479] The tendency of those bank agencies to minimize bank disclosures was suppressed by the coordinated effort based on the lack of comparability, variations between disclosure standards, and potential unfair competitive advantages as a consequence of being exempt from the standards and rules enforced on other securities

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[476] The US Government Accountability Office Report GAO-16-175 (Feb 2016).

[477] Stephen K Huber (n 384) 65.

[478] Melanie L. Fein, *Securities Activities of Banks* (4th edn,Wolters Kluwer 2016) 3-42.

[479] The Report of the Special Study of Securities Markets (1963) HR Document No:95,88th Congress,1st Session.

players. Those criticisms based on investor protection highlighted the great numbers of bank-issued securities trading in the OTC market, and the recommendation of the report was responded to with the first appearance of s 12(i) and therefore delegated the BRAs for bank-issued securities.

The intention of Congress' implementation of s 12(i) was discussed at length in terms of whether commercial banks were intended to be subject to full disclosure requirements. The uncertainty continued even during the 1980s when some banks failed to release negative results of bank examinations and claimed confidentiality privileges to avoid public disclosures.[480] Inconsistent development of US bank disclosure systems has been the reason for such ambiguity. For example, call reports to be submitted to the FDIC were not publicly available until 1972 for reasons of safety and soundness, and while such information was not available from the FDIC, disclosing the same information by reason of securities regulation would be inconsistent.[481]

As addressed in the case of *SEC v Youmans*,[482] information pertaining to bank problems is deemed material for the purposes of the securities regulation such that the confidentiality of the OCC report with adverse information about the bank should not be the reason for omitting the same information from SEC filings. In *Youmans*, negative feedback about the bank's activities received from the bank examiners was not provided in the filings made with the SEC based on the idea that the information was confidential as being a part of the examination report. However, the SEC asserted that, even if the

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[480] Robert P. Bartlett III,'Making Banks Transparent'(2012) 65(2) Vanderbilt Law Review 293,308.

[481] See 37 Fed. Reg. 28,607-02(1972). However, the FOIA provides bank regulators power to reject the disclose examination reports.5 USC§552(b)(8).

[482] *SEC v Youmans*,543 Fed. Supp.1292(E.D.Tenn. 1982).

information in the examination report might be confidential, bank management was aware of the negative condition of the bank 'simply by virtue of their presence'[483] and, further, that it did not ask for the full disclosure of the examination report itself, but instead the substance of the report was deemed material so that disclosure was required. Though the case presented an acceptance of this type of distinction, it did not specifically address the issue of the concurrent application of two separate bodies of laws by the same agency; rather, the court just presented its decision on the side of disclosure without touching upon the core discussion about why the principle of public disclosure is preferred over confidentiality in the case.[484] Overall, in weighing the interests, the court here supported the view that interests emanating from the investors' capacity to make well-informed decisions outweigh the interests based on the bank's protection-from-disclosure provisions.

It has been mentioned that the bank regulators, as having discretion to disclose information in their examination records, provide a confidentiality cloak to banks in avoiding disclosure, which is material for the investors.[485] The doctrine of regulatory confidentiality is justified on prudential grounds where circumstances might require confidential resolution of supervisory and enforcement issues.[486] It is true that the running of the bank oversight system requires a degree of reticence, but the limits of public disclosures by BRAs is also on a constant change in the long run. For example, the argument was made for the enforcement actions taken by the BRAs in terms of revealing

[483] James C. Treadway,'Deposit Insurance Reform: The Response from the SEC Insuring Confidence' (1986) 5 Ann Rev of Banking L 149,151.

[484] *SEC v Youmans* (n 482) at 1301.

[485] David G. Oedel,'Civil Liability for the Concealment of Bank Trouble' (1987) 6 Ann Rev Banking L 443,466.

[486] Chapter 3,Section 5.

wrongdoings by banks and by persons associated with them.[487] Enforcement actions are inherently adverse information, which might leave question marks in people's minds that while the disclosure of formal enforcement actions that threatens bank safety is allowed, other examination reports are not.[488] Malloy discusses that this complication appeared in the past and resulted in favour of disclosure to investors even though such information generally falls under the confidential treatment by BRAs.[489]

Exemption 8 of the FOIA provides that the rule that requires agencies to make public disclosures does not apply to matters that are 'contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions'.[490] The use of the FOIA exemption has developed with court decisions that have utilised broad standards including overall security of the financial system or the protection of public confidence in banks.[491] The broad coverage of this exemption provides flexibility to bank regulators,

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[487] BRAs publish the formal enforcement actions (except sanctions taken against the personnel) online. 12 USC§1818(u) stipulates public disclosures of final orders and agreements by BRAs. 12 USC§1818(u)(4) establishes that BRAs can delay public disclosures of administrative enforcement proceedings if such disclosure creates a danger to the safety and soundness of the bank and as provided at 12 USC§1818(u)(1)(A). BRAs, as a result of their discretionary decision, might decide not to disclose violation-revealing agreements or statements if the public interest requires to do so.

[488] See the discussion at Section 2.1.2.

[489] Malloy, *Banking Law & Regulation* (n 472) ch 8.02.

[490] 5 USC§552(b)(8). 'The extent to which a particular record will be deemed "related to" an examination report, however, depends on the individual facts and circumstances, and is subject to some litigation risk…'Kevin J. Harnisch, Paul H. Pashkoff and Michael A. Umayam,'Controversial Dodd-Frank FOIA Provision Repealed, Revised' (2010) Lexology Article (Accessed Dec 22,2016)https://www.lexology.com/library/detail.aspx?g=cc5a97e3-4a66-432f-add7-269a5c45d7e5.

[491] Courts have applied exemption 8 to information that could undermine public confidence and investment in the regulated institution and in the financial sector. For the elaboration of court

as '[A]ll records, regardless of the source, of a bank's financial condition and operations' can fall under exemption, as one court found,[492] and additionally the court only needs to find that such information is related to matters about reports.[493] So, the courts have interpreted this exemption in line with the interests of BRAs. Together with the FOIA exemption from public disclosure and relevant confidentiality rules of those federal bank agencies, the protection of the relationship among the banks and their supervisory agencies and ensuring the security of banks have been possible.

In general, the examination and operating reports including supervisory ratings are not available to the public. Examiner-related information about banks is surely a great source of information in pricing the securities and towards the more transparent financial system; one cannot guess whether the same enhanced disclosure trend will change the disclosure limits of non-public supervisory information in the future. Basically, the extent that some supervisory information is deemed confidential is the key element in differentiating securities regulation and bank regulation.[494] Under current conditions, bank regulators are advised to reach a combination of public and private oversight on the optimal level[495] if they are not willing to fully share the information that they possess with the public.

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decisions about exemption 8 see the Department of Justice Guide to the FOIA(accessed Oct 1, 2016)https://www.justice.gov/sites/default/files/oip/legacy/2014/07/23/exemption8.pdf.

[492] See *Judicial Watch* (n 296) at 38.

[493] See *Public Investors Arbitration Bar Association v. SEC* (n 296).

[494] Chapter 3,Section 5.

[495] Flannery (n 455) 299.

However, outsiders might acquire substantial bank information through other ways such as the bank's reports of condition and income (known as 'Call Reports'),[496] annual disclosure statements,[497] the bank's Uniform Bank Performance Report (UBPR),[498] the information provided by CRAs, other reports or ratings about the bank compiled by private firms which track the performance of banks, and any information released by banks being a registered entity under the SEC.[499] Accordingly, some information disclosed based on securities regulation might be already publicly available by way of publication of other information by BRAs.

It should be noted that banks have never been exempted from the SEC enforcement of anti-fraud regulations[500] and general anti-fraud rules[501] and they are applicable to banks and their enforcement is given to SEC, not to BRAs. The authority granted under s 10(b) of the 1934 Act might create some publicity concerns in relation to banks. The particular rule states that it is prohibited to '… to make any untrue statement of a material fact or to omit to state a material fact necessary … in connection with the purchase or sale of any security'.[502] It is clear that the rule aims to equalize access to information. Given the

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[496] Call Reports are required by law at each calendar quarter and they must be submitted to Federal FIs Examination Council (FFIEC). See12 USC§324 for state member banks;12 USC§1817 for state non-member banks and 12 USC§161 for national banks.

[497] For OCC regulated banks see 12 CFR§18.3-9. For FDIC regulated banks see 12 CFR§350.3.

[498] The UBPR is a financial analysis of a commercial bank, which files its Call Report to FFIEC. See https://www.ffiec.gov/ubpr.htm(accessed July 2, 2016).

[499]Also, BCBS disclosure rules reflected in laws ask for information about risk levels and capital status of the bank. See 12 CFR§3.61-63;3.212;3.171. Further, information about loan-to-deposit ratio or lending patterns of banks is required under the Community Reinvestment Act. See 12 CFR§Part 25,228,345,195.

[500] 15 USC§78(j) and 17 CFR§240.10b-5.

[501] Banks are not subject to the anti-fraud rule established at the 1933 Act,s 12(2).See 15 USC§771(2).

[502] 17 CFR§240.10b-5.

indirect enforcement authority of BRAs over the banks' and bank-associated parties' 'violations of a law, rule or regulation',[503] one might think that BRAs have the authority to enforce the general anti-fraud rule for violations pertaining to bank-issued securities even if it is not one of the sections numerated under s 12(i) of the 1934 Act. In this sense, theoretically, BRAs can find an indirect enforcement authority to take actions for the violation of the anti-fraud rule.[504] Yet, it is a matter of interpretation.

In conclusion, the SEC has jurisdiction over the application of anti-fraud provisions over banks and it creates several policy questions regarding public disclosure of information. Assuming that the disclosure of information might be detrimental to the safety and soundness of the system, the first question is whether the courts will place as much emphasis on the protection of depositors, the banking sector, and the markets in general as BRAs do.[505] The second (and a hypothetical one) question is, if a BRA decides to take action, such as limiting a bank's operations or recommending the liquidation of assets or loans, or organizing the merger or acquisition of the bank, is there a necessity to release such information when stability of the banking or financial system is in question?[506] Enforcement and administration of anti-fraud provisions by the SEC is part of the general question whether banks really should be subject to securities laws disclosure regimes. There is bank information which is non-public and the property of the relevant BRA. In a case where the information is not classified as non-public, but its public disclosure is

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[503] 12 USC§1818(b)(1).

[504] Malloy, *Banking Law&Regulation* (n 472) ch 8.02[F].

[505] Bruce Alan Mann, 'Securities Disclosure Requirements-Vive La Difference' (1975) 92 Banking Law Journal 109,117.

[506] Ibid 118.

also not desired by the BRAs, the method of handling concerns about liability based on anti-fraud regulations should be addressed.[507]

The parallel system of disclosure that BRAs establish for the securities of individually operating banks is identical to SEC regulations; but other elements that make banks different from other public firms (such as the BRA's authority on the bank capital formation (bank capital formation necessitates the chartering BRA to perform a merit review on the proposed issuance of preferred stocks))[508] or capital adequacy regulations) suggest that banks are constrained in various ways in the securities markets. Full application of securities regulation to banks has further implications for the division of regulatory domain. In the context of functional regulation, where distribution of the duties is made based on the nature of the activity performed in each organization, all securities activities of banks might be subject to the SEC rather than a BRA based on the premise that there is one institutional identity of the bank and it should be regulated under one single agency for the overall safety and soundness of the bank.

Codification of the concept of functional regulation under the Financial Services Modernization Act of 1999 (GLBA) did not disrupt the exemption provided to bank-issued securities under the 1933 Act. The SEC, as a supporter of the accommodation of functional regulation, does not engage in issues about whether disclosure might lead a

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[507] Another question is that, if BRAs change their approach from incorporation by reference to issuance of substantially similar provisions to those established for other public companies, can the SEC directly compel banks to follow their disclosure regimes by the threat of enforcing Rule 10b-5 on banks where it considers the disclosure requirements established by BRAs unsatisfactory? However, this question does not go from being a theoretical one.

[508] For example for national banks see 12 USC§51a.Also see 12 CFR§5.46(g) for the cases where prior approval of the OCC is seen necessary to increase the bank's permanent capital.

firm to fail or a whole sector to deteriorate; rather, it is the market's judgment, not the SEC's conclusion to eliminate the firms from the market.[509] The main pillar of the disclosure system is to provide and maintain a system in which competing private institutions operate on fair and equal grounds to serve the public and any differentiated treatment of a firm for public policy and interest reasons might result in the distortion of competition (for example, such behaviour might lead to changes in the way the weaker competitor is treated).[510]

Accordingly, the SEC supports the adjustments in the capital-raising mechanism being made without favouring any parties even if the disclosure standards accepted by BRAs are substantially similar to theirs so that equal enforcement is accepted as a necessity of equal regulation. However, the SEC's approach ignores that regulators must establish the laws that are tailored to the risk profile of the institution. It might seem a very protective approach not to treat banks as any other public companies; yet the disclosure standards established by those BRAs generally showed parallelism with SEC disclosures as they use incorporation by reference method.

S 12(i) has consistently withstood the structural reform and as interest groups have recurrently bring up the this duplicative shadow systems residing in s 12(i) to the agenda by recommending that all securities activities should be regulated and enforced by one agency under a centralized system of securities regulation which can simply be

[509] Mathewson (n 379) 158.

[510] John R. Evans,'Regulation Bank Securities Activities' (1974) 91(7) Banking Law Journal 611,614.

accomplished by the elimination of s 12(i).[511] The existence of s 12(i), therefore, is important for the application of systematic disclosure rules to banks; yet the materially important underlying information, in theory, might not be fully disclosed if bank regulators think that the implementation of such regulation is not necessary or appropriate for the public interest or for the protection of investors. It can therefore be said that the statutory authority of the SEC in disciplining the banks is less than that of bank regulators. The important point is that all BRAs have decided to incorporate by reference to SEC's rules for those given sections. It means that banks are at present following the same rules as other public companies.

The fragmented system applicable to banks is only a subject of academic discussion. The full application of market discipline is one of the pillars for market confidence and investor protection, and the inclusion of banks directly to SEC disclosure requirements was seen as necessary for uniform standards, comparability, and consistency for shareholders. The split between authorities applicable to banks, as one represents substantive regulations and another stands for securities regulation, might be abandoned in favour of one uniform regulation. However, the application of the materiality test for banks might not produce the same results as other public companies because those firms do not have to follow a regulatory authority which might encourage the decision of changing the bank management or the date by which the bank must fund itself up to a certain amount if the bank is deemed as not well capitalized or not well managed.

[511] For those proposal reforms supporting the repeal of s 12(i) see US Department of the Treasury, Modernizing the Financial System: Recommendations for Safer, More Competitive Banks (1991) and the Report of the Task Group on Regulation of Financial Services(1984).

The interference by BRAs directly or indirectly influences the bank management and operations as well as the bank's ability to make distributions to its shareholders. First of all, the business subject of the banks is different from those non-financial firms in the capital markets; and so, apart from banks' importance in safety and soundness of the financial system, direct regulation by the SEC and full application of materiality test might not directly provide comparability on a fair and equal ground.[512] On the other hand, the persistence of keeping s 12(i) rather than placing banks directly under the SEC jurisdiction might create doubts because BRAs have embraced that securities regulation should be taken care of by the SEC.

2.1.2. Bank Holding Companies

Most of the commercial banks in the US are subsidiaries of BHCs and their assets and liabilities are therefore part of their holding companies.[513] It means most banks are accustomed to SEC regulations.[514]

A BHC means any company that has control over or ownership of one or more US banks.[515] They are not banks as they do not comply with the description provided at the 1934 Act,[516] and if they satisfy the 12(g) requirements, they are simply subject to SEC jurisdiction. This is important because it means that, in Loss and Seligman's words,

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[512] D'Arista (n 451) 341.

[513] Nicola Cetorelli,'How Bank Holding Companies Evolved?'(2015) World Economic Forum (accessed July 17, 2016) https://www.weforum.org/agenda/2015/10/how-have-bank-holding-companies-evolved/.

[514] Alfred M. Pollard and Joseph P. Daly, *Banking Law in the Unites States Vol* I (4th edn,Juris Publishing 2014) 14-11.

[515] The BHC Act of 1956,12 USC§1841(a)(1).

[516] 15 USC§78c(a)(6).

'…inevitably gives the indirect say on the financial and other disclosures acquired with respect to the subsidiary banks.'[517]

BHCs can be considered as financial malls of shops dealing with financial intermediation such as brokerage, mutual funds, brokerage, underwriting and a bank and such an organizational structure brings several problems, as experienced during the GFC.[518] BHCs have been heavily criticised because they were associated with the TBTF and SIFI phenomenon and their size, complexity and its internal connections between shops made them black boxes due to the lack of reliable information about their assets, related risks and portfolio holdings for each shops they hold. The regulators of each shop and the policies of those regulators are different: Safety and soundness of a subsidiary bank, protection of FDIC funds and depositors and other related prudential concerns are subject to bank regulatory system while the SEC sees the whole big organisation from the investor protection and abidance to fiduciary duties point of view.[519] Yet, as it is discussed further under this subsection, the crisis triggered such tension for BHCs.

Even though the bank owned by a holding company is subject to the OCC and FDIC regulations, the BHC has to register with the Board of Governors of the FR System. Therefore, the FR as a supervisory authority has control over those BHCs regardless of whether the bank is a state or national bank so that they are subject to supervisory

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517 Loss&Seligman (n 469) 485.

518 Tamar Frankel,'Why BHCs Need to be Broken Up? (2014)(accessed Jan 5,2016)https://www.bu.edu/today/2014/why-bank-holding-companies-need-to-be-broken-up/.

519 As banks have access to the Fed discount window, some investment banks changed their charters to BHCs to reach the Fed assistance during the GFC. Eva Becker, *Knowledge Capture in Financial Regulation* (Springer VS 2016) 166.

measures such as capital adequacy rules, risk exposures, and their components.[520] The organizational structure of BHCs require them to deal with reporting to two regulators because while their bank subsidiaries have to make disclosures to their primary regulators, the BHC itself has to report to the FR. BHCs might therefore make disclosures in more than one place, such as the SEC and the FR, and they are required to provide the information where such information can be found by the public.[521] As mentioned above, BHCs with respect to the registration of securities for public sale, periodic and other reporting requirements, and tender offers are all subject to regulations of the SEC under the 1934 Act, not BRAs. Therefore, as a public company, a BHC's disclosures of the trades to its stockholders are regulated by the SEC.

The traditional services that bank involve have changed in time as they have been heavily influenced by the wholesale markets, more specifically derivatives generally at the cost of the conventional banking activities.[522] Such transformation, as long as it is detectable from the balance sheets and from other released information, is addressed under the SEC disclosure regime as well as the established parallel bank regulator disclosure system. However, the objectives of these disclosures are different, and the SEC addresses it thus:

> We are cognizant of the fact that securities and banking disclosures serve different purposes in light of the different missions of their respective regulatory regimes. Where our disclosure regime serves our core missions of investor protection, fair, orderly, and

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[520] 12 CFR§225.

[521] For example,12 CFR§217.62-63 establishes the public disclosures about the bank capital adequacy.

[522] The OECD Report for G20 Leaders (2013)(accessed Sep 2, 2015)http://www.oecd.org/finance/privatepensions/G20reportLTFinancingForGrowthRussianPresidency2013.pdf.

efficient markets, and capital formation, the U.S. banking agency regulatory regime is premised largely on ensuring safety and soundness of banking organizations.[523]

Here, tension over the public interest between the SEC and BRAs should also be mentioned because, as examined previously,[524] the inherent conflict mentioned also appears in the interpretation of public interest. For the SEC, disclosure of material information on a rapid and current basis is in the public interest, and so the SEC interprets the public interest in the context of the protection of investors, the promotion of efficiency, competition and capital formation where public disclosure is a major tool to serve the public interest.[525] However, in terms of the disclosure of certain items such as material compliance violations that require formal enforcement actions, events of default or a requirement to disclose material contracts (especially contracts, commitments, demands, events or uncertainties that result in, or that are reasonably likely to result in, the firm's liquidity increasing or decreasing in any material way[526]) under Regulation S-K, the application of the term 'public interest' under banking regulation implies 'confidentiality'.[527] According to Miller, classifying some material confidential information (that has to be disclosed according to the SEC) for protection of the stability of the banking and financial system is an intentional informational asymmetry permitted by BRAs.[528] Another discussion is about the disclosure restrictions on confidential

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[523] SEC,'Request for Comment on Possible Changes to Industry Guide 3' (Feb 7,2017) at 74 (accessed April 30, 2017)https://www.sec.gov/rules/other/2017/33-10321.pdf.

[524] Chapter 3,Section 5.

[525] Analysis of Disclosures by Bank Holding Companies for SEC File Number S7-02-17 at 26-27 (accessed Jan 7,2018)https://www.sec.gov/comments/s7-02-17/s70217-1749647-151707.pdf.

[526] 17 CFR§229.303(a)(1).

[527] '… unless the appropriate Federal banking agency, in its discretion, determines that publication would be contrary to **public interest**.'(emphasis added)12 USC§1818(u)(1)(A).

[528] This treatment applies to large banks whose failure would disrupt the financial system. This discussion is not about CSI that BRAs want to remain confidential for efficiency and operational purposes, it is about the discretion provided to BRAs to withhold adverse

supervisory information (CSI), as securities laws might compel banks to describe the impact of any MoU or other non-public enforcement order that is material to investors.[529] Yet, there is no clear-cut answer provided by BRAs about this matter.[530]

Therefore, designation of materiality in the purposes of securities regulation is a difficult task for banks in drawing the limits of what makes information material for investors. Changing disclosure standards for public companies remains a perpetual challenge for BRAs to endure the disclosure of supervisory information by banks to public since it is material for the purposes of the securities regulation.

However, it also should be noted that the materiality standard under securities law is parallel to one embraced by bank regulator disclosure universe; but the concept of materiality is more compatible with the interests of bank itself rather than being more investor-focused.[531] Yet, certain points should be pointed out. The materiality standard,

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information if it is in the public interest. Omission of material information did not apply to small depository institution holding companies (those with assets less than 10 billion US dollars) because the Federal Reserve itself routinely discloses that information and state bank regulators require all enforcement actions to be publicly available. Miller addresses this situation as: 'Apparent market stability, but a fragile stability dependent upon information asymmetries that conceal fraud and systemic risks affecting all investors in large depository institution holding companies.'Beckwith B. Miller,'Information Asymmetries Conceal Fraud and Systemic Risks in the U.S. Banking Industry'(Aug 19,2017) Harvard Law School Forum on Corporate Governance and Financial Regulation (accessed Jan 13,2018)https://corpgov.law.harvard.edu/2017/08/19/information-asymmetries-conceal-fraud-and-systemic-risks-in-the-u-s-banking-industry/. See 12 USC§1818(u)(1)(A) that gives appropriate BRA discretion to disclose or withhold formal enforcement actions. See footnote 477 and 12 CFR§261.2(c)(1)(ii).

[529] Clifford S. Stanford,'Towards a Coherent and Consistent Framework for Treatment of Confidential Supervisory Information' (2018) 22 North Caroline Banking Institute 41,61.

[530] Section 2.1.1.

[531] The US Basel III Adopting Release (n 457).

as it is applicable in parallel disclosures required by BRAs, might be a weak form of materiality. As established at BCBS, there are rooms for banks not to disclose specific items of information (ie particular commercial or financial information which might deteriorate the bank's position) and when banks decide not to disclose, they need to work with BRAs to make more general disclosures to public as an alternative to prescribed disclosure.[532] Yet, the SEC system does not allow a company to decide not to make disclosures based on its own discretion and rather, a CTO must be requested from the SEC by following the relevant procedures.[533] Considering the investor-oriented focus of the SEC, it might be asserted that it is not easy to have a CTO for information, which is deemed material by the Commission.[534]

The SEC has specifically addressed BHCs' disclosures under the Statistical Disclosure by Bank Holding Companies, known as Guide 3, to help investors in assessing the firm's earnings and exposure to risks in view of the changing activities of banks.[535] The focus of this specific guide is to provide information about loans that the banks have extended and also surrounding risks and uncertainties that the loans offer. Information regarding loans includes items such as the type, maturity, interest rate characteristics, loan loss

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[532] BCBS,'International Convergence of Capital Measurement and Capital Standards'(2006) at 228 (accessed Jan 2, 2015)http://www.bis.org/publ/bcbs128.pdf.

[533] 17 CFR§230.406 and 17 CFR§240.24b-2.

[534] The joint requirement that the information is commercially important but immaterial to investors poses an inherent problem in CTO application. P. Cade Newman,'Requests for Confidential Treatment and "Silent Filings"' (1996) 29(9) Review of Securities&Commodities Regulation 99,106.

[535] Guides for Statistical Disclosure by Bank Holding Companies, Securities Act Release No. 5735, Exchange Act Release No.12,748,41 Fed. Reg. 39,007(September 14, 1976).Recently there has been a request by the SEC to make changes on Guide 3.See Request for Comment on Possible Changes to Industry Guide 3 (n 523).

experience, or breakdowns of loans (whether the loan falls into past due, restructured non-performing, or non-accrual categories).[536]

Financial innovation in the banking industry, for example growing use of derivatives by banks, might underscore the simplicity and transmissibility of the information pertaining to complex financial activities of banks. The catastrophic experience of the collapse of Lehman Brothers and its window-dressing practices to conceal its true financial standing (ie short-term borrowing transactions are used to report inaccurate leverage amounts) have led to enhancements in the disclosure of management's discussion and analysis of financial condition and results of operations (MD&A).[537] MD&A has gained more importance to ensure that information related to banks' capital resources and liquidity is accurately provided with an eye towards used complex and risk sensitive financial instruments, loan losses and possible future risks and risk exposures.[538] So, with specific to banks, MD&A stands as a significant item exposing bank's riskiness from the eyes of the management compared to other general elements of disclosure requirements. In the past and during the GFC, MD&A disclosure created stability-related discussions as to disclosure of emergency support from the CB at the height of financial crisis. Yet, the S&L crisis already produced a result about it.

The S&L crisis ended up with the failure of hundreds of banks and the use of significant amount of federal assistance.[539] This was the first step for the SEC to acknowledge that FIs actually do not publicly disclose information about the financial assistance they

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[536] Ibid.

[537] The Interpretive Release,Securities Act Release No:9144, Exchange Act Release No:62,934, 75 Fed. Reg. 59(Sep 28, 2010).

[538] 17 CFR§229.303.

[539] Carl Felsenfeld, 'The Savings and Loan Crisis' (1991) 59 Fordham Law Review 7.

receive. In 1989, in the heat of the crisis, the SEC interpretive release provided that FIs should disclose any types of federal financial assistance if they 'have materially affected, or are reasonably likely to have a material future effect upon, financial condition or results of operations, the MD&A should provide disclosure of the nature, amounts and effects of such assistance'.[540] This ruling titled 'Effects of Federal Financial Assistance upon Operations' is still applicable; but secret borrowings by FIs were not appropriately or fully disclosed either because they did not accept that their massive borrowing from the Fed was material and available information was satisfying for investors; or it was the Fed's tacit encouragement made for the protection of financial stability.[541] So, pursuant to the Guide 3, it is expected from reporting BHCs to disclose any type of assistance in the MD&A section.

In turbulent times, specific disclosure provisions regarding to liquidity, trends and uncertainties become more important and create grounds for political sensitivity. Item 303(a)(1) of the Reg S-K requires the firm to 'identify any known trends or any known demands, commitments, events or uncertainties that will result in, or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way.'[542] Further, the market risk disclosure rule requires additional statistical and narrative disclosure related to derivatives and other financial products, which can be the source of market risk. Item

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[540] SEC Releases Nos.33-6835; 34-26831; IC-16961; FR-36(May 18,1989)(accessed May 11, 2017) https://www.sec.gov/rules/interp/33-6835.htm#P295_64970.

[541] 'I would have expected some discussion in the management discussion and analysis of how this has had a positive impact on these banks' operating results. The borrowings had to have an impact on their liquidity and earnings, but I don't ever recall anybody saying "we borrowed a bunch of money from the Fed at zero percent interest."' Lynn E. Turner cited from Gretchen Morgenson,'Secrets of the Bailout, Now Told' NY Times(Dec 3,2011)(accessed Dec 5, 2017) http://www.nytimes.com/2011/12/04/business/secrets-of-the-bailout-now-revealed.html.

[542] 17 CFR§229.303(a)(1).

305 of Regulation S-K[543] establishes the '… rules that require disclosures about the policies used to account for derivatives, and certain quantitative and qualitative information about market risk exposures.'[544] Also, several items on Form 8-K, for instance, item 2.06 requires firms to release information about the date and magnitude of material impairments of their assets. Proposed acquisitions, participation in TARP funds, use of discount window facility and relevant information can be disclosed on Form 8-K.

The information provided above shows that the SEC has an industry-specific guide for BHCs based on idiosyncratic characteristics (engaging in lending, deposit-taking and derivative activities) of these banking organizations to make them more open and understandable in the market for investors. Recent discussions on BHC disclosures focus on enhanced transparency regarding to material effects of prudential regulation (such as stress tests and resolution plans) and derivatives positions and incorporation of regulatory disclosures in SEC filings.[545]

Yet, application of the SEC's maximum transparency approach came into question in some cases and revealed that information sharing in pursuant of securities regulation is not fully compatible with the bank and financial stability and bank prudential regulators' interests in safe and soundness of top-tier FIs.

2.2.Cases to Explore: American International Group and Bank of America

The emphasis given for BHCs is generally related to their riskiness due to their size and

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543 17 CFR§229.305.

544 Cited from https://www.sec.gov/divisions/corpfin/guidance/derivfaq.htm (accessed July 18, 2015)

545 Request for Comment on Possible Changes to Industry Guide 3 (n 523).

complexity in the system. Their controlling power on US bank assets via consolidation and the range of activities they engage in the financial system with their subsidiaries operating in diversified areas such as brokerage and dealing, commercial banking, insurance or asset management emphasize the importance of BHCs and their debts in terms of preventing systemic risk and potential failures. Having great influence over the financial system as being generally systemically important FIs, disclosure related concerns appeared in the case of the AIG in 2008.[546]

2.2.1. American International Group Bailout Mystery

AIG, as a publicly traded insurance company, was required to file current reports in a Form 8-K to the SEC within four working days after experiencing certain events and those reports are publicly available.[547] The event in this case was to contract involving Maiden Lane III (MLIII), which is a financing entity (SPV) created by the AIG and the Federal Reserve Bank of New York (FRBNY) to buy CDOs (on which AIG had written credit default swap contracts) from the AIG counterparties at the height of the financial crisis, and the MLIII was an important recipient of federal bailout money to lessen the impact of the crisis and prevent the balance sheet type-contagion.[548] It is also seen as a 'backdoor bailout of counterparties' (especially banks) because the lion's share of the

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[546] For an extensive examination for the AIG case, see Congressional Oversight Panel,'The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy'(Jun 10, 2010)(accessed Dec 16, 2016) http://www.law.du.edu/documents/corporate-governance/empirical/AIG-rescue-cop-061010-report.pdf.

[547] 15 USC§78(m)(a)(1).

[548] 'Public Disclosure as a Last Resort:How the Federal Reserve Fought to Cover Up the Details of the AIG Counterparties Bailout from the American People' Special Report of Committee on Oversight and Government,111th Congress (Jan 25, 2010)(accessed March 11, 2015) https://oversight.house.gov/report/public-disclosure-as-a-last-resort-how-the-federal-reserve-fought-to-cover-up-the-details-of-the-aig-counterparties-bailout-from-the-american-people/.

assistance provided to AIG channeled to the banks.[549]

AIG attempted to disclose some information about the names or values of the assets bought by MLIII as a result of SEC filings. In a draft of one regulatory filing, AIG explained that it had paid banks (including domestic and foreign banks (such as Deutsche Bank and SG) and big banking organizations whose public exposures can disturb the market and the public confidence) the full value of the CDOs that they had purchased from the company. Yet, in the final draft, the FRBNY's counsellors omitted this information. The main discussion was about the attachment to an agreement between AIG and MLIII: Schedule A. So, disclosure of Schedule A (including information about counterparties' identities, identification numbers of each transaction and prices that MLIII was buying underlying assets at) was bypassed by the recommendation, or pressure, of the FRBNY.

When FRBNY officials discovered the SEC's rejection, they straightaway intervened with the SEC to obscure the information held in Schedule A.[550] Due to the high governmental interest in withholding such information from public, FRBNY asked for an alternative way from the SEC to keep that information secret.[551] The SEC did not answerback to the FRBNY's pressures for absolute non-disclosure; but instead, it behaved differently to the situation than it treats to other companies in their confidential submissions. Schedule A was delivered by hand to a SEC official and put in a specific

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[549] Ibid.

[550] Ibid 7.

[551] E-mail from James Bergin to Thomas Baxter (13 Jan 2009)BATES #FRBNY-TOWNS-R3-004119.

place where national security related files are deposited.[552] Ultimately, pressure from the SEC for full disclosure was responded to with a partly redacted (names of banks and some bank-specific information was redacted) Schedule A and with an application for confidential treatment for those censored parts.[553] CTO was requested not because the overall financial stability of the state would be in danger, at least it was not the reason showed on the letter, it was requested based on 'substantial competitive harm' that the AIG and its counterparty banks would face if Schedule A was publicly available. As a result, the SEC provided the CTO.

This unusual practice was addressed by the Vice Chairman of the Fed by two main reasons. The first one is about the stability of the FI itself: '… I would be very concerned that if we started giving out the name of counterparties here, people would not want to do business with AIG.'[554] The second one addressed the overall stability and wellness of the financial system: '…(G)iving the names…could have serious knock-on effects to the rest of the financial markets and the government's efforts to stabilise them.'[555] After all, the situation gave the view that the Fed was the invisible authority to control the content and timing of the AIG's disclosures and it thwarted the full disclosure attempts of the AIG. Yet, the FRBNY later stated that such assertions are incorrect:

> …[R]ather than seeking to conceal information, the FRBNY comment was made in an

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[552] E-mail from James Bergin to Thomas Baxter (Jan 13, 2009) BATES #FRBNY-TOWNS-R3-004119 cited from the Special Report of Jan 25, 2010 (n 548) 7.

[553] William K. Sjostrom Jr.,'Afterword to AIG Bailout', (2015) 72(2) Washington and Lee Law Review 795,814-19.

[554] Donald L. Kohn's Statement (2009) Hearing before the Committee on Banking, Housing and Urban Affairs US Senate 111th Cong, 1st session at 13(accessed June 6, 2016) https://www.gpo.gov/fdsys/pkg/CHRG-111shrg51303/pdf/CHRG-111shrg51303.pdf.

[555] Ibid.

> effort to help ensure the accuracy of the disclosures so as to avoid any suggestion that the FRBNY had made a commitment that was not made at the time (and in fact was never made).[556]

Taking a step back and looking at the bigger picture of the AIG's disclosure problem provides that, even if Schedule A was amended several times to satisfy the SEC, overall impression of the SEC and the Fed was about their partly alliance in withholding information from taxpayers.

Apart from the fact that AIG is an insurance company, not a bank, the tension appeared here showed that the Federal Reserve could be disturbed by the idea of public disclosure of some facts, which are closely associated with its stability mandates.

2.2.2. Merger of Bank of America and Merrill Lynch

Another example of a similar situation involves a bank and it was observed in the epic acquisition of the ML by the BoA in 2009. According to a lawsuit brought by state of New York, prior to the merger vote, the BoA did not disclose to shareholders that the ML suffered substantial losses more than $16 billion and also it refrained from full disclosure in its proxy materials related to bonuses paid to the investment bankers who structured the deal.[557] There were strong arguments about the materiality of the non-disclosed

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[556] The FRBNY's Statement regarding Public Disclosures of AIG concerning MLIII LLC (Jan 19, 2010)(accessed Dec 17, 2016) https://www.newyorkfed.org/markets/st100119.html. Yet, some statements show that the FRBNY has influence on the AIG's disclosures. 'It was appropriate as a party to the MLIII transactions for the FRBNY to comment on a number of issues, including disclosures, with the understanding that the final decision rested with AIG and its external securities counsel.'Congressional Oversight Panel, Testimony of Thomas C. Baxter, Jr., general counsel and executive vice president of the legal group, FRBNY, COP Hearing on TARP and Other Assistance to AIG (May 26, 2010).

[557] BoA was accused of violation of s 14(a) of the 1934 Act and Rule 14a-9.

information and public outrage related to the non-disclosure has given birth to arguments whether the merger and the non-disclosure was made at the behest of the government.

To establish a timeline of important events about the merger, on September 15, 2008, BoA entered into a merger agreement with ML. As the Attorney General who investigated the merger highlights that the timing of the merger was paramount to save the ML from demolition.[558] Shareholders accepted the merger on 5 December 2008, and the week after the shareholders vote, ML's quick and quiet process of booking additional losses ended up with $7 billion worse than it was supposed to be when the deal was voted. BoA executives were aware of some these substantial losses before the shareholder vote; but they avoided to disclose this information (which is described as 'staggering amount of deterioration'[559] at ML) to shareholders until middle of January 2009. On 17 December 2008, the CEO of the BoA, Kenneth Lewis, consulted with the Treasury Secretary Henry Paulson about invocation of the Material Adverse Change (MAC) clause, on the grounds that BoA had a legal basis to abandon the deal. According to Lewis, federal government officials put pressure on BoA to complete the merger deal and not to disclose the substantial losses of ML. Further, the Fed chairman and the Treasury secretary informed BoA that such a move would highly disturb the market, create systemic risk and cause reputation loss for the bank.

On 22 December 2008, the board was advised about not to invoke the MAC clause and

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[558] The letter from Andrew M. Cuomo (Attorney General of the State of NY) to J.Dodd, B. Frank, M.L. Schapiro and E. Warren (April 23, 2009)(accessed Jun 11, 2016)https://ag.ny.gov/sites/default/files/press-releases/archived/BofAmergLetter.pdf

[559] Ken Lewis's statement, cited from Cuomo's letter.Ibid.

Lewis accepted that Paulson's pressure changed his decision about the merger.[560] The minutes of the meeting revealed that the Treasury and the Fed were in agreement to finalize the merger in order to overcome the crisis of confidence.[561] The minutes of another meeting held on 30 December 2008 was supportive of the view that BoA would abandon the merger deal by MAC clause.[562]

Though ML's deteriorated operating results and capital position would be a legitimate ground to invoke the MAC clause, BoA chose not to make a disclosure about such substantial losses or the effect that it would have on the merger. BoA did not disclose that there was a real potential to invoke the clause. As Cuomo's letter shows, Lewis testified that the decision to withhold information was based on Paulson's and Bernanke's instructions. Yet, the merger was completed on 1 January 2009 and on 20 January 2009 BoA publicly disclosed that (i) it planned to receive additional funds from the government and (ii) ML's losses were around $15.3 billion in 2008.[563] The timing of the disclosure can be criticized because seemingly there is an effort to lessen the negative effects of

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[560] Paulson did not call his behaviour as threat and instead, he said he mentioned the Fed's powers to Lewis if BoA would pursue the course of invoking the MAC clause. See Paulson's testimony, Bank of America and Merill Lynch: How Did a Private Deal Turned into a Federal Bailout?Part III: Joint Hearing before the Committee on Oversight and Government Reform, 111th Cong. 111-46 (July 16,2009)(accessed Jan 1,2017) https://www.gpo.gov/fdsys/pkg/CHRG-111hhrg55765/html/CHRG-111hhrg55765.htm.

[561] Minutes of Special Meeting of Board of Directors of Bank of America Corporation (Dec 22, 2008)(accessed Jan 4,2017)https://ag.ny.gov/sites/default/files/press-releases/archived/Exhibit%20B%20to%204.23.09%20letter.pdf.

[562] Minutes of Special Meeting of Board of Directors of Bank of America Corporation (Dec 30, 2008)(accessed Jan 4,2017) https://ag.ny.gov/sites/default/files/press-releases/archived/Exhibit%20C%20to%204.23.09%20letter.pdf.

[563] Janet E. Kerr,'The Financial Meltdown of 2008 and the Government's Intervention:Much Needed Relief or Major Erosion of American Corporate Law' (2011) 85 (1) St John's Law Review 49,51-53.

disclosure of ML's financial condition by the disclosure of the positive news that the BoA will have extra funding from the government.

While the communication and settlement between the SEC and the BoA for the bonuses was discussed thoroughly whether the bonus information was material or not, the elephant in the room in this case was the government's actions. As Davidoff has addressed in 2009:

> The SEC charged on the bonuses but not on the more flagrant issue of failure to disclose the ML losses… This is likely a political calculus due to government support and its role in the non-disclosure. Nonetheless, BoA's lawyers apparently justified this disclosure by asserting that it was non-material given the performance of other banks and the economy … [M]ateriality should be assessed in light of the environment … The bottom-line is a negative lesson: the treatment of materiality in this case is likely to be stretched by both the financial crisis and the government's conduct, and any decision should be taken with a grain of salt.[564]

When the arguments produced for the support of the acquisition as a necessary step to protect financial stability and prevent a potential panic after the infamous bankruptcy of Lehman Brothers and the arguments about the attempts of Lewis, to invoke the MAC clause are taken together, allegedly there is a general impression about the pressure coming from the Treasury and the Fed.[565] The SEC brought suit against the BoA to explore why it left its stockholders in the dark about the deteriorating financial condition of the ML.[566] So, this acquisition left questions about stretching the boundaries on behalf of the whole economy as articulated by Kerr as:

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[564] Steven M. Davidoff,'Bank of America/Merrill Lynch: Lessons Learned'(2009) Practical Law Article 6-500-8385 1,4

[565] Kerr (n 563) 60.

[566] *Securities and Exchange Commission v. Bank of America Corporation*, Civil Action Nos. 09-6829, 10- 0215(S.D.N.Y) where the BoA agreed to pay $150 million to settle SEC charges.

> Saving a corporation or multiple corporations from failure is certainly commendable, especially when these efforts may significantly help the overall American economy. However, is it legal, or at the very least good corporate governance, for boards of directors to yield to governmental pressure and consider the welfare of the overall American economy, which arguably equates to considering the American public at large, when making such decisions?[567]

The SEC settled its law suits against BoA in two stages: The SEC filed a suit against BoA but in August 2009, BoA and the SEC concluded a settlement under which BoA would pay $33 million for disclosure violations. Yet, Judge Rakoff rejected the settlement in September 2009[568] and after the SEC expanded its lawsuit against BoA, Judge Rakoff (though the court was not satisfied) approved the settlement of $150 million civil fine.

These incidents should be interpreted with the unprecedented government intervention happened in 2008 when numerous systemically important FIs were on the verge of collapsing. One of the toolkits to revive those institutions was the creation of the TARP, which the government provided billions of US dollars to those corporations to stop further deterioration of the economy.[569] So, the government simply gave loan to BoA via TARP and then provided more to make it acquire about-to-fail ML.[570] Apart from other allegations (such as Treasury Secretary Paulson's threat to BoA to replace their management if the MAC clause is invoked), the overall view about the finalisation of the

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[567] Kerr (n 563) 52-53.

[568] *C v. Bank of America Corporation* (2009) Civ 6829 (SDNY).

[569] Chapter 2,Section 3.1.3.1.

[570] Considering the provided amount of money to the BoA ($45 billion), it seems that taxpayers bought ($50 billion) the ML for the BoA. 'Bank of America and Merrill Lynch: How Did a Private Deal Turn into a Federal Bailout?Part III: Hearing Before the H. Comm. on Oversight and Government Reform, 111th Cong. 23-24 (Jun 11, 2009)(accessed March 23, 2015)https://www.gpo.gov/fdsys/pkg/CHRG-111hhrg54877/html/CHRG-111hhrg54877.htm.

merger and related issues such as non-disclosure of information lead to several questions: Did the Fed and the Treasury abused of their powers, (or at least presumed that they should have superiority over other agencies) in handling with instability by not considering the shareholders' interests of BoA and by –allegedly- keeping the agency tasked with investor protection and market efficiency unaware of the potential merger?[571] Was the government's relations with and authority over the private sector revealing a legal problem? To be more precise, was investor protection lost in the powerful rhetoric of financial stability? In Coffee's words:

> This is a longstanding tension. You have to understand the bank regulators and the SEC disagree about transparency. Bank regulators are primarily focused on protecting bank solvency and a fear a run on the bank. The SEC is primarily focused on transparency and aiding shareholders and they want maximum disclosure. Those two agendas conflict and this is the classic kind of case before the Federal Reserve did not want shareholders knowing that the losses at Merrill Lynch were staggering because the Merrill Lynch Bank of America merger was a keystone in their financial plan to prevent a total meltdown. I think they were right, there would have been a meltdown had that merger not occurred.[572]

These cases are important because it is a recent clear example of the controversy between a federal regulatory agency and the SEC and it provides a compelling reason to argue that BHCs with systemic importance might be under pressure by their federal bank regulators at some point to hide various details from investors which means there is a considerable tension between handling with systemic risk and the level of corporate disclosures.

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[571] Discussions centre upon the government's behind-the-close-door activities in their actions for the protection of financial stability because neither Fed nor the Treasury informed the OCC or the SEC for the merger beforehand. On the other hand, such actions taken by the government can also be seen as footsteps of macroprudential regulation where CBs are provided with more powers and toolkits to protect the stability.

[572] John Coffee's speech on Bloomberg News, 'Columbia Professor John Coffee on Bloomberg TV', CEO Wire (Dec 11,2009) ProQuest.

2.3. Overall View of the Information Disclosed by Banks under the US Securities Regulation

This part establishes that even if the BRAs establish substantially similar disclosure regulations to those established under securities regulation, institutional bias towards BRAs and potential conflicts within the BRAs to administer and enforce disclosure rules theoretically stand as a barrier to fulfilling the market's demands for the information. A similar bias might be seen at the side of the banks such that they have developed a strong antipathy towards the SEC regulations in consequence of the SEC's 'rigorous enforcement' approach in enforcing exposure of misconduct.[573] The general composition taking BRAs as supervisory agencies and the SEC as an enforcement agency against the after-the-fact violations might not describe the rightfulness of claims for jurisdiction over banks, and the fact that BRAs use public disclosures as a supplementary tool of supervision establishes that the tension between the two regulatory systems is not as high as before.

Another concern is about the necessity and functionality of such a dual regulatory system in consideration of present market conditions.[574] As can be seen, enforcement and administration of those specified disclosure-related sections by the BRAs are accomplished through the ignorance of clear statutory instruction stating that those BRAs '… shall issue substantially similar regulations and rules issued by the Commission'.[575] This ignorance is a virtual one, which is simply fulfilled by full incorporation by reference to SEC regulations.

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[573] Maloney (n 420) 454-55.

[574] Michael P. Malloy,'Public Disclosure as a Tool of Federal Bank Regulation'(1990) 9 Annual Review of Banking Law 229,247.

[575] 15 USC§78(l)(i).

Overall, banks, as issuers of securities, are (virtually via s 12(i) or under the BHC structure) subject to the disclosure requirements of federal securities regulation. Anti-disclosure provisions established in the FOIA or relevant BRA laws make a point related to the disclosure of examination, operating, or condition reports produced by and for BRAs and take this information as the property of the relevant BRA. However, the view based on the view that banks and banking sector are susceptible to adverse information and therefore warrant of some degree of secrecy is necessary might be seen as a self-serving rationale. It was stated that even in the 2008 financial crisis, where the information on certain material supervisory determinations by BRAs was publicly available, dissemination of negative information did not trigger a bank run. [576] However, the cases examined here provide that confidence component of financial markets is a valid ground for stability regulators to act upon it.

The general view taken from those cases is that, negative information related to large FIs is likely to disturb markets and at the height of the crisis, financial stability regulators have interest in non-disclosure of adverse information of such institutions. Concerning to banks, the BoA disclosure issue did not directly affect depositors in a sense that wrongdoing of the BoA in high-profile merger did not prepare the ground for loss of depositors' confidence. Yet, the general view suggests that financial stability regulators need to have a room to resolve bank-related issues secretly. So, rather than having such tension with the SEC and interfering with the institution behind the closed doors or at least providing such an impression; legal certainty is suggested.

[576] Julie Andersen Hill,'When Bank Examiners Get It Wrong'(2015) 92(5) Washington University Law Review 1101,1182.

Overall, perhaps as a result of bank failures in the 1980s where the efforts of withholding financial information about banks did not work out as a solution against failures based on fraud and bad management, BRAs see public disclosures as being in the public interest, and direct application of SEC disclosure requirements on BHCs or indirect application of those rules over individual banks underpin the BRAs' approach in utilizing public disclosures as complementary to supervision and protecting and enhancing the public confidence. The very broad protective coverage of exemption 8 of the FOIA is also relevant here as the heavy criticism of BRAs after the GFC have reignited the discussion regarding whether exemption 8 has outlived its usefulness in today's transparency and accountability-driven environment. BRAs often used this exemption during the GFC and the court later held that confidentiality under exemption 8 should be granted to BRAs, not the bank, which means the exemption served its policy objectives in terms of protecting the bank's security.[577] However, as mentioned, there is always room for further discussions about the present regulatory framework vis-à-vis prudential concerns.

In accordance with the increasing importance of financial stability, commentaries on the changes for Guide 3 address the jurisdictional tension between prudential regulators and markets regulators and then advise collaboration and more updated and enhanced disclosure for BHCs to prevent systemic risk and market instability.[578] This approach highlights market-based prudential regulation over prudential market regulation.[579] In other words, banks complying with the enhanced disclosure-oriented focus of market regulation is one of the strongest views recommended for the financial health of the

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[577] *McKinley v. Board of Governors of Federal Reserve System* (n 297).
[578] Michael S. Piwowar,'Remarks before the Quadrilateral Meeting of the FMLC/FMLG/FLB/EFMLG'(July 20,2016)(accessed May 11,2017) https://www.sec.gov/news/speech/speech-piwowar-2016-07-20.html.
[579] Ibid.

banking and financial system; yet, it does not response to the dilemma investigated here in a problem-solving manner. Transparency as an *ex ante* mechanism is surely beneficial under favourable and good market conditions; yet, forecasting a crisis and preventing its occurrence is not always possible,[580] so other mechanisms should offer preventive mechanisms to cover future possibilities.

So, BoA and AIG cases revealed two important aspects of this discussion: first, authorities found out that 'they did not have the powers to resolve problems in the way they would have liked';[581] second, the law should respond to the need to delay or limit disclosure of certain information for systemically important and large FIs for the protection of financial stability.

3. Legal Framework of Disclosure Regulations in the UK Securities Laws

3.1.Synopsis of UK Capital Markets Regulation

Legal sources for UK securities regulation cannot be thought of outside the frame of the EU. Legislative interference at the EU level has played a large part in UK securities regulation as applicable today as a result of the integrated pan-European capital markets.[582] Directives and regulations are the driving force in establishing the minimum

[580] Fabio Canova,'Were Financial Crises Predictable?'(1994) 26(1) Journal of Money, Credit, and Banking 102.

[581] J.R. Barth, D.G. Mayes, M.W. Taylor,'Safeguarding Global Financial Stability, Overview' in Gerard Caprio Jr.(ed), *Handbook of Safeguarding Global Financial Stability* (Elsevier 2013) 228.

[582] Ellis Ferran and Look Chan Ho, *Principles of Corporate Finance Law* (2nd edn,OUP 2014) 360.

level of transparency in the markets.[583] Implementation of high-level principles can be seen in the form of legislation and more detailed principles of FCA regulations.[584] In terms of disclosure of information, there are a number of pieces of EU law such as the Prospectus Regulation (PR),[585] the Transparency Directive (TD)[586] and the MAD, which was repealed. The objective of the PR is to provide necessary materials to the investing public in the prospectus so that investors can make informed decisions whether to make a financial commitment. The TD's goal is to specify the information that has to be disclosed by the issuer in order to ensure transparency of information for investors via a regular flow of disclosure of periodic and ongoing regulated information. The MAD, which was replaced by the MAR, aims to increase market integrity and investor protection via prevention of market abuse rules, which requires ad hoc disclosures in the capital markets.

[583] The EC also establishes technical regulations to provide details about the framework principles and securities directives are implemented into UK securities laws through statutes and regulations.

[584] Alastair Hudson, *Securities Law* (2nd edn,Sweet&Maxwell 2013) 1-03.

[585] Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC.

[586] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC. TD is amended by the Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013 amending Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and Commission Directive 2007/14/EC laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC.

The primary act on the regulation of capital markets in particular, and of financial services in general, is the FSMA. Other statutory instruments subordinate to the FSMA also provide securities regulation in other contexts. Another major source for capital markets transparency is the FCA Handbook which establishes Listing Rules (LR), Prospectus Rules (PR) and Disclosure and Transparency Rules (DTR).[587] The FCA is the UK's securities regulator simply because it oversees market disclosures, reviews and approves prospectuses, and operates the UK listing regimes, acting as the UK listing authority (UKLA).

Finally, the interaction between securities laws and general law should not be overlooked since general law covers all types of substantive law, excluding FCA-based principles and regulatory principles residing in the Directives. This means that other laws (such as common law, equity, tort, contract and criminal law) can apply to capital markets transactions. Overall, a mixture of EU legislation, domestic legislation and rules constructed by the FCA together with other rules developed by the stock exchanges themselves regulate transparency.[588]

The historical evolution of disclosure practices in British capital markets shows that information disclosure has always been a primary pillar of the system. The UK, where securities regulation began as far back as the 13th century,[589] had formed specific disclosure regimes for joint stock firms by the end of the 19th century. This occurred through the administration of informal mixed disclosure rules to the market. In addition,

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[587] It also includes guidance notes incorporated into the FCA Handbook.

[588] Gullifer and Payne (n 319) 493.

[589] B. Rider, C. Abrahams and M. Ashe, *Guide to Financial Services Regulation* (3rd edn,CCH 1997) 3-4.

the London Stock Exchange (LSE) urged joint stock companies to transfer the copy of the accounts to the LSE, which had been declared to their stockholders through their Annual General Meetings.[590] Voluntary public disclosure of annual balance sheets was popular among companies that had many shareholders, which showed that regular and systematic disclosure of information was possible according to market needs.[591]

UK securities markets regulation builds upon two principles: (i) members of the public must have access to full information prior to making a financial commitment; and (ii) the investing public must have efficient remedies for losses emanating from incomplete or inaccurate disclosure.[592] Following the GFC, safe harbours or exemptions provided to issuers relating to public disclosures and delay provisions have been subject to changes that reflect the needs of the financial system. More than just laws having changed, regulators' understanding of their approach to public interest and its relevance to financial stability has also changed. For example, overarching public interest exemption provided in the PD and now in the PR has been interpreted with reference to financial stability.[593] Considering the UK's position as an important world financial centre, any piece of law proposing the opposite of 'more and more transparency' would be a courageous step. New thinking about delayed but planned disclosure for banks has been the product of poor experiences of banks that first occurred in the UK and then in France. Those experiences planted the seeds for the new MAR.

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[590] R.A. Bryer,'The Late Nineteenth-Century Evolution in Financial Reporting: Accounting for the Rise of Investor or Managerial Capitalism?'(1993) 18(7) Accounting, Organization and Society 649.

[591] Christopher Naphier,'*United Kingdom'* in Gary Previts, Peter Walton & Peter Wolnizer (eds), *A Global History of Accounting, Financial Reporting and Public Policy* (Emerald Group 2010) 243-73.

[592] Gullifer and Payne (n 319) 521.

[593] PD, art 8(2)(a); PR, art 18(1)(a).

To understand the development of changes in transparency laws in the UK together with other EU states, it is beneficial to understand how British law has approached bank disclosures up to the present. As such, the next part will explain British bank disclosure practices from a historical perspective to present day conditions.

3.1.1. Bank Disclosures in the UK

The development of bank disclosures in the UK has been largely affected by the fear of instability and the concept of non-disclosure has developed based on particular reasons such as hiding the true benefits and capital or the utilisation of hidden reserves.[594] The support towards non-disclosure was seen as a result of the conversion of private banks and partnerships to joint-stock banks in an amalgamation process. Their replacement of those banks via mergers created a concentrated banking industry in the beginning of the 1920s which resulted in the control by big five commercial or clearing banks over the banking system.[595]

The environment surrounding non-disclosure was supported both by the government and banks. The market structure, with limited numbers of big joint-stock banks and its accompanying convenience for the regulators, was seen as preferable for overseeing stability through those banks. Banks favoured non-disclosure because the non-disclosure was the result of the implicit agreement with the regulators that banks would behave as monetary policy mechanisms for the government and in return they could enjoy the

[594] Billings (n 242) 287-90.

[595] John D. Turner, *Banking in Crisis: The Rise and Fall of British Banking Stability,1800 to the Present* (CUP 2014) ch 3.

benefits of non-disclosure such as keeping the use of inner reserves,[596] the real capital and profits earned for themselves.[597] The stability argument asserted by banks in favour of non-disclosure was underpinned by the premise that incompatibility in bank disclosure regimes around the world might place British banks in a disadvantageous position in terms of competition.

Exemption of banks from disclosures was justified on grounds of higher public interests. Shareholders' interests in information was valued less than depositors' simply because depositors' interests represented public interest in the overall stability of the banking system.[598] Though contrasting views for such an exemption bestowed on banks began to appear, and full disclosure of reserves and profits was demanded by the securities regulatory community starting in the 1960s,[599] the demise of non-disclosure became possible in early 1970s.[600] It was perhaps because of the informal regulatory contract and informal relationship between the government, the regulator and the bank: While banks serve government interests by supporting the goal of ensuring the safety and soundness of the financial system, the government gave certain privileges to the banks such as exemption from disclosure.[601] A concentrated banking system, with a lack of competition

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[596] The prohibition of the use of hidden reserves did not apply banks based on the exemption provided to them. See Companies Act of 1947, Part III of the First Schedule.

[597] Billings (n 242) 288.

[598] For example see the reference to banks about undisclosed reserves at paragraph 101 of the Report of the Committee on Company Law Amendment (Cohen Report) (1945) cmnd 6659 (accessed July 20, 2016) http://www.takeovers.gov.au/content/resources/other_resources/cohen_committee.aspx.

[599] For example, the Report of the Company Law Committee (Jensen Report) (1962) cmnd 1749 paras 399-405.

[600] Raymond J. Chambers, *Securities and Obscurities* (Sydney University Press 2006) 109.

[601] See Don Cruickshank's Presentation to the Banking Industry and Analysts, 'Competition in UK Banking: A Report to the Chancellor of the Exchequer' (20 March 2000) (accessed Nov.

and preferential treatment, according to Capie and Billings, was the BoE's long-standing approach in allowing a 'banking status quo in government circles'.[602] The exemption was justified on two grounds: First, it helped banks to reduce shareholders' excessive dividend expectations. Second, hidden losses formed a cushion against losses during a potential crisis and therefore assured the long-term survival of banks.[603] The trust in and credibility of banks, by not disclosing certain information for individual and collective interests, was, therefore, supported in law.[604]

The amount that shareholders received in their dividends depends on the banks' profits and it is addressed that there was an inherent conflict of interest between the depositors and the shareholders since there had been a possibility that banks did not inform their shareholders about their undisclosed transfers to secret reserves.[605] Depositors, on the other hand, might have enjoyed the prolonged durability of banks, even during stressful times, owing to that reserve.

British banks gradually became more transparent with the end of the non-disclosure era in the 1970s due to the pressure from shareholders and developments in bank transparency in other countries.[606] Hence, British banks voluntarily abandoned the

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22, 2018) https://webarchive.nationalarchives.gov.uk/20050301221631/http://www.hm-treasury.gov.uk/documents/financial_services/banking/bankreview/fin_bank_reviewfinal.cfm.

602 Forrest Capie and Mark Billings,'Evidence on Competition in English Commercial Banking, 1920-1970' (2004) 11(1) Financial History Review 69,97.

603 Alan Ball and Andrew Haldane,'Does the Usage of Fair Values Increase Systemic Risks?' in G Livne and G Markarian(eds), *The Routledge Companion to Fair Value in Accounting* (Routledge 2018) 8.

604 Billings (n 242) 292.

605 M.Billings and F. Cappie,'Transparency and Financial Reporting in the Mid-20th Century British Banking'(2009) 33 Accounting Forum 38,48.

606 Ball and Haldane (n 603) 8.

practice of non-disclosure and decided to be more transparent for shareholder protection purposes.[607] Yet, a legal uncertainty about transparency requirements for banks appeared in the UK that heralded shortcomings in the legal framework. This is the infamous case of the NR.

3.2.The Run on Northern Rock

The failure of NR is a good starting point for presenting the case for interaction of laws in the way that one prevents another from achieving greater public goals by creating a regulator's dilemma. The collapse of NR was also related to the failure of the mechanisms of intervention where functionality of the deposit insurance scheme, LoLR facilities and the share of responsibilities among the organizations forming the tripartite system were severely criticised.[608] Public disclosure of information introduced new dimensions to the boundaries of and interrelation between financial stability, public confidence and the functionality of laws in resolving problems in times of distress. The theoretical questioning of mere or good compliance appeared as a side-product of the crisis. This indicates that the interaction between the web of laws[609] that the banks operate under prevented the efficient operation of the LoLR function of the CB such that the investigation of the pertinence of public disclosure of bank information has appeared.

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[607] Ibid.

[608] Chapter 2,Section 3.1.3.

[609] Mervyn King(the governor of the BoE) classified four different laws as a barrier of LoLR function of the BoE:The Take Over Code, the rules consisting the deposit insurance system, absence of insolvency laws regarding to bank failures and the MAD.

3.2.1. The Background to the Run

NR, like other smaller British banks, was a mutual bank that changed into a regular commercial bank whose stocks were floated on the LSE. When the crisis hit the US, NR was the third highest among all European banks in its loan-to-deposit ratio.[610] As it was highly leveraged, relying on securitisation and increasingly dependent on overnight interbank financing to run its daily operations, disruption in the market made NR vulnerable, and as it was not successful in accessing private funding from fellow UK banks, it turned to the BoE for assistance.

The timeline of events shows that NR's business model was profitable for some years until global financial turbulence exposed NR to a low-probability-high-impact risk associated with large-scale liquidity scarcity in British financial markets.[611] In late July/early August 2007, banks had already been alerted to the exposure to potential losses on high-risk US mortgages and this led them to show liquidity hoarding behaviour and reduce interbank lending. On August 14, Mervyn King was alerted to the effects of the global liquidity squeeze on the fragile NR in a phone call with officials at the FSA and the Treasury. On August 16, the former NR chairman approached Mr King regarding potential support and then started to search for a buyer. On September 10, after its failure to secure a firm bid, NR stopped its attempts to find a buyer and rescue was inevitable.

Emergency lending granted by the BoE did not prove sufficient to save the bank since on 13 September 2007 the BBC's evening news broadcast announced that NR was experiencing serious funding problems and had sought assistance from the BoE under its

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[610] Turner (n 595) 97-98.

[611] Bruni and Llewellyn (n 28) 20.

LoLR capacity which set in motion a run on the bank. The next morning, the BoE announced the support and NR had to confirm the agreement made with the BoE. In a statement, tripartite organs stated that NR was solvent, and a standby funding facility would allow NR to 'fund its operations during the current period of turbulence'.[612] Similarly, the CEO of NR emphasised that it was business as usual for the firm. However, these statements were not comforting for analysts and depositors. Support from the BoE was not seen as a confidence-bolstering measure, rather, this expression of support accelerated a retail run as it was taken as a sign of failure. Announcement of the assistance, as discussed in the parts related to public confidence[613] and depositor-exerted market discipline,[614] led depositors to line up all at once to withdraw their funds as soon as possible.

3.2.2. The Role of Deposit Insurance Scheme

Two main discussions regarding the deposit insurance regime were about coverage (i.e. what limit should be applied to the size of deposits insured, or if interbank deposits should be covered) and co-insurance (whether protection within the limit should be less than the total or not).[615] Since the British deposit insurance system was designed to fully insure depositors up to £2,000, and then only 90 per cent of deposits up to £35,000, it is not

[612] House of Commons Treasury Committee, The Run on the Rock, Fifth Report of Session 2007-08 Vol. I: Report, together with Formal Minutes (24 Jan 2008) at para 344 (accessed Nov 25, 2018) https://publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf.

[613] Chapter 2,Section 3.

[614] Chapter 3,Section 4.

[615] David T. Llewellyn, 'The Northern Rock Crisis' (2008) 16(1) Journal of Financial Regulation and Compliance 35, 45-7.

surprising that depositors were strongly incentivised to move their funds.[616] The regime was actually designed to incentivise depositors while disciplining banks. In line with this market discipline approach, the British deposit insurance system, by insuring only 90 per cent of allowable claims above a £2,000 minimum, was designed to make those insured open to some losses so that they could monitor the bank and exert disciplinary power.[617] So, while this co-insurance element of the scheme was preferable on efficiency and long-term stability grounds, it was disadvantageous for short-term stability. The system meant that most depositors had something at risk, and a realistic approach of depositors during a crisis was to instantly secure their funds below £2,000. Mervyn King also commented that '…if you have deposit insurance, there is no point having 90%, because that will not stop the bank run, as we saw, it has to be 100% but only up to some limit'.[618]

Another discussion about the maintenance of co-insurance under the FSMA also concerned the general ignorance of depositors about the compensation scheme and their

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[616] Financial Services Compensation Scheme of 2001. See FSA Handbook Release, Compensation Sourcebook Instrument (2001/66) at Ch. 10 (accessed Nov 23, 2018) https://www.handbook.fca.org.uk/instrument/2001/2001_66.pdf.

[617] The US system of deposit insurance, being discernibly different than the British co-insurance system, provided full coverage for each account at the time for the first US$100,00 without subjecting small depositors to a co-insurance system. Dodd-Frank Act increased this amount to US$250,000. FDIC, (accessed Nov. 23, 2018) https://www.fdic.gov/news/news/press/2010/pr10161.html. It should be noted that, together with the full coverage up to a certain amount-based deposit insurance scheme, the US also had a system of resolving bank failures under FDICIA provisions. FDIC, Resolutions Handbook (accessed Nov. 23, 2018) https://www.fdic.gov/about/freedom/drr_handbook.pdf.

[618] He highlighted the importance of having a special resolution regime in place to prevent excessive risk-taking by banks, rather than keeping mechanisms such as coinsurance. House of Commons Treasury Committee, Vol. I (n 612) para 224 (accessed May 26, 2017) https://publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf.

difficulty in understanding the complexity of the concept of coinsurance.[619] Under these conditions, the general panic aired on TV and in other media organs reinforced and escalated the pressure on depositors to join in the run.[620] On September 17, depositors were still queuing at NR branches across the UK and Alastair Darling (Chancellor of the Exchequer at that time) had to intervene by pledging that the government would guarantee all deposits with NR. The protection (which later covered existing and renewed unsecured wholesale funding) was designed to continue until the crisis conditions subsided, and it was to be applicable to depositors of other banks if necessary.[621] First, disclosure of the blanket guarantee and, second, the increase in depositor insurance to £35,00 on 1 October 2007 reassured depositors and was effective in stopping the run.[622] However, the disclosure of the support operation was another question.

3.2.3. Northern Rock's Disclosure Problem

Mervyn King later revealed that NR could have been funded without publicising the support and that would have prevented the run. The fact is that both the FSA and the BoE were informed about the NR's funding problems and up until the time the BoE confirmed

[619] Maximilian J.B. Hall, 'The Sub-Prime Crisis, the Credit Squeeze and Northern Rock' (2008) 16(1) Journal of Financial Regulation and Compliance 19.

[620] Hyun Song Shin, 'Reflections on Northern Rock: The Bank Run Heralded the GFC' (2009) 23(1) Journal of Economic Perspectives 101.

[621] BoE, Financial Stability Report Issue No.22 (October 2007) at 11(accessed Nov 23, 2018) https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2007/october-2007.pdf?la=en&hash=4A9894951877F0AA063331C61065E0801F414A6D.

[622] FSA, Compensation Sourcebook Instrument 2007, 2007/57 (28 September 2007) (accessed Nov. 23, 2018) http://media.fshandbook.info/Legislation/2007/2007_57.pdf. Insurance was increased to £50,000 of full coverage in October 2008; and since December 2010, there is full coverage up to £85,000 (as of Dec. 2018). See FSCS (accessed Nov. 23, 2018) https://www.fscs.org.uk/what-we-cover/banks-building-societies/.

the BBC news's announcement, the FSA and BoE were trying to lighten the effects of the crisis behind closed doors by seeking a buyer for NR – which they failed to do.

As discussed in Chapter 2, *en masse* depositor withdrawals are largely created by a psychology-driven environment. The application of traditional thinking on bank runs is based on coordination failures among creditors but this does not fit perfectly well in the case of NR. First, coordination failure describes a psychological setting where an individual depositor is afraid that if other depositors withdraw their funds there will be no funds left for the remaining depositors.[623] NR was not purely a depositor-based bank run as when the first signs of the credit crunch came to light collective withdrawal of credit hit the whole market, not just some institutions including NR.[624] Second, the run on NR was initiated by sophisticated institutional investors to protect themselves against aggravated market conditions, not by individual retail depositors. However, these explanations about the run on NR do not mean that negative news from the BBC and ensuing statements by the BoE were of no consequence. Rather, the run on NR resulted from a combination of loss of public confidence and market-wide elements consisting of banking and capital markets conditions. NR making the LoLR facility overt in order to provide reassurance to its retail customers did not work as expected. Aside from how the run on NR developed, questions appeared on the applicability of the 'behind closed-doors' approach followed by the BoE and the FSA to rescue NR.

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[623] This situation is a portrayal of the prisoners' dilemma: 'If bank depositors were able to collude they would gain collectively by refraining from precipitating withdrawals.' Paul M. Dickie and Marian Bond, 'Creation of Market Based Structures and Policy Instruments to Facilitate Increased Capital Mobility in APEC Region' in Douglas H. Brooks and Monika Queisser(eds), *Financial Liberalisation in Asia*(OECD ADB 1999) 121.
[624] Shin,'Reflections on Northern Rock' (n 620) 110.

The government's need for room for manoeuvre which would enable the authorities to take necessary measures for the protection of stability and confidence discretely was expressed by Mr King. The implication here is that too much honesty in a world of fragile trust could be and is counterproductive. He stated that he would prefer to grant covert help to NR without public awareness of such interference.

There have been other dissenters to the idea that such information be disclosed. For example, Buiter asserts that the BoE was hopelessly and unnecessarily confused about its legal powers and restrictions while acting as LoLR. He thinks that the assertion that the MAD was an impeding factor against the covert support of individual institutions was mistaken because neither the MAD nor the UK's gold-plating of the MAD would prevent the covert nature of the transaction.[625] Yet, the NR, after taking legal advice, decided that this was not possible because art 6 of the MAD established that publicly quoted companies must disclose inside information as soon as possible which is deemed important for investors, and the emergency liquidity support by the BoE fell into this classification. Such support from the BoE or another CB is likely to have a powerful effect on the price of bank-issued financial instruments. Additionally, Mervyn King appeared to imply that the MAD was an impeding factor here: 'the ability to conduct covert support … is ruled out because of the Market Abuses Directive',[626] and again he said that the relevant wording of the MAD was ambiguous.[627]

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[625] Willem H. Buiter,'Central Banks and Financial Crises'(2008) LSE Discussion Papers No:619 at 114 (accessed Dec 26,2017) http://eprints.lse.ac.uk/24438/.

[626] House of Commons Treasury Committee, The Run on the Rock, 5th Report of Session 2007-08 Vol. II: Oral and Written Evidence (24 Jan 2008) at Q14 (accessed May 26, 2017) https://publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56ii.pdf.

[627] Ibid,Q21-22.

Yet, the MAD, like other securities laws disclosure requirements, provides flexibility to handle exceptional circumstances.[628] As such, it can be asserted that there was no such contradiction as the governor stated but rather that 'it was all a matter of interpretation'.[629] The BoE had been engaged in commercially sensitive negotiations with publicly quoted companies before 2007 and NR was the first case that triggered such debates in that sense. The Directive was unresponsive to this situation because using the legitimate interests of the issuer as grounds for the delay was only possible if the public was not misled by the omission of information and if that information was kept confidential. So, a possible case scenario allowing for the omission of information would be that the liquidity support does not conflict with previous statements and reports of the bank, and it does not change the public perception about the price of instruments. Rather, government support is expected in the nature of the bank's daily operations. Yet, as the subsequent discussions reveal, this approach is again a matter of interpretation.

Therefore, a relevant discussion should start by establishing the reasons that cause such tension. The NR disclosure problem requires discussion of several categories of behaviour within the purposes of the MAD. These were the behaviour that were likely to give a false or misleading impression,[630] disseminate false or misleading information,[631] or distort the market.[632] However, regardless of these potential behaviours, which might be applicable to the case of NR, the FSA had already drafted a provision whose wording

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[628] MAD,art 6.

[629] Sonia Ondo Ndong and Laurence Scialom,'Northern Rock:The Anatomy of a Crisis-The Prudential Lessons' in Robert R. Bliss and George G. Kaufman(eds), *Financial Institutions and Markets* (Palgrave Macmillan 2009) 59.

[630] FSMA,s 118(5)(a).

[631] FSMA,s 118(7).

[632] FSMA,s 118(8)(a)(b).

could have been adapted to a crisis situation.[633] Given that provision, the FSA already had the necessary power to prevent NR's disclosures, even if the FSMA's market abuse provisions were still applicable. Namely, the FSA had the authority to suspend its own requirements with respect to NR's disclosures to the extent that it deemed it to be appropriate.[634] Once again, this can be a matter of interpretation. It is the restrictive interpretation of the FSA not to step into this complexity.

There was another thought-provoking provision in the FSA Guidance that could have been used for non-disclosure. Given the types of behaviours that fall into market abuse, the guidance stated that if a transaction is made in compliance with a prior legal or regulatory obligation owed to a third party, then the behaviour is considered as a legitimate reason.[635] So, technically, while it was not possible for the FSA to remove the disclosure obligation of inside information as soon as possible, a broader interpretation of the FSA Guidance may have provided room for non-disclosure.

The regulator's dilemma in this situation was that the FSA, in having the legal responsibility to patrol the civil offence of market abuse, was in communication with the BoE and the Treasury regarding the private arrangement of the use of the LoLR facility for the troubled NR. Any possible support operation would be the result of a concurrent resolution within the tripartite system.

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[633] DTR 1.2.1(R)(accessed March 11, 2015) http://www.compliance-exchange.com/governance/library/Listing%20Rules%20April%202010.pdf.

[634] Andrew Haynes, 'Market Abuse, Northern Rock and Bank Rescues'(2009) 10(4) Journal of Banking Regulation 321,324.

[635] FSA 2005/15 at 1.6.6.E(1)(accessed Feb 2,2017) https://www.handbook.fca.org.uk/instrument/2005/2005_15.pdf. See Section 3.3.

The next section examines the laws applicable during the GFC and presents cases that led to substantial changes in the bank disclosure laws in capital markets across the EU, with a particular emphasis on British practice after NR and diagnosis of the problem in detail.

3.3.Before/During the Crisis Regulation and Problem Analysis

Mervyn King identified the MAD as one of the reasons why the BoE could not provide covert support to the NR. The MAD and other relevant laws in this context require further explanation of capital markets transparency rules as a preventive factor to accomplish both bank and state stability goals.

While the MAD's first judicial test of a bank was the Fortis case where its near collapse and dismantling led different states to engage in the case,[636] the core discussion about bank transparency and financial stability began with NR. The NR case proved that disclosure rules were not drafted with a bank crisis in mind. The MAD shows no interference with the firm's business-as-usual approach and it is focused on abuse of financial markets. However, there have been dissenters of this view, based on the idea that a prudent interpretation of rules would nip disclosure-specific issues in the bud. For example, Haynes suggests that if a liberal construction was applied to disclosure rules and there had been a deep desire to prevent the downfall of NR, there was a potential for that in the DTRs as the 'FSA may dispense with, or modify, the disclosure rules … as it considers appropriate'.[637]

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[636] Michiel Luchtman and John Vervaele,'Enforcing the Market Abuse Regime: Towards an Integrated Model of Criminal and Administrative Law Enforcement in the EU?' (2014) 5(2) New Journal of European Criminal Law 192,195-97.

[637] FSA 2005/16,Annex B (Disclosure Rules Sourcebook)1.2.1(R)(1)(accessed Jan 30,2017) https://www.handbook.fca.org.uk/instrument/2005/2005_16.pdf.

This provision is based on the view that a firm with a disclosure-related concern will apply to the FSA for dispensation or modification and then the FSA would be in a position to decide on the appropriateness. The FSA could have invoked this provision if it thought it was appropriate for NR to withhold information from the public. A technical examination, however, reveals that the FSA could not put aside s 118 (regulating market abuse) of the FSMA. Instead, it could have used its authority to suspend its own requirements with respect to s 118. As such, the FSA applied a restrictive approach towards interpreting its own rules on disclosure, which could have helped FSA handle NR's disclosure problem.[638] Having said that, the dissenting view argues that the FSA's power to change the disclosure rules in specific cases might be interpreted as the authority to grant a short-term dispensation to prevent a run and its adverse repercussions on the overall financial system.[639]

Another relevant compelling provision that could be applied to the case of NR was the FSA Guidance on the descriptions of behaviours that amount to market abuse. The FSA makes references to behaviours that have 'other than legitimate reasons'. CoMC 1.6.5(E) to 1.6.8 (E) of the Guidance explains the factors to be considered when deciding whether the behaviour results from legitimate reasons or not. The first paragraph of 1.6.6(E) provides that, 'if the transaction is pursuant to a prior legal or regulatory obligation owed to a third party', then the behaviour can be considered outside the scope of market abuse. What does that mean within the context of the NR's disclosure problem? Can the support

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[638] Haynes (n 634) 324.

[639] '…It is not clear whether this option was considered or could have been used in this particular situation.'Charles Proctor, Northern Rock and Market Abuse Directive (Mimeo 2008).

of the BoE be associated with a prior legal or regulatory obligation? Again, this can be a matter of interpretation.

The logic behind the CoMC 1.6.6 could have been interpreted with the prior legal or regulatory obligation that the tripartite system establishes on the troubled bank by allowing the bank to stay quiet on the support. According to Haynes, such a case would not call for a revision of the logic lying behind the laws and regulations about market abuse.[640] Yet, provisions of the CoMC are designated with letter codes that are reflections of the weight attributed to them. Evidential provisions describe the behaviours that are considered by the FSA (FCA now) to decide whether certain behaviour amounts to market abuse. This means that evidential provisions are in a weaker position compared to the safe harbour (C), which provides conclusive evidence for the behaviours.[641] Considering the weight attributed to the given provision, the FSA's interpretation might seem valid. Again, as Haynes argues, the reason of the provision could have offered a more broadened sense of understanding than the literal reading of its terms to create a solution for NR.

These arguments show that the authorities strictly interpreted the rules perhaps because they could not foresee the run. One way or another, the main rule of disclosing inside information as soon as possible unless a delay provision applies was applicable and it was the heart of the argument.

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[640] Haynes (n 634) 324.

[641] Andrew Tuson,'Market Abuse' in George Walker, Robert Purves and Michael Blair (eds), *Financial Services Law* (4th edn,OUP 2018) 12.25-26.

NR was willing to make a public disclosure not just to portray a positive image to the public about receiving funds from the BoE but also as a result of the legal filter it applied: (i) the situation of NR had seriously changed since the last time it had provided information to the market and for this reason, it wanted to issue profit warnings to the market; and (ii) the nature of the information was material enough to disclose.[642] NR's readiness to make a public statement was later discussed within the reality of market conditions such that Alastair Darling asserted that 'there was every chance that this was going to leak and I was dead right'.[643] In other words, the result would not change, regardless of whether NR was prepared to publicly disclose. This statement also means that it was impossible to avoid transparency as many authorities and people were involved in the use of ELA.[644]

Several points are open to discussion because there have been many different views about the application and real effects of the MAD on this case. For example, Buiter states that the ECB had undertaken covert lending in the past, which followed the MAD framework and it stands against the approach of the BoE in interpreting the MAD.[645]

In the context of the CB's LoLR capacity as an immediate response to bank crises, delay provisions of MAD and other applicable laws require an examination of the inside information within the framework of bank information. For the case of NR, it has also been questioned whether the gold-plating in the UK was a determinant of the BoE's hesitation to support NR. For this to be true, it must first be determined if the potential

[642] House of Commons Treasury Committee,Vol. II (n 626) Q1757-1760.

[643] Alastair Darling's response to John Thurso, Ibid Q1766.

[644] Ibid Q268,Q373-374 and Q624.

[645] Ibid Q889-Q890.

support by BoE to NR was inside information in the eyes of MAD and, if it was, whether delay provisions provided in art 6 could have been used for NR. It must be borne in mind that the MAD is no longer in force and changes made by the MAR are proof that this area of law was not well-drafted to respond to situations like NR.

3.3.1. What is Market Abuse?

Types of behaviours labelled as market abuse include insider dealing, non-disclosure of inside information, failure to observe proper standards of behaviour, giving false or misleading impressions, carrying out transactions that employ fictitious devices or deception, dissemination of false or misleading information, market distortion and encouragement of others to take part in market abuse. Market abuse regulations, therefore, aim to maintain integrated and efficient financial markets by taking measures against illegal market operations and ensuring full and proper market transparency through *ad hoc* disclosures.

3.3.1.1. Is Emergency Liquidity Assistance Inside Information?

One of the arguments levelled against MAD was its use of the same definition of inside information for both insider dealing cases and disclosure duties.[646] The only difference is that, under the disclosure regime established under art 6, only the information directly related to the issuer must be disclosed. Having said that, the term 'precise nature' is another part of the jigsaw defining inside information for disclosure purposes.

The precise nature test, in its application to bank information, provides a general framework. The information is deemed of a precise nature:

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[646] MAD,art 1(1); MAR,art 7.

> … if it indicates a set of circumstances which exists or may reasonably be expected to come into existence or an event which has occurred or may reasonably be expected to do so and if it is specific enough to enable a conclusion to be drawn as to the possible effect of that set of circumstances or event on the prices of financial instruments or related derivative financial instruments.[647]

So, it is unsurprising that, in the NR case, rational investors might believe that the information regarding the ELA satisfies the precise nature test. Such information would show that the bank is apparently in financial distress and would change the prices of bank-issued securities.

Therefore, the general rule applied according to art 6 requires issuers to disclose inside information as soon as the prohibition to deal arises without undue delay. The NR case was about the ELA facility but inside information can capture different scenarios such as M&As, sudden deterioration of assets and fraud, and is therefore considered on a case-by-case basis.

3.3.2. Would Safe Harbours Have Applied to the Northern Rock?

After designation of the type of information, the next step is to determine whether a safe harbour is provided in the law. For NR, there was no relevant safe harbour exempting certain behaviours from liability and tripartite authorities agreed on the identified inside information to be disclosed to the market.

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[647] Article 1(1) of Commission Directive 2003/124/EC of 22 December 2003 Implementing Directive 2003/6/EC of the European Parliament and of the Council as regards to Definition and Public Disclosure of Inside Information and the Definition of Market Manipulation [2003] OJ L339/73.

In terms of behaviours falling under the category market abuse, the ones that might be applicable to bank failures were (i) to give false and misleading impressions; (ii) to disseminate misleading information; and (iii) to distort markets.[648] Safe harbours established under the MAD, FSMA and CoMC that designated the behaviours outside the scope of the market abuse offences would not help the troubled bank withhold information regarding emergency financial support because safe harbours provided through MAD included (i) trading in own shares as part of a share buy-back scheme;[649] (ii) price stabilisation activities'[650] and (iii) transactions carried out in pursuit of monetary policies[651]. S 118A(5)(a) of the FSMA also provides a statutory exception: '[B]ehaviour does not amount to market abuse for the purposes of this Act if it conforms with a rule which includes a provision to the effect that behaviour conforming with the rule does not amount to market abuse.' These exceptions act together with other safe harbours established under the CoMC.

Another safe harbour discussion revolves around art 1(2) of the MAD. Some question whether the British authorities would use the exception provided in the definition of market manipulation. In short, if transactions were completed except for legitimate reasons and if they conformed with acceptable market practices on the regulated market, then there was a room for NR to escape the market manipulation coverage of the MAD.[652] Covert support of the BoE could have been taken as an acceptable market practice by the

648 Haynes (n 634) 323.

649 MAD,art 8.

650 Ibid.

651 MAD,art 7.

652 MAD, art 1(2) goes as follows: 'Market manipulation' shall mean… unless the person who entered into the transactions or issued the orders to trade establishes that his reasons for so doing are legitimate and that these transactions or orders to trade conform to accepted market practices on the regulated market concerned.'

FSA, which was the authority to designate what was an accepted market practice.[653] Nevertheless, this would be contrary to the spirit of the MAD as the stated safe harbours did not include such a case and it would be considered a circumvention of the law.

Overall, safe harbours were not helpful for cases like NR. Given the inapplicability of safe harbours to the banks receiving covert or open support, another option was to consider whether delay provisions could have been used.

Art 7 of the MAD, which exempts CBs from its provisions, provides that there was no obstacle to the BoE's covert use of the LoLR facility as it only applied to the BoE itself. In this respect, the MAD seems to give greater freedom of movement to the BoE in its operations. However, there is a dissenting opinion about the BoE's freedom in acting as LoLR as the MAD not only bites on the recipient firm itself but also public institutions like BoE.[654] As such, the MAD does not directly prevent the BoE in the conduct of its LoLR function, but it obliquely created an obstruction for the BoE, which was charged with financial stability duties together with the FSA.

Therefore, the question that arises is whether the recipient should be required to make the information public. This was discussed broadly in the House of Commons, and it was decided that the duty of disclosure was on the shoulders of the board of the NR rather than the regulatory authorities or the BoE.[655] Furthermore, during the evidence sessions, it was argued that, regardless of the MAD's disclosure provision, the overall set of characteristics of the marketplace would not allow withholding an operation of such size

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[653] Haynes (n 634) 326.

[654] House of Commons Treasury Committee,Vol. II (n 626) Q834-Q835.

[655] Ibid Q264-Q272.

and complexity.[656] Independent of the standing of the MAD alone, the duty to disclose information to CRAs was another factor. It is implied that this had nothing to with the legislation. Rather, it is today's transparency-driven market conditions which are not easy to bypass or abstain from.

3.3.3. Delay Mechanism

With this in mind, continuous disclosure requirements articulated in art 6 of the MAD rules that issuers are required to inform the public without delay of any inside information that affects the issuer.[657] Article 5(2) of MAD seeks a proper balance between the interests of the issuers and of the investors by providing a delay mechanism for issuers[658] and the pertinent section reveals four points to consider: (i) delay occurs under the issuer's own responsibility; (ii) there must be a legitimate reason for the delay; (iii) omission would not mislead the public (which is maybe the most elusive criterion for delay); and finally (iv) confidentiality of omitted information must be ensured.

So, the MAD framework allows companies to delay disclosure of inside information at their own risk, if other conditions are met. Legitimate interest, here, is another point to explore. A non-exhaustive list of examples of legitimate interests is provided in the Implementing Directive.[659] With relation to the case of NR, these examples include:

> (a) negotiations in course, or related elements, where the outcome or normal pattern of

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[656] Ibid Q268, Q373-374,Q624.

[657] MAD,art 6.

[658] MAR,art 17(4).

[659] Article 3 of the Commission Directive 2003/124/EC of 22 December 2003 of the European Parliament and of the Council as regards the definition and public disclosure of inside information and the definition of market manipulation(L339/70).

> those negotiations would be affected by public disclosure. In particular, in the event that the financial viability of the issuer is in grave and imminent danger, although not within the scope of the applicable insolvency law, public disclosure of information may be delayed for a limited period where such a public disclosure would seriously jeopardise the interest of existing and potential shareholders by undermining the conclusion of specific negotiations designed to ensure the long-term financial recovery of the issuer; …[660]

In the subsection above, financial viability of the issuer is given as a legitimate reason to delay disclosure of inside information. Yet, the ability to delay is contingent upon two prevailing requirements: (i) the company is required to ensure confidentiality of inside information, which means if any leaks occur, delay is no longer possible, and (ii) non-disclosure should not be likely to mislead the public. Silence can amount to authorization of a specific misapprehension by the market due to the company's latest statements. As such, the MAD framework establishes a duty on the company to correct an impression stemming from its recent market statements which was now conflicting with the inside information which had arisen.[661] A wide range of behaviours by the bank, including staying quiet on the topic and providing a misleading impression to the market regarding the value of a relevant investment, would cause market distortion under the MAD.

The criterion to not mislead the public is difficult to interpret. Considering the nature of inside information, any delay in the disclosure of inside information actually has the capacity to mislead the public in broad terms. However, this thinking would erase the raison d'etre of the delay mechanism provided to issuers. This means it becomes an arduous task to delay disclosure while not misleading the public. The Committee of

[660] Ibid.

[661] 'Letter from the Governor of BoE to the Chairmen' in House of Commons Treasury Committee,Vol. II (n 626) Evidence:218.

European Securities Regulators (now ESMA) directs this with the non-exhaustive circumstances that it provides in its guidelines.

In the end, the FSA, as the Listing Authority, made it clear that the ELA could not be covert on the basis of the overriding requirement about misleading the public, irrespective of the confidentiality condition.[662] Even if the issuer is in grave and imminent danger, the issuer must follow requirements regarding not misleading the public and assurance of confidentiality.

3.3.4. Gold-Plating

During evidence sessions of the Treasury Committee, an investigation was conducted regarding whether it was the UK's gold-plating of the MAD or whether it was the inaptitude of the tripartite system for deciding on disclosure of inside information about troubled FIs.[663] HM Treasury's implementation approach in targeting super-equivalence was considered an impeding factor to the covert support. This was part of the discussion about the UK's broader definition of market abuse than in the MAD. While this argument was discussed, there was another point to consider – whether the UK was entitled to gold-plating in the first place. This examination directed the question to another point, which was whether the MAD was a maximum harmonization directive or not.[664]

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[662] House of Commons Treasury Committee Vol. I para 136 (n 612).

[663] House of Commons Treasury Committee,Vol. II (n 626) Q1823-Q1830.

[664] Recent questioning about whether the MAD is a maximum harmonization directive or not was the Specter Photo case where the European Court of Justice (ECJ) concluded that determination of harmonisation is not relevant to the case. *Spector Photo Group and Van Raemdonck v Commissie voor het Bank-, Financie- en Assurantiewezen(ECJ)(Case C- 45/08)*, 23 Dec 2009(accessed Sep 23, 2016) http://curia.europa.eu/juris/document/document.jsf?docid=77184&doclang=en.

The MAD was more ambivalent compared to previous legislative measures in the same field[665] as it did not directly prohibit member states from accepting stricter rules. So, neither court decisions nor the MAD illustrated the level of harmonization, and interpretations vary between commentators. For instance, Moloney argues that the MAD was a minimum-standards measure.[666] Yet, in terms of the overall view of what the MAD provides (i.e. emphasis on the establishment of a level playing field, exclusion of the adaptation of super-equivalent rules in the MAD compared to the previous directive and high level of details provided at the MAD, such as clear definitions and prohibitions), the MAD appears to be a maximum harmonization directive, not a minimum one. However, this questioning is out-of-date as the MAR came into force to close gaps in regulation.

The UK's broader definition of market abuse was related to its restrictive implementation of legitimate interest, which was articulated in the Implementing Directive.[667] Additionally, this was about the UK's decision to keep the legacy offences that predated the MAD. The maintenance of such offences in the law ultimately extended the scope of market manipulation compared to those established by the MAD. The consequence of this was that, according to McCreevy, the MAD itself was not an impeding factor for the covert ELA. Instead, it was the additional material kept by the UK, in other words, super-equivalencies of the UK:

> … I have always been of the view that when the stability of a FI is at risk, the situation is best resolved behind closed doors. …[G]old-plated transparency rules stood in the way of the quiet resolution of a problem before it became a crisis: The result was that transparency rules that were intended to underpin investor confidence, when put to the test, actually promoted investor panic.

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665 Council Directive 89/592/EEC of 13 November 1989 Coordinating Regulations on Insider Dealing [1989] OJ L334/30.

666 Niamh Moloney, *EC Securities Regulation* (2nd edn,OUP 2008) 35.

667 Ibid.

> Panic that culminated in a bank run - averted only by a central bank lifeboat which in turn spread moral hazard throughout the system. It would surely be irresponsible for regulators not to reflect on this experience and not to draw the appropriate lessons. Clearly transparency that culminates in panic, followed by a rescue, followed by the proliferation of moral hazard is transparency that we would be better off without. [668]

Gold-plating here meant that silence about the ELA would cause market manipulation according to the UK laws, while the MAD itself did not rigorously call for market manipulation for the same action. While the MAD required some specified positive actions, the FSMA, by including super-equivalent provisions, also covered behaviours that did not necessarily require positive action. This means that if an issuer does not correct information that provides a false or misleading impression, then it would fall into s 118(8) of the FSMA.[669] Under these circumstances, the tripartite organs interpreted the mere silence as market manipulation.

However, it is again a matter of interpretation, and the assumption that, if NR delayed the disclosure, then there was a potential for the NR's behaviour to be categorized as an offence of misleading dissemination under the MAD. As such, gold plating was not the problem.

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[668] The European Commissioner Charlie McCreevy's speech in Dublin (26/10/2007)(accessed May 17,2016) http://europa.eu/rapid/press-release_SPEECH-07-668_en.htm.

[669] Joris Latui,'Disclosure of Inside Information and Troubled Financial Institutions:A Critical Analysis of Member State Practice' (2011) 5(1) Law and Financial Markets Review 62,73.

3.4. Post-Northern Rock Cases

3.4.1. Societe Generale: Is it a Political Lesson Learnt from Northern Rock?

One of the most cited cases in the rogue-trading world is that of SG where weak control and lack of management supervision enabled broker Jerome Kerviel to engage in fictitious trades and other fraudulent transactions for more than two years.[670] Poor internal control services in SG ultimately resulted in a fine of four million Euros.[671]

Detection of the massive fraud occurred on 18 January 2008 by the risk inspectors. Consequent examination showed that SG would bear a loss of fifty billion euros, in addition to the loss of its stability and reputation. The French securities regulator (AMF) and the Bank of France were alerted on 20 January and rescue plans and concerns about the stability of both the bank and the state arose. The board of SG asked for a delay of public communications and bank results until the end of unwinding. A crisis committee consisting of financial regulators agreed to the concealment of the incident, so the bank could unobtrusively resell the products that Kerviel had bought. The timeline of events shows that after the discussions about the situation and its potential consequences by the relevant authorities, information about the loss of 4.9 billion Euros through market activities, the SG's estimated 2007 results and information regarding capital increase which allowed it to increase its solvency ratio (tier 1) were only revealed on 24 January 2008.[672]

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[670] Marius-Christian Frunza, *Introduction to the Theories and Varieties of Modern Crime in Financial Markets* (Academic Press 2016) 126.

[671] Paul Constable,'Combating Stock Market Manipulation in Australia'(2013) 16 International Trade and Business Law Review 325,340-41.

[672] 'The Report to the Prime Minister on Lessons Learned from Recent Events at Société Générale' (Feb 2008) part 1.2 (accessed Dec 22, 2016)http://www.ladocumentationfrancaise.fr/rapports-publics/084000062/index.shtml.

SG's position under the MAD was questioned in this case because the authorities were inclined to withhold the incident from the public. Therefore, the discussion here was whether competent authorities could call for delay provisions of the MAD for withholding information about the fraud and the implied increase in capital without misleading the public.[673]

As discussed, the MAD creates questions about delays in cases where banks are in a grave condition with implications for systemic risk or for the state's financial stability. The MAD framework requires three conditions to be fulfilled for the delay. After NR, the fraud at SG revealed the merit of reconsidering whether failure to satisfy confidentiality and not misleading the public should automatically prevent the issuer from using a delayed disclosure mechanism. Such an investigation becomes more important when there is increased market uncertainty, threats to financial stability, and when the magnitude of the event has a negative ripple effect on the bank as well as the European and the world's marketplace.

The information about such an exceptional fraud was accepted as inside information by the authorities. Yet, their decision to delay public disclosure perfectly presents the public interest approach. First, unwinding the positions was crucial to decrease exposures to the risks that were threatening SG and the European financial markets. Second, a capital increase to strengthen the SG's equity was a confident step to prevent a market breakdown. An opposite decision would be the immediate disclosure of SG's actual exposure to risks

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[673] EC,'Public Consultation on a Revision of the Market Abuse Directive' (25.06.2010) at 14 (accessed Dec 26, 2016) http://ec.europa.eu/finance/consultations/2010/mad/docs/consultation_paper_en.pdf.

of equity derivatives markets and it would have caused the loss of confidence in the market, starting from SG's counterparties.

A loss of confidence on the side of SG's counterparties would have not only disturbed the French marketplace but also initiated a domino effect in other markets. Michel Prada, president of the AMF at the time, believed that 'it would be dangerous to announce fraud without also showing an appropriate response'[674] and so the delay was granted to SG by way of invoking a new exception that did not exist in the MAD. So, even if the delay was also in the best interest of SG, the overriding concern here was the financial stability of the state and the markets and this concern was best reflected by the French authorities' decision to keep silent about such a massive fraud. This decision was also a product of smooth and good communication and cooperation between SG and the French authorities, namely, Banque de France and AMF. The criticisms about the NR case were, inter alia, described as a failure of coordination within the tripartite system and the SG case is a proof that lesson well-learned after the NR. However, it posed another concern: The decision to pursue for mere compliance or good compliance of the law.

The MAD was part of French law, and information about the fraud was of a precise nature that would greatly affect the price of SG's financial instruments. Delay provisions, as discussed above in examining the MAD, require three conditions to be fulfilled and SG was unable to fulfil the 'not misleading the public' condition. This was the biggest challenge of AMF assistance to SG. Exploration of fraud revealed that there was a discrepancy between SG's previously posted financial standing and its actual financial position. As such, the public was required to know this 'information of a precise nature'.

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[674] Cited from (accessed Dec 21, 2016)https://www.challenges.fr/entreprise/societe-generale-la-fed-et-la-bce-prevenues-avant-l-annonce-des-pertes_377502.

It should also be noted that art 6(2) of the MAD provides room for the member states to establish a rule that requires an issuer to inform the competent authority of the decision to delay public disclosure of inside information. This was the case in Spain but not in France which means that SG would delay the information without reaching an agreement with the AMF.[675] This examination rearticulates the main question, which is the extent of the role of the AMF in deciding to disclose or delay, and its application of MAD's delay provisions to the SG case. *Ex ante* consultation with the AMF appears to be inconsistent with the level playing field that the EU laws aimed to accomplish, and such a situation also brings about legal uncertainty about the banks' position under the MAR.

The wording of art 6(2) of the MAD states that the issuer decides to delay disclosure under its own responsibility, which means that the AMF is the authority that can pursue an enforcement action if a violation regarding market abuse rules occurs. However, the straightforward cooperation between SG and the AMF obviates discussion about the potential imposition of enforcement actions on the SG. However, it directs the question to another point: Would the AMF be responsible for breaching EU law?

The foundational law of the EU in this context is the Treaty on the Functioning of the European Union (TFEU).[676] If a member state manifestly and gravely disregards the legal limits of its political discretion and contradicts with EU law, it runs the risk of being pursued by the EC.[677] Yet, in the SG case, the French authorities did not prosecute SG

[675] Latui (n 669) 67.

[676] Consolidated version of the Treaty on the Functioning of the European Union [2012] OJ C326/01.

[677] Arts 258 and 259 of the TFEU provide the basis for the Commission and member states to bring a violation before the Court of Justice.

and the Commission did not pursue the French state for infringement of market abuse rules.

This case reveals that, after NR, the EU states were aware that the MAD was not drafted with an eye to crisis conditions. Mere compliance with the law would require the immediate disclosure of the fraud to the public and in that case, there would be no room for the authorities to be involved in the situation and prevent a larger breakdown. However, there was also no good compliance with the law. Rather, it appears that the prudential-logic-based characteristics of the regulatory and supervisory authorities, combined with the political imperative to protect the state against the subprime crisis, led them to abandon the strict application of the descriptive framework of the MAD. Once again, the MAD was seen as an impediment for the implementation of stability-specific solutions and it became well-acknowledged that the MAD was there to protect markets and that the delay provisions were unresponsive to the exceptional nature of some situations involving FIs.

3.4.2. Merger of Halifax Bank of Scotland (HBOS) and Lloyds TSB

Another relevant case in terms of disclosure of bank information is the crisis merger of two banks with considerable market overlaps. The precipitous fall in HBOS's shares was the result of the GFC global drama and so a rescue merger was announced. The government encouraged the merger between Lloyds and HBOS, as HBOS was a systemically important bank.

The merger required both banks to issue prospectuses and although Lloyds shareholders did not vote against the proposed merger, there was general negativity about the transaction. Post-merger acts revealed that the financial standing of HBOS was worse than expected so that thereafter Lloyds itself had to be rescued by the government. Regarding MD of information by banks, the discussion here was twofold: (i) market abuse rules and (ii) prospectus requirements.

The deal was concluded in January 2009. However, in November 2009, it emerged that the BoE provided a secret lifeline to HBOS during the 2008 crisis even though it had agreed to be taken over by Lloyds. The loan was repaid by HBOS before the completion of the deal. Yet, neither the takeover prospectuses of Lloyds nor HBOS revealed the fact that HBOS was receiving emergency aid from the BoE.

In the light of this background information, the first part of the discussion should be examined: market abuse rules. On this, the FSA determined that its own rules about market abuse did not require HBOS to disclose that it was receiving emergency funding from the BoE. The FSA clarified its position by accepting that non-disclosure of the ELA was not a breach of law. On 6 December 2008, DTRs were amended to provide clarification for banks: 'An issuer may have a legitimate interest to delay disclosing inside information concerning the provision of liquidity support by the BoE or by another CB to it or to a member of the same group as the issuer.'[678]
As a lesson taken from the NR case, the FSA concluded that concealing the amount and scale of the support from the shareholders and the public was acceptable.[679] This explains that a stability-embraced approach to bank disclosure was clearly needed.

[678] DTR 2.5.5AR as of 06.12.2008.
[679] FSA Annual Report 2008-9,Examination of Witnesses(25 Nov 2009) (accessed Jan 27,2017)https://www.publications.parliament.uk/pa/cm200910/cmselect/cmtreasy/35/9112503.htm.

Regarding prospectus requirements, FSMA s 87A provides the criteria for the approval of a prospectus. It requires it to include necessary information that enables investors to make informed assessments of the investment.[680] In these conditions, while the information about ELA was not publicly available because public disclosure would damage the financial stability of the markets, it has been questioned why the same information was not material enough for Lloyds shareholders who were asked to purchase HBOS. The responses regarding prospectus requirements are interesting because the continuing banking crisis was the reason for this move and so it was assumed that all market participants were already aware of the financial support provided to commercial banks.[681] Two things can be asserted from this: first, even if shareholders had been aware of the situation, their decision would still be in favour of the takeover, which does not seem right from a shareholder point of view; second, the same logic of the application of market abuse rules also applied here and public disclosure of adverse information would be damaging to overall stability. These two assertions seem contradictory.

There is another point to discuss here which proves that the government needed more space to respond to the crisis in a way it deemed the most efficient. The law itself provides exemptions from disclosure when the disclosure is contrary to public interest. Considering that the government encouraged the takeover, it can be questioned why the public interest exemption was not used here.[682] Maybe the Secretary of the State or the

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[680] FSMA,s 87A; PR,art 6; PD,art 5.

[681] For the debate about non-disclosure of ELA see FSA Annual Report 2008-9, Examination of Witnesses at Q21 (accessed Jan 27,2017)https://www.publications.parliament.uk/pa/cm200910/cmselect/cmtreasy/35/9112503.htm.

[682] PD,art 8; PR, art 18(1)(a) and FSMA,s 87B.

Treasury did not want to assume responsibility by issuing a certificate for the omission.[683] It is also asserted that the government wanted to demonstrate its support for the defenders of the protection of depositors and other creditors while providing covert support to HBOS.[684]

While not using the public interest exemption for disclosure purposes,[685] Parliament took the first step towards mitigating bank disclosure-related concerns. On 21 February 2009, the Banking Act of 2009 came into force. S 252 of the Act provides that registration of charges of the Companies Act of 2006 does not apply in respect to charges provided to the BoE, other CBs, or the ECB in order to receive emergency liquidity.[686] Therefore, registration no longer brings about early disclosure of liquidity support. Following the amendment made in the DTRs about liquidity assistance, this was another important step before the enforcement of the MAR.

One aspect of the merger is related to the limits of the government's power to protect financial stability through rescue operations. The media commonly referred to this merger as a shotgun marriage arranged by the British prime minister.[687] Discussions about the merger were mainly about putting competition concerns aside and focusing solely on

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[683] FSMA, s 87B(2).

[684] Julia Black,'Managing the Financial Crisis-The Constitutional Dimension' LSE Working Paper 12/2010 at 39 (accessed Feb 19,2017) http://eprints.lse.ac.uk/32895/1/WPS2010-12_Black.pdf.

[685] As it will be discussed in the subsequent paragraphs, a new public interest ground is introduced to the competition rules.

[686] Banking Act 2009,s 252(1).

[687] House of Commons Treasury Committee,'Banking Crisis: Dealing with the Failure of the UK Banks', Seventh Report of Session 2008-9: Report, together with Formal Minutes(21 April 2009) at 53(accessed Sep 23,2016)https://publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/416/416.pdf.

financial stability. The tripartite authorities submitted that the successful and precise conclusion of the merger was crucial in order to preserve the confidence of HBOS creditors (especially after the run on NR) and to prevent a systemic-stability triggering incident emanating from a weak and standalone HBOS.

The merger was completed in 2009 in spite of the Office of Fair Trading's (OFT) disagreement[688] and the government's reaction (together with the BoE, FSA and the Treasury) was to change the law so that the merger could happen without a second phase merger investigation.[689] The UK merger control rules under the Enterprise Act of 2002 allowed the Secretary of State to intervene in relation to mergers when the merger raises a defined public interest concern.[690] Yet, this public interest ground was intended to be interpreted narrowly, particularly for issues of national security and quality, plurality and standards of media.[691] For this reason, in October 2008, the Secretary of State passed a new public interest ground for maintaining the stability of the UK financial system to tailor the law to the HBOS and Lloyds merger.[692]

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[688] OFT was the agency responsible for the first phase merger decisions. It merged with the Competition Commission (CC) in 2014 and formed the Competition and Markets Authority (CMA). It should be noted that the FCA gained concurrent powers with the CMA to enforce UK and EU competition law in the financial services sector in 2015.

[689] Bruce Lyons and Mnyan Zhu,'Compensating Competitors or Restoring Competition? (2013) 13 J Ind Compet Trade 39,56

[690] Enterprise Act 2002,s 42 and 58.

[691] Louise Smith,'The Lloyds-TSB and HBOS Merger:Competition Issues' (2008) Commons Briefing Papers SN04907 (accessed May 16, 2017) http://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN04907.

[692] Enterprise Act 2002, para 20B of Schedule 8. Also see the 'Explanatory Memorandum to the Enterprise Act 2002'(accessed Jan 14, 2017) http://www.legislation.gov.uk/uksi/2008/2645/pdfs/uksiem_20082645_en.pdf.

The merger was completed on the basis of HBOS's severe financial difficulty along with the risk of losing public confidence, and the risk of a systemic crisis if the bank failed.[693] The result here was that, as was apparent in the change of competition rules, there was a trade-off or at least a compulsory choice to be made between two interests: ensuring the financial stability of state and maintaining competitive and efficient markets. As the case reveals, the merger's benefits for the UK's financial stability outweighed the potential that the merger would result in anticompetitive outcomes. An additional choice was between short-term and immediate reestablishment of stability and long-term development of competitive and efficient markets.[694] This discussion also recalls the discussion in Section 5 of Chapter 3.

This pragmatic approach in pursuance of financial stability poses a view parallel to the government's need to manoeuvre in terms of restoring the financial position in the market and it accepts that financial stability entails a higher public interest character in the long-term than protecting competitive markets in the short-term. Having said that, discussions about the place of a standard model of competition in the financial sector is traditionally

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[693] '…However, having had regard in particular to the submissions made to the OFT by the tripartite authorities (HM Treasury, the Financial Services Authority and the Bank of England), the Secretary of State considers that the merger will result in significant benefits to the public interest as it relates to ensuring the stability of the UK financial system and that **these benefits outweigh the potential for the merger to result in the anti-competitive outcomes identified by the OFT**. As a result of this decision, no reference will be made to the CC.' (emphasis added) See the Decision by Lord Mandelson, The Secretary of the State for Business, not to refer to the Competition Commission to Merger between Lloyds TSB Group plc and HBOS plc under section 45 of the Enterprise Act 2003, Commons Library Deposited Paper Dep2008-2685 (31 October 2008) para 12.

[694] Ioannis Kokkoris,'Competition vs Financial Stability in the Aftermath of the Crisis in the UK' (2014) 59(1) The Antitrust Bulletin 31,34.

seen as a facilitator of bank instability,[695] and therefore prioritization of financial stability over competitive banking industry might seem aligned with this competition-fragility approach.[696]

It should be noted that both prudential regulation and competition policies pursue the common goal of sustainable competitive and efficient markets and prudential regulators are not necessarily capable of foreseeing long-term repercussions of suspending the requirements of competitive markets, as they are not the experts in that field. This approach is compatible with the general stability-focused move towards concentration on results in preference to the conservation of the rules of the game.

However, this entails a risk as well as prompt authorization of mergers in periods of crisis to save banks, or the market might bring about TBTF problems in the financial industry, which raise the further examination of this topic. Once again, putting more emphasis on financial stability as a post-crisis regulatory objective reiterates the question of whether financial regulation can and also should be framed to mainly reflect public interest in protecting overall financial stability.

These examples show that the UK experienced uncertainty regarding bank disclosure requirements vis-à-vis the need for some secrecy. Unplanned disclosure of adverse

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[695] J. Goddard, P. Molyneux, J.O.S. Wilson and M. Tavakoli,'European Banking: An Overview' [2007] 31 Journal of Banking&Finance 1911.

[696] However, it should be noted that prudential regulation together with safety nets inherently limit the full penetration of competition in the banking industry and as the OECD report puts forward, it is the regulation to be blamed for the development of the crisis, not merely competition. OECD, 'Competition and Financial Markets'(2009) at 26 (accessed June 14, 2017) https://www.oecd.org/daf/competition/43067294.pdf.

information and its consequences, such as rapid loss of public confidence, pose greater risks than delayed but planned disclosure.[697] That is why the FCA revised the FCA Handbook and acknowledged that receiving liquidity support from a CB might be a legitimate reason to delay disclosure of inside information.[698] Yet, the FCA abolished this constellation when the MAR came into force.

3.5.The Way Forward: Market Abuse Regulation and A Striking New Ground for Delay of Disclosure

As the cases reveal, the crisis put an emphasis on matters surrounding market abuse and financial stability, including short selling[699] and public disclosure of information by publicly listed banks. The cases experienced in different states have confirmed the necessity of a new approach in bank disclosures, proving that timely and full bank transparency is not always optimal for the overall stability of financial markets and the state.

The MAR replaced the MAD and came into effect across the EU states on 3 July 2016. Regulatory arbitrage and the need for strict harmonisation might be the reason for choosing a regulation rather than a directive. Overall, at the EU level, listed banks now have a new ground for delaying public disclosure of information if conditions are met.

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[697] Tripartite Authorities,Financial Stability and Depositor Protection:Strengthening the Framework (Jan 2008) Cm 7308 at 43.

[698] FCA Handbook,DTR 2.5.5A(as of Jun 30,2016)(accessed Jun 19,2017) https://www.handbook.fca.org.uk/handbook/DTR/2/5.html?date=2016-06-30.

[699] Like the SEC, the FSA also use the ban on short selling in certain securities to restore investor confidence in securities markets and to safeguard FIs from rapid declines in their stocks. FSA,(18 Sept 2018)(accessed Jun 19, 2017) http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/102.shtml.

Art 17(5) of MAR clearly identifies financial stability of the financial system (as long as other conditions are also met) as a new basis for delay. The pertinent sections of art 17 are the following:

> 5. In order to preserve the stability of the financial system, an issuer that is a credit institution or a FI, may, on its own responsibility, delay the public disclosure of inside information, including information which is related to a temporary liquidity problem and, in particular, the need to receive temporary liquidity assistance from a central bank or lender of last resort, provided that all of the following conditions are met:
> (a) the disclosure of the inside information entails a risk of undermining the financial stability of the issuer and of the financial system;
> (b) it is in the public interest to delay the disclosure;
> (c) the confidentiality of that information can be ensured; and
> (d) the competent authority specified under paragraph 3 has consented to the delay on the basis that the conditions in points (a), (b) and (c) are met.
>
> 6. For the purposes of points (a) to (d) of paragraph 5, an issuer shall notify the competent authority specified under paragraph 3 of its intention to delay the disclosure of the inside information and provide evidence that the conditions set out in points (a), (b) and (c) of paragraph 5 are met. The competent authority specified under paragraph 3 shall consult, as appropriate, the national central bank or the macro-prudential authority, where instituted, or, alternatively, the following authorities:
> (a) where the issuer is a credit institution or an investment firm the authority designated in accordance with Article 133(1) of Directive 2013/36/EU of the European Parliament and of the Council;
> (b) in cases other than those referred to in point (a), any other national authority responsible for the supervision of the issuer.
>
> The competent authority specified under paragraph 3 shall ensure that disclosure of the inside information is delayed only for a period as is necessary in the public interest. The competent authority specified under paragraph 3 shall evaluate at least on a weekly basis whether the conditions set out in points (a), (b) and (c) of paragraph 5 are still met.
> If the competent authority specified under paragraph 3 does not consent to the delay of disclosure of the inside information, the issuer shall disclose the inside information immediately.

> This paragraph shall apply to cases where the issuer does not decide to delay the disclosure of inside information in accordance with paragraph 4.
>
> Reference in this paragraph to the competent authority specified under paragraph 3 is without prejudice to the ability of the competent authority to exercise its functions in any of the ways referred to in Article 23(1).

ESMA has made it clear that delay conditions are to be interpreted narrowly.[700] However, there are several points to be made regarding the above section. As seen at art 17(6), responsibility for a decision to delay is given to the issuer rather than the regulator. The issuer applies for delay on the basis that public disclosure of inside information poses the risk of damaging the financial stability of the issuer as well as the financial system. This provision is confusing as it begs the question of how a FI is capable of determining whether disclosure can undermine the financial stability of the state.

Art 17(4) of the MAR, similar to the one provided in the MAD, already provides a ground for an issuer to delay disclosure of information when immediate disclosure is likely to prejudice the legitimate interests of the issuer, when withholding the information is not likely to mislead the public, and when confidentiality is ensured. Under the new law, issuers are required to make an *ex post* notification to the competent authority when disclosure of inside information is delayed.[701] This notification system requires issuers to be prepared to demonstrate the grounds for the delay decision. Overall, the pertinent delay provision of the MAR is broadly the same as the MAD and the application of the

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[700] ESMA, Draft Technical Standards on the Market Abuse Regulation (28 Sep 2015) ESMA/2015/1455 at para 251(accessed Dec 24,2017) https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-1455_-_final_report_mar_ts.pdf.

[701] MAR,art 17(4).

legitimate interest test is also valid within the context of MAR.[702] This means that banks can still use usual delay provisions when conditions are met. It is interesting how a listed bank can use the usual delay provision when there is also another delay mechanism specifically provided to them.

The first question here should be how a bank can determine whether the disclosure has the capacity to undermine financial stability or not. As art 17(4) reveals, the issuer has the ability to assess its own financial standing and stability and decide to delay (as long as other conditions are met). The new provision therefore provides a new dimension of this assessment and tasks the banks with determining the financial stability of the state. It also requires the banks to provide evidence that the conditions set out in point (a) of paragraph 5 are met for the delay.

Even if the ultimate decision maker for the delay provided in art 17(5) is the competent authority, banks have a duty to provide evidence about the negative effects of information on the financial stability of the state. It seems confusing that banks are bringing the stability of the financial system to the attention of the competent authority instead of relevant bank supervisors and regulators. Yet, as art 17(6) provides, the competent authority, as appropriate, should consult with the CB or macroprudential authority that is charged with the protection of financial stability. Here, the term 'as appropriate' gives the impression that the competent authority reaches stability-focused authorities only if it is appropriate, which means it is not an automatic cooperation. In practice, one does not

[702] 'Final Report: Guidelines on the MAR-Market Soundings and Delay of Disclosure of Inside Information' (13 July 2016) ESMA /2016/1130 at 13-14(accessed June 21, 2017) https://www.esma.europa.eu/sites/default/files/library/2016-1130_final_report_on_mar_guidelines.pdf.

expect the competent authority to decide on stability-related concerns of FIs and keep a FI's intention to delay disclosure of inside information from stability-regulators. Instead, a more sensible approach would be a direct referral to stability-mandated authorities in drafting the law.

Another point is related to the public interest condition. Art 17(5)(b) requires 'public interest in delay' as a condition that has to be proved by the issuer. Similar to the discussion about the bank's determination of the stability of the financial system, it is ambiguous how a bank can prove that delay is in the public interest. Public interest itself is a difficult concept to address and the discussion about the nature and parameters of the investigation continues.[703] Public interest often appears to be a wide and vague concept that can be described at different times with different perceptions. Different people describe it with different values and therefore the public interest test or filter that banks apply may differ from what regulators or supervisors use. Surely, in the current context, it must address financial stability.

Additionally, when the first condition is met, namely when the bank decides that the public disclosure of some information could undermine the stability of the financial system, the question of how the public interest condition is fulfilled should be answered. It is sensible to think that concerns for financial stability itself are directly linked to the public interest. This means that the fulfilment of the first condition also satisfies the public interest condition. The wording of the regulation, therefore, does not establish a clear and direct link between financial stability and public interest.

[703] Mike Feintuck,*The Public Interest' in Regulation* (OUP 2004) ch 1.

So, a literal reading of the provision provides an assumption: When disclosure of particular information entails a risk of damaging the financial system, it does not necessarily and automatically call for a public interest rationale. This means that, while there is a possibility that disclosure is damaging to the financial system, the delay is not in the public interest. As set out in art 17(6), the issuer is required to provide evidence that the delay meets all of the conditions.

Therefore, it appears that the public interest condition alone does not provide a precise and conclusive message about what is expected from banks. Certainly, the purpose of the law approaches public interest from a financial stability of the state point of view. However, in practice how this provision will be addressed is a concern that requires further exploration. There is no doubt that the delay mechanism is reassuring to stressed or troubled banks that have an interest in delayed transparency. So, even if the bank's motives for delay are not the same as a financial stability regulator's or a bank regulator's, if the ultimate result of delay is beneficial to the whole society, then this discussion might seem unnecessary.

Nevertheless, banks, as companies pursuing their own welfare maximisation are expected to reflect their own economic considerations, not other concerns, ie democratic expectations, integrity and competitiveness of the financial markets and so on that policymakers seek when deciding public interest. Tasking banks with providing evidence regarding the fulfilment of the public interest condition is, in theory, abortive. Instead, a provision providing that the stability regulator (with other authorities regulating/supervising banks) is required to consider public interest in deciding whether to delay would be a better approach, which is already the raison d'etre of the financial regulation.

Banks, while using art 17(5), explain why delay is in the public interest, provide evidence about their financial facts that include their market share, liquidity positions, interbank loans, their risk and geographical concentration, and contagion channels. In this context, they will provide the same information that bank supervisors/regulators are already required to know. After all, it is possible that public interest here provides a constructive ambiguity as banks can produce their own arguments about the effects of disclosure and its results within the context of public interest. This does not change the fact that a competent authority makes the delay decision. Even if the evidence that a bank provides is not compelling enough, it is possible that the competent authority (if deemed appropriate, after consultation with the CB or macro prudential authority or any other national authority charged with bank supervision) grants the delay to the issuer because those authorities are better qualified and equipped to gauge the risks emanating from public disclosure. Interestingly, this is done at the expense of the issuer's own responsibility. Also, there are extra information costs to banks as they are required to provide evidence to the competent authority for delay authorisation.

The last condition is confidentiality. As discussed in the NR case, it is difficult to withhold information from the public when the issue is the stability of important FIs. Especially when economic recession or tension is in the air and when the public expects government interference over the tension, it is not an easy task to keep such information secret. This is even more so when a bank receives emergency support from the government – there are many counterparties involved in the whole process.[704] Yet, the new MAR sets out art 17(5) for a reason and highlights financial stability, and there is no doubt that confidentiality is one of the most important pillars of the delay mechanism considering the delicacy of the matter. Therefore, while capital markets transparency rules are transformed, CB or other relevant transparency and accountability procedures are tailored as well. The ECB decided that starting from 16 September 2015 CBs have the choice to communicate publicly regarding provision of ELA to the banks in their territory, which means that disclosure of ELA is optional.[705]

There are other arguments to be made for art 17(5) of the MAR. The wording of the relevant section reveals that 'information related to a temporary liquidity problem and in particular, the need to receive temporary liquidity assistance from a CB or lender of last resort'[706] is not the only reason for a bank to delay disclosure of inside information and, instead, adverse information about the monetary condition of the bank and the information regarding the ELA seems to be given as examples to use the delay mechanism. As such, one might think that the relevant provision is badly drafted by not limiting the

[704] However, it should be remembered that the BoE provided secret loans to the RBS and HBOS in 2008 and it was disclosed in November 2009 to avoid a similar case like NR. Black (n 684) 32-33. As discussed in the US part, secret public lending during the GFC was a common aspect of government actions including in the US. Gary Gorton and Guillermo Ordonez,'Fighting Crises with Secrecy' (2017) NBER Working Paper 22787(accessed June 24, 2017) https://www.sas.upenn.edu/~ordonez/pdfs/CB.pdf. See Chapter 2,Section 3.1.3.1.

[705] ECB, Press Release on Sep 16,2015(accessed on May 14,2017) https://www.ecb.europa.eu/press/pr/date/2015/html/pr150916.en.html.The ECB also announced 'Agreement on Emergency Liquidity Assistance'(17 May 2017) Part 8 of the Agreement (accessed May 19, 2017) https://www.ecb.europa.eu/pub/pdf/other/Agreement_on_emergency_liquidity_assistance_20170517.en.pdf.

[706] MAR,art 17(5).

reasons for the delay but, rather, by allowing other grounds for the delay of disclosure as long as the disclosure threatens the financial stability of the issuer and the financial system, it is in the public interest and the confidentiality of that information is ensured.

Recital 52 of the MAR also supports the view that examples provided in s 17(5) are not *numerus clausus*. The pertinent recital states that:

> In order to protect the public interest, to preserve the stability of the financial system and, for example, to avoid liquidity crises in FIs from turning into solvency crises due to a sudden withdrawal of funds, it may be appropriate to allow, in exceptional circumstances, the delay of the disclosure of inside information for credit institutions or financial institutions. In particular, this may apply to information pertinent to temporary liquidity problems, where they need to receive central banking lending including emergency liquidity assistance from a central bank where disclosure of the information would have a systemic impact.[707]

Given the information above, the recital is confusing to the extent that it does not specify the grounds for delay with precision. While protection of public interest and preservation of stability of the financial system are given as a basis for the delay, it is not certain whether avoidance from liquidity crises is provided as a new ground or whether it is provided as an example supporting the preceding 'financial stability' ground. Even if liquidity crisis is given as an example to underpin the financial stability ground, it does not change the motivation for delay since liquidity crisis is highly linked to financial stability. The argument here, therefore, can be related to the poor drafting of the recital or it can be the main purpose of the lawmaker by adopting an indefinite and amorphous approach, which is interpreted within the needs of the financial stability. In this sense, avoidance of liquidity crises appears to be an example of the financial stability ground.

[707] MAR,Recital 52.

To prevent a potential situation like NR, there is particular emphasis on the disclosure of ELA and LoLR facility even if it could have been interpreted in the wider context of financial stability.

All things considered, the wording of art 17(5) together with the pertinent recital seems to provide a comprehensive ground under the notion of financial stability and, by doing so, it ensures that avoidance of liquidity crises via ELA or LoLR facilities are considered grounds to evoke a financial stability basis for delay. It is noteworthy that the lawmaker has preferred delay mechanism over a safe harbour. It means that rather than defining which specific bank behaviour does not amount to market abuse, the delay mechanism is favoured.

Maybe another possibility would be either adding a new and separate safe harbour for nationalisation, merger, emergency liquidity support or other actions needed for the protection of financial stability by the CB/relevant macroprudential authority; or adding a new financial stability exemption to article 6 of the MAR in addition to policies regarding monetary, exchange rate of public debt management. Maybe it is because the lawmaker has considered that not every liquidity support links with potential severe threats to financial stability that requires absolute opacity, and banks' straightforward exclusion from disclosure mandates via a possibly broadly drafted safe harbour would provide the image of regulatory capture and cause public outcry derived from accountability and legitimacy concerns.

Overall, as discussed in this section, such an overarching provision can be criticised on many levels. For example, how to decide whether it is in the public interest to delay, or how a bank, of its own responsibility, decides whether the disclosure of information is capable of undermining the financial system or not, or how the relationship between authorities will be handled in consenting to the delay.

This improvement should be interpreted along with the adoption of the so-called twin peaks structure in the UK and the approach to highlighting financial stability in financial regulation. As Chapter 2 addresses[708], combination of sectoral regulators in a single body might reveal the difficulties because monitoring market disclosures and enforcing compliance on the one hand and operating as a sectoral microprudential regulatory authority with a close relationship to financial stability organs and knowing that issuer bank will receive financial support on the other is a difficult task. The MoU between the FCA and the PRA establishes active cooperation between agencies such that banks are required to disclose to the PRA any piece of information that the PRA would reasonably want to know, and this includes the submission of draft prospectuses and other disclosures.[709] Along similar lines, the FCA (in its capacity as the UKLA) and PRA commit to actively sharing information that is of material interest to the other and they might ask each other about the details and status of a potential disclosure.[710] The PRA's right to veto certain FCA actions for the protection of financial stability[711] and greying of the lines that strictly separate the objectives of the prudential regulator from capital markets regulator via a new regulatory philosophy that enshrines the protection of overall systemic and financial stability show that (even if the regulatory system is structured around diversified goals of regulation (as the PRA and FCA stand for)) smooth

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[708] Chapter 2,Section 3.1.3.

[709] MoU between the FCA and PRA(accessed March 26,2017) para 38 https://www.bankofengland.co.uk/-/media/boe/files/memoranda-of-understanding/fca-and-pra.

[710] Ibid para 39.

[711] FSMA,s 3I.

cooperation and active information sharing between agencies, common understanding and empathic thinking about the delivery of their distinctive objectives are the new theme.

CHAPTER 5

PRIVATE LAW FRAMEWORK FOR CONFIDENTIALITY AND SECRECY VIS-À-VIS OTHER PUBLIC LAW DISCLOSURE REQUIREMENTS

1. A Conceptual and Theoretical Overview of Private Law Framework for Bank Confidentiality

Since one of the main components of banking business is 'information', the problem arises as to the way banks handle this life-time valuable data while protecting their reputation and financial position without damaging information-givers' and their own interests within the legal and political framework. In this confidence game, banks are under great pressure to deal with contractual and other such obligations to their depositors, stakeholders, staff and sometimes the public at large. Banking confidentiality is primarily grounded upon the rules of private law, meaning that information collection and its preservation is specifically characterized in the contractual relations between the bank and customer.[712] As a consequence, the nature of the relation between bank and customer deserves special attention to see if there is a tension over bank information on the private law-public law level.

The public law dimension of information held by banks is underpinned by concerns over public interest and public security. Since banks are unique sources as possessors of valuable knowledge, the administrative and penal authorities see them as perfect sources

[712] Mario Giovanoli,'Switzerland' in Ross Cranston (ed), *European Banking Law: The Banker-Customer Relationship* (LLP 1993) 185.

to obtain such information. Together with the internationalization process and possible global effects of bank runs and failures, frauds and money transactions falling under criminal investigations, the pressures of time may force public authorities to set a global level on regulations imposed on banks and require cooperation and collaboration of other states on the international level. However, conflicts may still appear when public law duties owed to different jurisdictions do not coincide with each other.[713] It means there is also potential for public law-public law challenges between different jurisdictions.

ML, as one of the main reasons for strong regulations in the banking industry, has made banks the centre of attention in terms of money flow. Criminal law-making on ML, underpinned by moral panic and a particular group of crimes, such as drugs, terrorism or other crimes including organized offences, have been deeply affected by the increasing internationalisation of criminal law and economics of laundering in the socio-legal framework.[714] As smooth operation of financial markets is highly dependent upon reputation and its resultant 'public confidence', ML and other related crimes both damage the soundness of a state's financial industry and stability of banks.[715] The perception is that the efficient functioning of banks and financial markets is profoundly based on the belief that banks operate within a structure of high legal, ethical and professional standards so that public confidence is protected. Injection of dirty money into the system has systemic and macroeconomic implications as it fortifies instability in the liability base

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[713] Colin Bamford,'Banker-Customer Relationship: Fiduciary Duties and Conflicts of Interest' (1997) 25 Int'l Bus Law 74,75.

[714] Peter Allridge,*Money Laundering Law* (Hart Publishing 2003) 1-43.

[715] Paul Allen Schott,'Reference Guide to AML and Combating the Financing of Terrorism'(2006)World Bank 2006/35052 II-4 (accessed March 1,2016) http://siteresources.worldbank.org/EXTAML/Resources/396511-1146581427871/Reference_Guide_AMLCFT_2ndSupplement.pdf.

or unsound asset structures that means the in and out flow of money within the system contributes to the shadow economy and monetary instability.[716] Banks' involvement in ML and related crimes means, *inter alia*, reputational loss that is transmitted to the sector in the form of withdrawal of funds, loss of loans and profitable business, decrease in share prices, asset seizures, termination of some banking facilities and other charges that damage the safety and soundness of a bank.[717] Adverse publicity, in this respect, maybe similar to the NR scenario but in a different vein, is translated as loss of confidence towards a bank, regulators and also the system in which the bank operates. Social and subjective emotions of borrowers, depositors or others such as bank counterparties that hold a relationship with a bank therefore generate tangible results on the financial standing of the bank as a cause of the loss of an intangible asset, namely confidence. This view therefore recognizes a positive link between compliance and public confidence.

Reputational risk is not only limited to fear of being fined but also expenditures on compliance.[718] From a public/stakeholder perception, disclosure of fines does not deliver confidence as it is adverse information and for large banks disclosure of such information has systemic ramifications. It can be said that integrity of banks 'remains of predominant importance, not because of the colour of the money, but because the trust bestowed by

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[716] P.J. Quirk,'Money Laundering: Muddying the Macroeconomy' (1997) 34 IMF Finance and Development 1,7-9.

[717] Schott (n 715).

[718] If it is too much compared to peers, rather than providing a sense of security to public, it might convey a negative message that the bank needs extra care for compliance or also it might give competitive advantage to other banks. Jackie Harvey, 'How Effective is Money Laundering Legislation?'(2008) 21 Security Journal 189,195-96.

customers in the promise of a proper handling of their property'.[719]

So, banks have intrinsic motives for due diligence and necessary economic incentives to be a part of this public-private partnership, even if it is a reluctant one. Reputational damage and its result in the form of capital flow from a contaminated bank to a non-contaminated one means that banks de-risk themselves by embracing compliance requirements to avoid fines and loss of public confidence.[720] It also means that banks with better risk management systems have more incentives to provide this information to the market.[721] This part of the discussion represents the concerns about bank disclosures from a financial stability and integrity of the financial system point of view as being different from the private law-public law tension. However, it signals another dimension of bank information disclosure.

Considering the significance of personal privacy in this age of information and corporate privacy in today's market-oriented economies, the law tackles the issue of secrecy of bank data by implementing some specific regulations or providing civil or criminal remedies against disclosure of bank information. Confidentiality needs to be seen as the interplay between political motives and the changing concept of privacy. The law, by allowing interference with bank information in certain cases, such as ML or tax crimes, needs to be adjusted in order not to pose a serious threat to the bank's professionalism. That is to

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719 Petrus C. Van Duyne, Marc S.Groenhuijsen and A.A.P.Schudelaro,'Balancing Financial Threats and Legal Interests in Money-Laundering Policy'(2005) 43 Crime Law&Social Change 117,124.

720 However, Harvey addresses that ML creates public confidence problem only when customers lose money. Harvey (n 718).

721 J. Harvey and S.F. Lau,'Crime-Money, Reputation and Reporting'(2009) 52 Crime Law Soc Change 57,66.

say, globalisation of crime, its socio-economic nature together with its legal ramifications today has laid the way open for further exceptions to bank secrecy. Therefore, in consideration of public interest, the law needs to strike a balance where intervention of the state should preponderate over the possibility of severe social detriment.[722]

Theoretical problems regarding the absence of a clear-cut universal definition of bank confidentiality and the overlap between various fields of law as a result of the interplay between the interests of the individual and the public have created questions as to how the law provides the balance and if it does then how sustainable it is. Historically, exceptions to bank secrecy have been grounded on the public interest and such decisions by governments have drawn the line between the public and private sphere. There must be genuine evidence or very valid reasons to overstep banking confidentiality which also means that states as the powerful party of the bank-state relationship can find valid grounds for intruding upon banking confidentiality and asking for information based on insubstantial suspicions or evidence.[723] This part of the issue reflects another dimension of transparency[724] which should be interpreted together with bank transparency. Thus, blurring the distinction between the public and private sphere should only be done in extremis. Such justifications for exceptions to bank secrecy bring other legal discussions as to why the law of the state, for example the tax law, is superior to the right of privacy.[725] Banks are in a difficult position in handling the information they have, keeping promises and the trust of customers and also resigning themselves to public authorities. It also leads to significant compliance costs. Thus, an examination in each specific case about the need

[722] Dennis Campbell, *International Bank Secrecy* (Sweet&Maxwell 1992) viii.

[723] Peter Koslowski, *The Ethics of Banking: Conclusions from the Financial Crisis* (Springer 2010) 113.

[724] It is government transparency and accountability.

[725] Koslowski (n 723) 113.

to lean on the banks could be a more prudent solution to striking a balance between public and private law dimension on disclosure of information.[726] The use of laws which contravenes bank secrecy might be interpreted by media campaigns and politicians as a step forward in preventing crimes committed against banks.[727] Therefore, public perception of the increase of state powers in today's world of civil rights has been possible as a result of greater access to financial matters in both the company sector and financial industry.[728]

A discussion about whether a bank's duty of confidentiality constitutes a part of the substantive right of privacy can be a good way to examine how a duty defined under contract law can be transformed into a fundamental right.[729] Personal information stored by banks is of importance for persons beyond its legal identity on both philosophical and moral grounds since it may be prejudicial to their private spheres. Customers, by placing their faith in banks and the financial community in general, expect a certain level of secrecy and do not expect the bank to be working in league with the government in providing private and personal information.

Financial privacy as a fundamental right has been subjected to objections as it can be a shield for banks to evade public scrutiny. Competing interests of public and private spheres, which are surrounded by relevant regulations, are generally investigated through human rights jurisprudence and laws, which regulate the balance of the rights of an

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726 Ibid.

727 Michael Levi,'Regulating Money Laundering:The Death of Bank Secrecy in the UK' (1991) 31 The British Journal of Criminology 109,125.

728 Ibid.

729 R Stokes,'The Banker's Duty of Confidentiality, Money Laundering and the Human Rights Act' (2007) JBL 502.

individual versus his public rights, should consider the right of privacy. This elusive right is a two-dimensional phenomenon; it is not only a right granted by a state to members of society but taken together with the power bestowed by the society to the state, it is also the right to interfere.[730]

The philosophical origins of privacy within the concept of natural and positive law have historically been widely discussed but various legal aspects and questions remain unchanged since the private sphere of persons is an evolving phenomenon.[731] The extent to which public laws may lawfully infringe privacy has been a recurrent theme, and shows a well-defined separation among criminal, statutory, regulatory law and the law of private operations.[732] This discussion about the limits of the public law in enforcing private morality has historical roots. Defining privacy in the banking industry is to some extent elusive; the status, features and the coherence of the information held by banks play a part in this complexity.[733] Such complexity might also require a certain degree of separation between confidentiality and privacy, which might be part of an open-ended question in terms of bank information in addressing the problem of third parties. It is related to the protections bestowed directly on the information that one has, as well as other actors such as informational intermediaries which hold the same information. From a legal standpoint, the difference between privacy and confidentiality is generally addressed with the concepts they surround: while the focal point of confidentiality is the relationship of trust not to expose the personal information to third parties regardless of

[730] Koslowski (n 723) 113.

[731] Alexandra Rengel, *Privacy in the 21st Century* (Martinus Nijhoff Publishers 2013) 7.

[732] Morton J Horwitz,'The History of the Public-Private Distinction' (1982) 130(6) University of Pennsylvania Law Review 1423,1424.

[733] Raymond Wacks, *Personal Information* (OUP 1989) 14.

which actors possess it,[734] the concept of privacy can be explained through descriptive, normative or legal standpoints where its scope is addressed with one's information, acts and decisions or one's special solitude[735] with the aim of preventing undesirable interference and circulation of personal information.[736] As such, they are related but not the same concepts given that one applies to the data and another applies to the person as the interrelation between them is summarized as 'confidentiality requires some privacy, but privacy requires no confidentiality'.[737] However, as times change, the concepts of personality in defining the rights under confidentiality and privacy might be re-formed and questions as to the corporate right to privacy such as a corporate borrower's right to financial privacy might require further exploration.[738]

Human scepticism over the proprietary interests of others together with envy as the source of protection in the private sphere can be the basis of banking confidentiality. However, full protection of the private sphere casts suspicion on collective badness and justifies a certain degree of intervention of the state with the purpose of asserting the common good. Problems may arise when the release of financial affairs of a person does more than satisfying public interest and rather becomes a political issue. Thus, excessive transparency vis-a-vis full secrecy is not optimal. On the contrary, issues of privacy, human rights, globalisation, liberalisation and financial innovations together with technology have at different point in times filled the conceptual vacuum surrounding bank

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[734] Neil M. Richards,'The Information Privacy Law Project' (2006) 94 Georgetown Law Journal 1087,1137-38.

[735] Helen Nissenbaum, *Privacy in Context: Technology, Policy, and the Integrity of Social Life* (Stanford University Press 2010) 2.

[736] Rosemary Pattenden, *The Law of Professional-Client Confidentiality* (OUP 2003) 10-13.

[737] Ibid 12.

[738] Elizabeth Pollman,'A Corporate Right to Privacy' (2015) 99 Minnesota Law Review 27.

secrecy at both international and national levels by producing certain limitations on the secrecy of financial data. Information held by banks is the one that the state most frequently employs and historically narrows the concept of right to secrecy. The message conveyed here is, therefore, that state surveillance through banks may create concerns over civil liberties and human rights in which persons may wish for more concrete legal principles for authorities to obtain and use their personal information in a more prudent manner.[739]

Increased attention on bank information should not merely be seen in the financial services nexus but should also be considered together with the law and practice of customer secrecy where liberties and duties clash. As such, the tension between private rights and public interest in the context of bank secrecy and confidential banking information indicates another paradigm although it is a similar dilemma that banks experience in the realm of financial services.

Under these circumstances, prevention and control of crimes may create concerns over turning the financial infrastructure of banks into police reporting networks by turning bankers into fiscal spies. The duty of confidentiality in its more traditional style is in jeopardy to the degree that it is seen as opposing public interests. Furthermore, given the fact that commercial interests of banks in conducting their assets and operations effectively may call for transfer and release of some customer information, the role of credit reference agencies in such information and the possible misuse of confidential bank data place the bank at the centre of greatly diverging interests in a complex and over-regulated legislative system.

[739] P.M. Connorton,'Tracking Terrorist Financing through SWIFT: When US Subpoenas and Foreign Privacy Law Collide' (2008) 76(1) Fordham Law Review 283.

While persons and firms in connection with banks might expect a better protection of information given to banks, banks have to deal with various dilemmas regarding the statutory erosions to duty of confidentiality.[740] This erosion is a kind that not only creates a tension on the private law-public law level but also has a bearing on the safety and soundness of banks and the financial and systemic stability of the state. Under these circumstances, changing boundaries of bank confidentiality should be assessed to discover whether secrecy will be able to survive as a sustainable legal concept.[741]

2. Interplay Between Public Law and Private Law in the Banking Industry and Implications for Bank's Private Duty of Confidentiality

A common theme running through discussions about the relationship between public and private law generally starts with a discussion of individual interests and the coercive power of the state as regards safeguarding the public interest.[742] The concept of public interest may be a matter of political and jurisprudential taxonomy where the limits of the state to intrude in the private sphere are specified.

Accordingly, in the battle between the interests of individuals and the interests of the public, private law institutions could be seen as barriers to social progress, public security or common good as its extreme form was illustrated by Lenin as 'all law is public law'.[743]

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[740] Gwendoline Godfrey and Simon Elcock,'England' in G. Godfrey(ed), *Bank Confidentiality* (5th edn,IBA 2011) 304.

[741] It is possible to say that now it is the banks that override the rights of individuals to de-risk themselves.Section 4.1.4.

[742] Amhlaigh, Michelon, and Walker (n 2) Chs 4, 5, 10.

[743] Cited from John Henry Merryman and Rogelio Perez-Perdomo, *The Civil Law Tradition* (3rd edn,Stanford University Press 2007) 95.

The multiplicity of social, property and economic relations of individuals has been interpreted with state policies and sometimes with political interferences due to the transformation of socio-economic relations into commercial ones over time, which may also be related to advancements in the welfare state.[744] For example, it can be said that the banker-customer relation as a product of self-contracting and consensus has changed from a classical profession with confidentiality responsibilities to a profit-oriented economic relationship with the growing commercialization in social settings and interactions; and considering the bank-customer relationship established with the people from all social strata have created strong commercial incentives for banks such that state control and relevant rules can be the reflections of the change of such relationships.[745] The ongoing notion placed on FIs that can be described as (almost) no room to self-regulate can be considered an outcome of unfortunate economic and social consequences of regulatory failures on the global level. However, this is not to go as far as saying that responsiveness of private law can be damaged by predomination of state policies vis-à-vis concomitant laws.

The public and private law dimensions of banks, ie whether banks are seen as mere products of private law; whether they are public companies or utilities based on their ownership status or benefits to society;[746] or whether they are private enterprises promoting useful public purposes or implicit public properties in the form of private firms by following the government's monetary and – supposedly – political decisions, may be

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744 Gunther Teubner,'State Policies in Private Law?A Comment on Hanoch Dagan' (2008) 56(3) The American Journal of Comparative Law 835,837-43.

745 Ibid 838-40.

746 Bray Hammond, *Banks and Politics in America:From the Revolution to the Civil War* (Princeton University Press 1991) 50-78.

interpreted as outcomes of the interaction with the state.[747]

The conventional principle which explains the existence of firms as being for profit maximisation for the welfare of shareholders might be inadequate to explain the public interest function of firms in that the aim of making profit might also be in the public interest based on the social character of companies.[748] As Parkinson suggests, the principles that make up company law must be re-analysed to be able to grasp how firms work for the interests of the shareholders and by doing that how they are of service to the public in general by being a player in the economy.[749] Such a communitarian approach also supports the social responsibility of firms, which can justify state intervention.[750] Regardless of the underlying rationale of the existence of firms, the historical development of the banking sector, from legal and economic contractarian theories[751] to concession theories,[752] indicates that the nature of the work that banks do has precipitated the conclusion that banks should not be fully independent of state control. By analogy

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[747] Susan Hoffmann, *Politics and Banking* (John Hopkins University Press 2001).

[748] J.E. Parkinson, *Corporate Power and Responsibility* (OUP 1994) 24-25.

[749] Ibid.

[750] D. Millon,'New Directions in Corporate Law: Communitarians, Contractarians and the Crisis in Corporate Law' [1993] 50 Washington and Lee Law Review 1373.

[751] Such theories take firms as a product of nexus of contracts which are formed for the benefit of the shareholders' interests and the status of the firm is gained independently without state interference by the formation of a series of private contracts and initiatives. So, the main focus of the theory is the contract among the firm and its members, not the outside world and therefore the relationship is a matter of private law. Benjamin J. Richardson, *Environmental Regulation Through Financial Organizations* (Kluwer Law International 2002) 102. See Chapter 1, Section 1.

[752] This is the theory which existence and maintenance of the firm is explained through the exercise of state power, which makes the firm a matter of public law. Virginia Harper Ho,'Theories of Corporate Groups: Corporate Identity Reconceived' (2012) 42 Seton Hall Review 879,902.

with theories beneath the aforementioned principles of company law, the organization of banks comprises a series of contracts and a charter to operate in a specific jurisdiction, which covers both public and private concerns. As such, banks require another approach given their nature as social enterprises with public functions, which could be better explained by the private/public dichotomy with an eye to internal and external perspectives that banks promote a broad array of social and political values and seek wealth maximisation at the same time.[753] So, while an external perspective represents the relationship between the bank and the public, an internal one tackles the dealings inside the bank (such as the ones with shareholders, depositors, staff, borrowers and so on).

By gathering these observations together, banking might mean different things in public and private law in the setting that taking public law measures as a result of public interest and private law arrangements as products of freedom from the state.

The legal ramifications emanating from public–private law engagement in banking appear to be like a three-legged stool typifying various laws regarding criminal, regulatory-administrative and other laws falling under private law. Each leg performs separately within their main objectives, yet these primary objectives may constitute legal difficulties for banks in a way that public law versus private law duties compete with each other where the scope of public law intervention for banks might be open-ended due to their public interest and safety objectives.[754]

Thus, private law matters in financial services have, in one form or another, been affected

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[753] David Millon,'Theories of Corporation' (1990) 39(2) Duke Law Journal 201.

[754] Chapter 2 and 3.

by state policies stimulated by economic, political and social incidents.[755] The banking sector in particular, as part of everyday life, has been subjected to public law measures with *ex ante* and *ex post* effects.[756] This also means that the law of banking is separate from the classical private law concept by being exposed to rules carrying *ex ante* characteristics, namely, regulations aiming to preclude possible unwelcome results for the sake of the state, financial markets or customers and investors. The concept of private law by its *ex post* nature, which suggests that private law comes into play after an incident occurs,[757] cannot be seen in banking law where the state deems it necessary to take preventative measures *ex ante*.

Regardless of the ownership structure of banks, whether they are public or private banks, they follow the same standards found in contract law and tort liabilities.[758] Thus, on the one hand the private law dimension of banks derives from general contract law principles with reference to their commercial activities. On the other hand, the private law dealings of banks are historically subject to intervention in the realm of public law.

The doctrine of confidentiality in financial transactions is deeply attached to the history of banking and it has become controversial to the extent that a state would like to absorb the rights of individuals in present-day conditions to detect illicit activities.[759] The inherent conflict appears on the side of banks which consider their public duties on the

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[755] O. Cherednychenko, *Fundamental Rights, Contract Law and the Protection of the Weaker Party* (Sellier 2007) Ch 2.
[756] Chapter 2.
[757] Hugh Collins,'The Hybrid Quality of European Private Law' in Roger Brownword and others(eds), *Foundations of European Private Law* (Hart 2011) 459.
[758] Norbert Horn, *Legal Issues in Electronic Banking* (Kluwer Law International 2002) 2.
[759] Edouard Chambost, *Bank Accounts: A World Guide to Confidentiality* (John Wiley&Sons 1983) 3.

one hand and private duties emanating from their contractual relationships on the other,[760] not to mention unsettled conflict of laws problems in the application of rules. All things considered, the authorities seek to uphold a high degree of confidence in society and exercise some restrictions in the form of public law rules on the private law. Thus, it is not an exaggeration to say that bank secrecy has been in limbo.

In an attempt to examine the private law framework of bank secrecy and transparency, subsequent sections will discuss the basis and nature of the relationship between the bank and the customer.

3. The Nature of the Relationship between the Bank and the Customer

Today, almost everything is directed by the law of contract, and as a matter of business, banks have to enter into a legal relationship with their customers[761] and clients in terms of execution of enforceable promises.[762] Furthermore, cases and commentaries historically have provided numerous doctrines and theories to establish rights and responsibilities developing out of a relation between banks and customers.[763] Such theories cover a wide array of views, ranging from the classic debtor-creditor view to the fiduciary or confidential nature of the relationship. Under all of these different views regarding the definition of this relationship, it is accepted that this relationship is simply based on the mutual manifestation of the consent of both parties where one of the parties provides services to another and another accepts.

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[760] Bamford (n 713) 75.

[761] The notion of customer used in this thesis is taken in broad terms as covering any persons dealing with a bank about a banking service.

[762] *Foley v Hill* (1848) 2 HL Cas 28.

[763] Edward L. Symons, 'The Bank-Customer Relationship:Part I-The Relevance of Contract Doctrine' (1983) 100 Banking L J 220,221.

The relationship has been classified as principal-agent, debtor-creditor, bailor-bailee, lessor-lessee, pledger-pledgee, licensor-licensee or trusteeship-executorship together with other varieties of miscellaneous and *sui generis* relationships that produce a spectrum of contract doctrines and, therefore, that have resulted in a wide range of rights and duties for both contractual sides.[764] Banks offer a variety of services to the market and, as it can be seen, their positions and names for each financial transaction are subject to change based on the different relationships available.

The theory provides a set of assumptions in terms of ascertaining the nature and scope of the relationship between banks and customers within the frame of contract law. Historically, the development of the contract-based approach evolved out of a tacit agreement between the bank and the customer before this relation was formalized in a standardized or boilerplate format.[765] Banks, by receiving the chattel goods of a customer, historically had to stick to the implicit rules that appeared with the exchange of offer and acceptance.[766] Together with *Foley v Hill,*[767] *Joachim v Swiss Bank Corporation*[768] examined the nature of this relationship and held that it was of a contractual nature.

Since the bank mechanism by its very nature requires banks to collect and produce more data and monitor it in a continuum, the contractual basis of the relationship establishes the needed necessary trust. Accordingly, as both holders and transmitters of funds and a special of pool information, banks are under great scrutiny due to their current and

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[764] Maurice Megrah*, The Banker's Customer* (2nd edn,Butterworth&Co 1938) 263.

[765] Richard A. Lord,'The Legal Relationship between the Bank and Its Safe Deposit Customer' (1983) 5(2) Campbell Law Review 263.

[766] Ibid 266.

[767] (1848) 2 HL Cas 28.

[768] (1921) All ER 92.

potential liabilities for fraud, ML or other such legal issues inquired by third parties.[769] In the words of Chief Justice Charles Hughes: 'Freedom of a contract is a qualified, and not an absolute right'.[770] Banks as commercial enterprises can draw up contracts as a matter of course but public policy concerns restrict this freedom at the heart of the relationship by imposing a requirement on banks to disclose necessary information that is gained during the contractual relationship.[771]

Banks have always experienced difficulties and challenges based on the conflict between customers' need for secrecy and public policy concerns, especially considering the fact that for such a long time banks have been part of internationalization, for example, by opening new branches or subsidiaries. This process, however, created a grey zone by producing doubts and concerns about the release of information.[772] These grey zones can be found in differences in law, judicial decisions and divergent approaches to contractual duties. While some jurisdictions oblige banks to release or share information on certain circumstances, others can be reluctant to respond to demands for information and prefer to provide more flexibility.

Contracts, whether in standard forms, drawn up by an association of banks or established with the volitional manifestations of parties impliedly or expressly impose one specific duty on the bank, the duty of confidentiality. There is a tacit or explicit term of contractual relationship; banks owe their customers a quasi-contractual or fiduciary-type of duty, but this duty is not absolute and has exceptions. *Tournier v National Provincial and Union*

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[769] William Blair,'Secondary Liability of FIs for the Fraud of Third Parties' (2006) 30 Hong Kong L J 74,91.

[770] Burlington & Quincy.R.R. Co. v. McGuire,219 US 549,567 (1911).

[771] Lord (n 765) 303.

[772] Francis Neate,*Bank Confidentiality* (2nd edn,Butterworths 1997) xix.

Bank of England[773] is considered to be the *locus classicus* and it is where the duty of confidentiality of a bank developed from being an ethical duty to a legal requirement, which allows a claim for damages in the case of a breach of duty.[774] According to this decision, there is an implied term in the relationship between a bank and a customer that any information about a customer must be regarded as confidential to any third person.

3.1.Duty of Confidentiality towards Customers

Theories regarding the classification of the bank-customer relationship imply a degree of confidentiality based on contract, property, agency, tort and evidentiary privilege.[775] Duty of confidentiality, transpired by courts, generally transcends classical contractual obligations that occur between a debtor and creditor.[776] It is derived from the requirement to prevent violation of personal rights or irruption into the private sphere, which means that the duty of confidentiality of a banker originates from the view that a customer/consumer should not be disturbed in his private and intimate sphere.[777] Thus, banking confidentiality consists of protection and the fundamental valuation of personality and proprietary rights residing in the things a legal or real person possesses.

The power which strengthens the duty of confidentiality can be found in its economic and

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[773] [1924] 1 KB 461.

[774] Bonita Erbstein, 'Common Law Bank Secrecy and Its Implications for US Securities Law' (1999) 2(4) Journal of Money Laundering Control 331, 335.

[775] Paul Eugene Ridley,'Confidentiality of FI Account Records under State Law: Substance or Illusion?' (1983) 3(3) Review of Litigation 567,575.

[776] Thomas C. Russler and Steven H. Epstein,'Disclosure of Customer Information to Third Parties: When is the Bank Liable?'(1994) 111 Banking Law Journal 258.

[777] F. Beutter,'Geheimnischarakter des Geldes und ethische Grundlagen der Geheimhaltungspflicht' (1978) 2 Acta Monetaria 9,15.

historical dimensions.[778] As in a relationship between a lawyer and a client, a bank-customer relationship involves confidential business, and the nature of the work economically requires a customer to share necessary information freely without hesitation. This approach deems banking confidentiality to be a professional duty based upon ground of privilege similar to a relationship between doctor-patient or lawyer-client.[779]

The common law duty of confidentiality of a bank is referred to in the landmark decision of *Tournier*.[780] The extensive impact of *Tournier* has not just been limited to the UK; the rest of the common law world has also adopted the principles established by it. Even though the development of the final concept of the banker's duty of confidentiality has been different in different jurisdictions, every common law jurisdiction has followed *Tournier* together with equitable, statutory and constitutional principles in establishing the limits of secrecy on financial matters.[781]

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778 E.P. Ellinger,E. Lomnicka and C.V.M. Hare, *Ellinger's Modern Banking Law* (5th edn, OUP 2011) 171-79.

779 The duty of confidentiality appears in different forms in different jurisdictions. While some jurisdictions establish statutory or regulatory codifications (for example see Banking Act of Singapore of 2003,s 47; Swiss Banking Act of 1934,s 47; Austrian Banking Act of 1993,s 38) others may leave it to the implied terms of the bank-customer contract (such as the UK).Hence, there are jurisdictions where no particular statutory provisions exist to force banks to keep to a duty of confidentiality; rather it is left in the field of contract law based on the principle of good faith. Furthermore, there are legal systems where banking confidentiality is assured by mandatory provisions under the civil code and contract law as well as protected by criminal law. Thus, it is possible to mention public law protection established in the private law.See H. Ping,'Banking Secrecy and Money Laundering' (2004) 7(4) Journal of Money Laundering Control 376.

780 [1924] 1 KB 461.

781 *Peterson v Idaho First National Bank*, 367 P2d 284,290(Idaho 1961). See David Chaikin,'Adapting the Qualifications to the Banker's Common Law Duty of Confidentiality to Fight Transnational Crime' (2011) 33 Sydney Law Review 265.

However, this implied duty is subject to a number of qualifications as stated by Bankes L.J. under four headings: where disclosure is made under compulsion of law; where there is a duty to the public to disclose; where legitimate interests of a bank require disclosure; and lastly where disclosure is made with implied or express consent of a customer.[782] Such qualifications were criticized and found insufficient due to the time that the exceptions were established.[783] The transformation of crimes from a domestic to a more international character is seen as the basis for the re-examination of duty of confidentiality and its exceptions.[784] The precise limits of qualifications established by this famous case have been interpreted differently and sometimes contradictorily by different jurisdictions, implying that domestic laws have determining roles to identify when compulsion of law takes place or what legitimate interest of a bank justifies it to make a disclosure. Likewise, exceptions to bank secrecy expanded and more interference was allowed following the events of 9/11.[785] In the UK, even before 9/11, the Jack Committee declared concerns over increasing inroads into common law duty of confidentiality and suggested the imposition of statutory requirements of disclosure on banking.[786] It was considered that these effects on financial privacy contained Orwellian overtones.[787] The burden on banks gradually heightened due to the nature of obligations given by law. For instance, voluntary disclosure of information is imposed on bankers with know-your-customer

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[782] [1924] 1 KB 461,472. Court of Appeal reaffirmed these qualifications at *Barclays Bank Plc v Taylor* [1989] 1 WL6 1066 at 1070.

[783] Chaikin (n 781) 267.

[784] Ibid.

[785] Paul Latimer,'Bank Secrecy in Australia: Terrorism Legislation as the New Exception to the Tournier Rule' (2005) 8(1) Journal of Money Laundering Control 56.

[786] The Report of the Review Committee on Banking Services Law and Practice (Jack Committee)(Feb 1989)(Cmnd 622) ch 5.

[787] Rose-Marie Belle Antoine, *Confidentiality in Offshore Financial Law* (2nd edn,OUP 2014) 87.

principles. Accordingly, the general law of confidence, data protection and mistreatment of private information should be viewed as complementary parts of established qualifications to the doctrine of confidentiality.

The duty of confidentiality of a bank can be discussed in terms of its endemic nature in a specific state. However, the topic itself should not be thought of as having no effect on the global level. For instance, offshore financial centres with a high degree of financial data protection might create inefficient market consequences and breach regulations of other jurisdictions.[788] In the US, major events such as the 9/11 terrorist attacks and a rapidly changing legal, commercial and political environment – with the growing need for memorandums of understanding and multi-lateral and bilateral agreements, globalization, technological improvements in the collection and exchange of data, the greater mobility of funds, criminalization of money have re-shaped the bank confidentiality concept into one that is more aggressive in relation to bank information, pushing bank privacy concerns into the background. The 9/11 terrorist attacks, acting as a threshold for a new legal framework towards the implementation of the Patriot Act, established stricter scrutiny and oversight of banks and introduced new compliance, customer due diligence, beneficial ownership checks, record keeping and reporting obligations.[789] Thus, in this new era, AML compliance measures, customer identification

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[788] Guttorm Schjelderup,'Secrecy Jurisdictions' (2015) CESifo Working Paper No:5239 (accessed May 6,2016) http://www.cesifo-group.de/ifoHome/publications/docbase/DocBase_Content/WP/WP-CESifo_Working_Papers/wp-cesifo-2015/wp-cesifo-2015-03/12012015005239.html.

[789] See the Title III of the Patriot Act, the Right to Financial Privacy Act of 1978 and the GLBA. The private law framework of bank confidentiality in the US cannot be thought without the importance of the US as being "the hub the global capital with largest financial markets" and the 9/11 attacks. Peter J. Manners, *Adapt and Thrive: The Sustainable Revolution* (Cornwall 2008) 171. Thus, pressure from the US, which is the largest investment fund centre and has the

policies and extra attention on foreign accounts have placed new additional [administrative] burdens on banks.[790] Such forcefulness towards the laws of other states might give the impression of legal imperialism due to its extraterritorial effects, as was the case when the Foreign Account Tax Compliance Act (FATCA) came into play; something which ultimately created tension with states with strong bank secrecy laws.[791]

The law regarding banking confidentiality has been subject to recent changes due to the judicial and statutory admission of the duty in different parts of the globe after discussions as to whether bank confidentiality is the exception rather than the rule. Subsequent parts will shortly discuss how this duty was transformed with established qualifications and limitations and how security, integrity and confidentiality of information kept by banks is balanced with the corresponding legislative response within this rapidly changing informational environment.

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most traded currency, might be the impetus for a change in the banking traditions of other jurisdictions. For example, with the implementation of FATCA in 2014, the arguments about FATCA's impact on offshore financial centres' banking policies have appeared. Jane G. Song, 'The End of Secret Swiss Accounts?'(2015) 35 Northwestern Journal of International Law&Business 687.

[790] Martin Carrigan,'The US Patriot Act, De-construction, Civil Liberties and Patriotism' (2008) 6(3) Journal of Business & Economics Research 19,21.

[791] Bruce W. Bean&Abbey L. Wright,'The US FATCA:The American Legal Imperialism?' (2014) 21 ILSA Journal of International &Comparative Law 333.Further, it is suggested that the OECD could find its motivation in establishing the Standard for Automatic Exchange of Financial Account Information after the sweeping compliance to the FATCA. Jay R.Nanavati wolf(Accessed April 14, 2016)http://www.globaltaxenforcement.com/tax-controversy/global-tax-enforcement-in-2016-what-you-need-to-know/.

3.2.Qualifications to the Duty of Confidentiality

In general terms, inroads made into the banker's duty of confidentiality can be addressed under two groups: the first group characterizes the cases that serve for the prevention of crimes and maintenance of public order via public law measures; and the second group represents the qualifications which aim at economic, commercial and financial improvement by allowing a degree of information disclosure to private bodies for the healthier assessment of credit risks, ensuring trust in commercial activities or enhancing competition.[792] This general classification can also be interpreted with *Tournier* qualifications since the adoption of a common law system and the guidance of *Tournier* qualifications in different countries provide a base to form a legal framework of qualifications of the duty.

3.2.1. In the Bank's Interest

Generally, this qualification is exercised when the bank needs to claim a right against its customer, guarantor or surety or the bank simply can act as a third-party claimant or defendant in a litigation among its customer and a third party.[793] There can be many circumstances where a bank is required to disclose some facts such as in case of payment of an overdraft,[794] as happened in *Tournier,* or the bank can decide to release relevant

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[792] Ruth Pluto-Shinar,'Cross-Border Banking: Reconceptualising Bank Secrecy' in Ross P. Buckley, Emilios Avgouleas & Douglas W. Arner(eds), *Reconceptualising Global Finance and Its Regulation* (CUP 2016)236-50.

[793] Ali Malek and John Odgers, *Paget's Law of Banking* (15^{th} edn, LexisNexis 2018) 3.21.

[794] This was the only example given to explain this qualification. Nevertheless, Scrutton LJ (together with Atkin LJ) provided a different approach: "The bank may disclose the customer's account and affairs to an extent reasonable and proper for its own protection."[1924] 1 KB 461,481.Atkin LJ's note at 586.

information to enforce its rights under a charge.[795]

As a matter of legal doctrine, the concerns related to what the legitimate interests of the bank consist of and how much information is sufficient and necessary to justify disclosure of confidential information should be settled by considering the facts and circumstances of each specific case. This qualification involves complex issues and introduces vital legal policy considerations regarding disclosure made within the bank's intra-group companies and disclosure made to CRAs and credit reference agencies[796]. Also, mergers and acquisitions, bankruptcy, outsourcing operational functions and operations related to restructure, transfer or sale of credit facilities of the bank together with cross-marketing practices might be used for banks to justify release of confidential information to relevant persons or authorities. Lawyers, accountants and auditors of the bank are also allowed to access bank information as a matter of course; and CRAs, because they have a big impact on banks as they allow assessing their risk portfolio, are also given information due to the need for corporate ratings in the private sector including banks.[797]

3.2.2. Customer's Consent

Since customers are the real owners of the data they provide to banks, they are fully entitled to allow banks to disclose their information[798] unless public law measures render such consent unnecessary. Generally, such consent is asked from a customer as part of standard terms and conditions in the contract. Thus, depending on the jurisdiction, the arguments relating to operability of the categorization of consents, whether explicit or

[795] *Kaupthing singer &Friedlander v Coomber and Burrus* [2011] EWCH 3589 (Ch) at 52.
[796] This issue is now generally addressed with the consent of the customer.
[797] Darbellay (n 166) 31.
[798] Lorne D. Crerar, *The Law of Banking in Scotland* (2nd edn,Tottel 2007) 214.

implied, or options provided to customers (such as opt out)[799] can show divergent approaches to the limits of consent given by the customer on his/her own information. Written consent and concomitant questions deriving from broad terms and conditions of the contract have been subject to arguments as to whether boilerplate contracts presented to customers may include permission for a variety of disclosures by the bank.

3.2.3. Public Duty/Public Interest

The classic explanation for this qualification is explained by the following quote: 'whenever the state faces any danger, its interests should be superior to the individual's interests'.[800] It may also be taken as an allowance to non-statutory inquiries directed at banks and represent an opportunity given to authorities with no power to rule the release of confidential information based on public interest.

This qualification established by *Tournier* is explained by making reference to situations related to danger to the state or public duty.[801] However, at the same time releasing information to the police is not guaranteed by pleading a public duty justification.[802] As mentioned, many examples can be given to justify disclosure on the grounds of public duty, which basically aims to protect the persons, the bank or the public in general against fraud or crime. This is all to say that this qualification was an outcome of a need for a spillover category at the time of *Tournier* and uncertainty and vagueness in the

[799] Such as GLBA.

[800] *Weld Blundell v Stephens* 1920, AC 956 at 965,966 HL.

[801] In *Tournier,* Bankes LJ quoted Lord Finlay's words in *Weld-Blundell v Stephens* [1920] AC 956,965-66.

[802] [1924]1KB 461,474.

application of public interest qualification to establish great flexibility to interpret the public interest differently depending on the facts of each case.[803]

Involvement of foreign crimes and public duty has also been another argument in relation to the dimensions of the qualification in an international setting. Questions regarding whether a public duty of another state can lead to a possible dilution of the bank's duty of confidentiality can be partly answered by case law.[804] The examples and terminology used to explain this qualification may be interpreted in a narrow sense but the elasticity of the term public duty and public interest itself provides flexibility to a great extent.

Considering other cases from other common law jurisdictions, the application of public interest qualification could not be clearly exemplified by the cases related to actual and great danger to the public.[805] As such, the question is whether public duty can be the subject of broad interpretation which implies that banks can act as whistleblowers of their customers in the event of fraud and crime.[806] The disclosure of iniquity, which could have been used to justify bank disclosures,[807] is seen as necessary based on the idea that iniquity is wider than a crime or misdemeanor, and therefore from the standpoint of the

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[803] Jack Committee (n 786) para 5.30.

[804] For example see *Libyan Arab Foreign Bank v Bankers Trust Co* [1989] QB 728*;Price Waterhouse v BCCI Holdings (Luxembourg) SA* [1992] BCLC 583;*Pharaon v BCCI SA* [1998]4 All ER 455.

[805] For example *Crisp v Australia and New Zealand Banking Group* [1994] ATPR 41-294(Australia); *Lesser Antilles Trading Co Ltd v Bank of Nova Scotia*[1985] LRC(Comm)39(Bahamas); *Canadian Imperial Bank of Commerce v Sayani* [1994] 2 WWR 260(Canada).

[806] Saul Froomkin,'Secrecy, Confidentiality and Banking'1990 Meeting of Commonwealth Law Ministers and Senior Officials cited from Kris Hinterseer,*Criminal Finance* (Kluwer Law International 2002) 107.

[807] *Allies Mills Pty Ltd v Trade Practices Commission* (1981) 34 ALR 105 at 141.

public interest, banks should decide whether a relevant case consists of iniquity.[808] Although the scope of this qualification is far from clear, its application is already very rare. As Donovan puts: 'It would be inadvisable for a banker to exercise his private judgment in such matters at the expense of a customer'.[809] In other words, even if the public interest is apparent, banks might not have a definite and overriding duty to the public, which approves the breach of confidence.[810]

In practice, this qualification under the common law system would be used very few times considering the fact that ever-growing numbers of laws have already imposed a duty on banks to disclose in certain situations. Duty to the public itself is vague since there is no unified standard in which cases of public duty occur which suggests that it is in courts' power to determine whether public interest occurs depending on the facts of each case.

The rationale for preserving this qualification today can be explained by convenience provided by a generalized public duty qualification as a measure to manage more complex financial wrongdoings of an international character.[811] Nevertheless, considering the fact that interpretation of public duty to that extent is not as necessary as it was at the time that this qualification was established based on the large spectrum of domestic and international statutory obligations imposed on banks to report such international financial crimes. Having said that, unexpected situations, which are not included in the law, to

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[808] *Initial Services v Putterill* [1968] 1 QB 396; *British Steel Corp v Granada Television Ltd* [1982] AC 1096.

[809] James O'Donovan, *Lender Liability* (Sweet&Maxwell 2005) 146.

[810] Ibid 134-35.

[811] UK Government,'Banking Services: Law and Practice'(White Paper No Cmnd.1026, March 1990) para.5.30.

allow release of confidential information, might be seen as a ground to keep the public duty qualification.[812]

The difficult judgment regarding whether a strong public duty overrides the private duty of confidentiality in the absence of pre-specified legislations may be indicative of why this qualification is rarely used. The application of the public interest qualification under common law, therefore, can be mentioned with no fewer than two criticisms: the absence of a precise threshold outlining the minimum level required to take the interests of the public into consideration to override the banker's duty of confidentiality; and secondly, the fact of holding this qualification in reserve for the cases beyond those situations compelled by law.[813] Despite this, it could be said that the common understanding of a bank's burden under the public interest qualification is a reactive one rather than a proactive one.[814]

Banks informally collaborate in this qualification to facilitate authorities in the aid of discovery and inquiries of major crimes, and in general this is done without the knowledge of their customers.[815] Today, public law influence over private interests embedded in bank confidentiality formalizes a different legal environment with ever-broadening legislative requirements for disclosure which makes the practice of this qualification unclear.[816]

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[812] Owen J. Morgan,'The Public Duty Exception in Tournier-Getting There the Hard Way in New Zealand' (1994) 9(6) Journal of International Banking Law 241,243.
[813] Simon Crawford,'Bank Privacy towards 2000' (1997) 29 Ottowa Law Review 425,439.
[814] Tara Walsh,'The Banker's Duty of Confidentiality: Dead or Alive?' (2009)1 Edinburgh Student Law Review 1,9.
[815] Evidence to Affairs Committee, The British House of Commons (November 1998) cited from Ross Cranston(ed), *Legal Issues of Cross-Border Banking* (Bankers' Books 1989) 85-86.
[816] Chaikin (n 781) 284.

3.2.4. Compulsion by Law

This qualification includes disclosure to judicial and supervisory authorities and law enforcement agencies. Disclosure orders force banks to release relevant information in cases where third-party tracing-claims or specific jurisdictions necessitate this to be done[817] and a judgment through a court order should be a product of careful thought on the clearest grounds.[818]

The law covers a variety of reasons to ask for information from banks in a large spectrum of fields of law. The need for information can derive from investigation or insolvency and bankruptcy of companies or it can be related to a failure of a taxpayer or criminal activities such as fraud which requires such disclosure. In the same way, bank information is of great importance for financial services and compelled disclosure has been a widely accepted phenomenon through safety and soundness laws and again through certain powers bestowed on financial authorities with the purpose of investigating suspicious incidents such as insider trading, fraud or embezzlement. Such powers given to regulatory

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[817] Malek and Odgers (n 793) 3.19.In countries where the mechanism residing in checks and balances is corrupted, questions as to the accuracy and legitimacy of court orders might appear and courts can be seen as the invisibly operating hand of governments giving rulings and making orders for the purpose of fishing expeditions or some other political purposes. Accountability and transparency of the public sector has been on the agenda of the national and international organizations and bodies since the late 1990s.Laurence Ravillon,'Transparency in International Business Law' (2015) 5 International Business Law Journal 433. Emotional responses emanating from acts related to terrorism, corruption or such other criminal behaviours can lead to a degree of public support and sympathy which justify political intrusions made via court orders. Thus, banks can be the centre of attacks made against liberties. Eric J. Gouvin,'Are There any Check and Balances on the Government's Power to Check Our Balances-The Fate of Financial Privacy in the War of Terrorism'(2005)14(2) Temple Political&Civil Rights Law Review 517.

[818] Lord Widgery's judgment in *Williams v Summerfield* [1972] 2 QB 512,518.

and investigatory authorities can be found in a variety of laws.

Since *Tournier*, several statutes requiring or permitting banks to disclose confidential information have been introduced in English law. These can be grouped under disclosure when banks are parties to civil litigation proceedings, when banks are not parties to civil litigation proceedings and disclosure is pursuant to specific statutes.[819]

As a party to civil litigation, under the Civil Procedure Rules 1998 (CPR), banks disclose necessary information under their control.[820] Where banks are not parties to civil litigation proceedings, there are various channels requiring disclosure. When disclosure is a cost-effective solution, or imperative to fairly dispose of proceedings, the courts, by examining if an application for disclosure is necessary for a case, can allow non-party disclosure.[821] Under the CPR, courts can issue witness summonses or subpoenas to compel banks to give evidence or create documents for the court.[822] The courts also have the authority to order disclosure to help with tracing claims [823]or pursuant to a Norwich Pharmacal order.[824] This inherently creates a tension between bankers' private duty of

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[819] Charles Hewetson and Gregory Mitchell, *Banking Litigation* (4th edn, Sweet & Maxwell 2017) Ch. 10.

[820] CPR, pt 31, r 34.2.

[821] CPR, r 31.17.

[822] CPR, pt 34.

[823] CPR 25.1(1)(g).

[824] It might be used when a bank has engaged in wrongful acts for another party without knowing and the victim of a wrongful act urgently needs information from the bank when the option to use a witness summons does not provide adequate assistance. *Norwich Pharmacal Co v Customs and Excise Commissioners* [1974] AC 133.For the conditions of the order see *Mitsui & Co Ltd v Nexen Petroleum UK Ltd* [2005] 3 All ER 511 at 19, 21, 24. For a discussion regarding the application of Norwich Pharmacal orders to banks, see Ellinger, Lomnicka and Hare (n 778) 181-84.

confidentiality and their public duty to conform to court orders.[825]

Orders under the Evidence Act 1975 also give power to the English High Court to order disclosure to assist foreign courts.[826] S 235 of the Insolvency Act 1986 establishes another disclosure channel. Banks may be under a duty to assist office0holders of insolvent corporate customers, and the courts may compel banks to produce evidence when necessary.[827]

Disclosure to investigators (such as the FCA) is also possible under the Companies Act 2006.[828]Additionally, Inspection orders under the Bankers' Books Evidence Act 1879[829] provide an alternative route for disclosure in legal proceedings. Finally, as Section 4.2 will discuss, disclosure to HM Revenue and Customs for prevention of tax avoidance purposes is another disclosure channel,[830] together with a multitude of statutory disclosure requirements under criminal law statutes.[831] These will be paid specific attention in subsequent sections.

It should be indicated that not every disclosure of information in order to satisfy government officials or authorities could be defended on the grounds of compulsion by

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825 By referencing *Tournier,* Lord Nolan acknowledged that banks are required to produce evidence for the courts. *Robertson v Canadian Imperial Bank of England* [1994] 1 WLR 1493.

826 Malek & Odgers (n 793) 33.13. See *X AG v A Bank* [1983] 2 All ER 464.

827 Insolvency Act 1986, s 236(2).

828 Malek& Odgers (n 793) 33.15.

829 S 7, 10.

830 Income and Corporation Taxes Act 1988.

831 These can be grouped as: Police and Criminal Evidence Act 1984, s 9; Criminal Justice Act 1987, s 2, Drug Trafficking Act 1994, ss 15-18; Terrorism Act 2000 21A, 21B, 21CA-21CF; Crime Act 2003, ss 32-46; Anti-Terrorism Crime and Security Act 2001; The Money Laundering, Terrorist Financing and Transfer of Funds Regulations 2017, SI 2017/692.

law.[832] This view suggests that banks should consider the confidentiality expectations of their customers and behave accordingly. In addition, implementation of judicial decisions or presentation of evidence in the course of civil, criminal or arbitral proceedings not involving the bank forms other grounds for compelling banks to release confidential information to the authorities.

Perhaps the most debated point regarding disclosures made under compulsion of law has been the promulgation of a plethora of laws which allow judicial authorities to intrude on bank confidentiality, thereby adding new qualifications and limitations to the duty of confidentiality. Besides, the extra-territorial dimension of legal compulsion is of importance because of international procedures to request or obtain evidence, incompatibility of laws between jurisdictions and sovereignty issues. International comity principles as the basis for exchange of information between states, multi-lateral cooperation and the power of international mechanisms such the Hague Convention[833] are of importance to compel banks to make disclosures as neutral custodians of information and provide them with safe harbours to protect them from any breach of duty. Although the disclosure by legal compulsion discussed in *Tournier* did not cover an order or a subpoena produced by a foreign court, or in other words compulsion under a foreign law; foreign subpoenas or orders such as the ones calling for transfer of funds abroad might be countered with public interest reasons based on the idea that cooperation with a foreign court may serve the common public interest, ie investigating the fraud that is beyond mere allegation. As it will be addressed in part 6, together with other financial crimes, steadily increasing AML and CTF legislations requiring banks to follow certain

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[832] Gibbs CJ's comments on *A & Ors v Hayden* [1984]156 CLR 532 at 545-47.

[833] Convention of 18 March 1970 on the Taking of Evidence Abroad in Civil and Commercial Matters.

procedures herald further ramifications with an effect on stability of the banks and the state.

4. Public Law Intervention in Bank Confidentiality

Involvement of governments in the operation of the market economy is done to establish a safe system, to make markets operate efficiently and to reshape the market results to satisfy the demands and expectations which society values. As mentioned, in theory, all laws contribute to the interests of the public.[834] However, in economic terms, the reason for regulation is explained by market inefficiencies where market failures and frictions that cause resource misallocation necessitate regulatory intervention of the state.[835] This interference based on the public interest suggests that collective action is superior to individual action in order to achieve the public good.[836]

The classic argument about public interest theory in designating the limits of intervention brings to the fore various theoretical discussions. First of all, the presumption that regulators are benevolent and purely concerned with the public interest might not always prove right.[837] There is a possibility that regulators are captured by regulated interests, which means regulators can function according to their systemically biased views about private sector operation. Second, regulators forwardly carrying out their work to safeguard the public interests by ignoring private interests might be harmful for the public interest in the long run. Arguments about the nature and limits of regulation based on the

[834] Merryman and Perez-Perdomo (n 743).
[835] Schooner and Taylor (n 399) xi-xiii.
[836] Carlos M. Pelaez & Carlos A. Pelaez, *Regulation of Bank and Finance* (Palgrave Macmillan 2009) 13-14.
[837] Johan Den Hertog,'Review of Economic Theories of Regulation'(2010)Tjalling C. Koopmans Research Institute Discussion Paper Series 10-18 1,2.

formation and development of social/economic organisations and powers of the state is ongoing within the intellectual sphere.

Looking through the lens of bank regulators/supervisors, theoretical discussions about how regulators see banks as private, self-interest motivated firms pursuing profit maximisation provide that banks are public-interest spurred institutions.[838] When deregulation began to happen from the 1970s, public interest in bank regulation was to leave banks to competitive forces so that well-organised groups pursuing private interests like banks could serve for the whole public by providing better services and goods;[839] while the classic public interest theory exerts that government intervention corrects failures and maximises social welfare.[840]

Considering the government borrowing and private interests of some power groups, one may also think that the extent of regulations over FIs can be very related to the extent of political interference. In other words, political capture can be veiled by regulations. These public and private interest approaches can be polar extremes within the analysis of today's financial systems and measures of democracy. However, exogenous variables, such as financial crises, might change the power that strikes a balance of public and private interests. The cost of the regulations should also be examined with information costs,

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[838] Chapter 1.

[839] George J. Stigler,'The Theory of Economic Regulation' (1971) 2(1) Bell Journal of Economics and Management Science 3.

[840] Randall S. Kroszner and Philip E. Strahan,'The Political Economy of Deregulation: Evidence from the Relaxation of Bank Branching Restrictions in the US' (1997) FRBNY Research Paper No.9720 (accessed March 2,2016) https://www.newyorkfed.org/medialibrary/media/research/staff_reports/research_papers/9720.pdf.

which creates concomitant monitoring, supervising and enforcement costs charged to the taxpayers.[841] It also determines the level of interference in banks.

So, the research agenda has discussed the regulatory policies, their enforcement and post-effects on the development and role of private firms in different theoretical settings that position boundaries of state and market in different scenarios. Intervention in the private sphere of persons for market failure reasons in economic terms or public interest reasons in the context of public policy objectives has implications for bank regulation, and the paradigm-shift in bank information disclosure exemplifies this approach.

As discussed in Chapter 3, bank disclosures in financial markets are of significance since disclosures allow bank stakeholders to make a better assessment of the bank and its risks by providing a clearer picture of its financial situation. The discussion conducted in this section so far is a snapshot of the previous chapters. On the other hand, disclosures made about the customers form another pillar of regulations based on public good. Criminal law, by its very nature, has been qualified as a mechanism for achieving the public good where the state establishes measures to protect all citizens of the state and prevent the occurrence of crimes. Due to the destabilizing outcomes of the crimes on society, the state is driven to intervene in the organizations when it sees it necessary to protect its own existence and its citizens as well. The level of intervention of the states in banks has increased through the internationalization of crimes and the interconnectedness of the financial markets via innovation in technology and information systems.

[841] Chapter 2.

Recognized principles of contract law that apply to banks and their customers have been superseded by superior laws which means private law protections pertaining to the information held by banks have been overridden by public law measures on both national and international levels to prevent and combat crimes.[842] Accordingly, the climate within which the bank-customer relation operates is subject to a continuing turnabout.

The overuse of the power of the state within confiscation, recovery and criminal investigations might end up with complete submission of banks to the state at the expense of balancing the public good. Superimposed disclosure obligations of banks through criminal law objectives can be analysed within AML, TF and tax evasion laws on the one hand, and through securities regulation, as discussed in Chapter 4, on the other. Policies to fight against crimes including but not limited to illegal narcotics trafficking, illegal sales of weapons, child pornography, human smuggling, financing of illegal activities, fraud or political corruption drag banks into a regulatory landscape where they are obliged to disclose information by law.[843]

The international focus of the fight against financial crimes exerts pressure over the countries' so-called offshore jurisdictions. Moving capital to such fiscal paradises is not just related to pure criminal law policies but also to unfair competition and distortions within the market.[844] Substantive policy and regulatory differences between the jurisdictions may channel the capital of people and businesses to those with more secrecy. The transparency of banks may also be gauged according to the state's commitment to

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[842] Section 3.2.4.

[843] Schott (n 715).

[844] Richard Gordon and Andrew P. Morriss,'Moving Money: International Financial Flows, Taxes and Money Laundering'(2014) Hastings International&Comparative Law Review 1,2.

automatic exchange of information with other states. Preventive measures for national security, public safety or fair allocations of wealth through fair taxation are evidently not bad things. There might be cases where the moving of funds between banks can be the result of illegal or corrupt actions like counterfeiting or smuggling or where the source of funds is legal, but their transfer is not permitted by law such as in cases of tax evasion.

Given the ordinary banking relationship with customers established under of private law and the challenges arising out of the elusiveness and complexity of the concept of those crimes and their ever-expanding requirements over banks, a problem might appear as laws may treat banks as nothing more than information suppliers. This issue involves concomitant problems such as conflicts of law or other related issues pertaining to balancing the measures of counterterrorism or other criminal activities and civil liberties. The structuring of a regulatory web and the enforcement system underpinning bank disclosures can be symptoms of a new type of political control.[845]

The extent of the social responsibility of banks is another contentious issue questioning whether the measures taken to protect investors and others residing in criminal law to prevent and combat crimes assign banks moral or ethical responsibilities beyond their profit maximisation objective due to their importance to the socio-economic system.[846] This line of thought implies that banks should go beyond mere compliance with the rules and willingly take on the responsibility to contribute to the integrity and stability of

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[845] Sanaa Ahmed,'The Politics of Financial Regulation' (2015) 11(1) Socio-Legal Review 61.

[846] For a discussion about the societal responsibility of banks, see Indira Carr and Robert Jago, 'Corruption, Money Laundering, Secrecy and Societal Responsibility of Banks' in Nicholas Ryder, Umut Turksen and Sabine Hassler (eds), *Fighting Financial Crime in the Global Economic Crisis* (Routledge 2015) 144-67.

markets, and they should have a societal responsibility to abdicate their commitment to bank confidentiality to a certain extent.

Overall, there has been a great effort by governments and law enforcement agencies to combat financial crime as these crimes have a high political profile, especially after the GFC, when integrity of the financial system has become so paramount. This was maybe because banks were seen as imprudent in their business conduct to maximise their financial profits and a great deal of regulatory investigations of banks reduced confidence in banks in general. In this respect, banks receive most of the pressure for their commercial activities. It has been a difficult task to establish a balance between providing services in existent and new markets, fulfilling their private law contractual duties to their customers and increasing its financial welfare and market stability whilst exercising their duties emanating from criminal law and other regulations.[847] Loss of public confidence based on public awareness about the involvement of banks in facilitating financial crime, regardless of whether it is done knowingly or unintentionally, motivates further exploration about whether there is a potential for systemic risk similar to ones discussed in Chapter 4.

4.1.Anti-Money Laundering and Terrorism Financing Laws

ML is a special type of crime that has effects on the global level and it involves the proceeds of many criminal activities such as smuggling, drug trade and trafficking, insider

[847] Alan Bacarese, Kenneth Levy and Hari Mulukutla,'The Management of Information in the Context of Suspected Money Laundering Cases' in Barry Rider(ed), *Research Handbook on Financial Crime* (Edward Elgar 2015) 507.

trading, embezzlement, bribery, arms trafficking and fraud.[848] Criminalization of ML is relatively new[849] and it has been advanced by the advent of global integration where the sovereign preserve of individual states in the establishment and enforcement of criminal law measures have been substantially challenged by international characteristics and globally accepted detrimental effects of this crime.[850]

Illicit financial flows from developing countries can result in a decrease in domestic expenditures and investments through creating social and financial fragmentation in the country by damaging public confidence in banks and the financial system as a whole. The movement of funds can be related to diversification of the portfolio and spreading risk; it can be a result of unfavourable changes in political, economic and social circumstances in the state including 'financial instability, weak currency and runaway inflation rates'[851] or simply it may be related to potential benefits from tax competitions between the states.

Its negative impacts on the systemic stability of banking systems,[852] which place unjust economic burdens on the ones behaving within the legal economy, corruption and

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848 Jayesh D'Souza, *Terrorism Financing, Money Laundering and Tax Evasion* (CRC Press 2012) 39.

849 Emmanuel Ioannides, *Fundamental Principles of EU Law Against Money Laundering* (Ashgate 2014) 2.

850 Robin Booth and others, *Money Laundering Law and Regulation* (OUP 2011) 2.

851 E.U Savona, *Responding to Money Laundering: International Perspectives* (Harwood Academic Publishers 1997) 185.

852 Banks can cause liquidity risk in the financial system due to their affiliation with ML activities. Banks viewed as related to ML activities are exposed to reputational, concentration or operational risk, which have repercussions on the country's financial and monetary stability. In and out money flows of a financial system, confidence loss and concentration risks emanating from ML threaten the systemic stability. Kern Alexander, Rahul Dhumale,John Eatwell, *Global Governance of Financial Systems: The International Regulation of Systemic Risk* (OUP 2006) 31-32.

accompanying side concerns about civil liberties have remained on the global agenda and it still creates tension among the global initiatives battling with ML and the states following their best national welfare policies.[853] However, the tension that emanates from the heterogeneity of AML regulations might not necessarily be a result of welfare policies of the states; it can be related to their cultural and social values and traditions which are deeply rooted in their law.

Competition for illegal money and its links with countries with strict bank confidentiality laws is not new. As mentioned, though variances within AML rules remain between states, there is a great global effort to develop international standards. Such standards are not mere products of international public law measures but rather voluntary contributions from the private sector. This has provided great synergy in terms of the application of soft laws and non-binding measures.[854] The Wolfsberg AML principles are good examples of the participation of the private sector to combat ML.[855] At the same time, international soft law and convention-based measures have responded to the menace of ML by developing global standards and forming a minimum degree of disclosure regimes and exchange of information to combat ML. Mutual recognition of the self-interest of states and measures established by global initiatives (such as the Financial Action Task Force (FATF) [856], BCBS and OECD) create consultation and negotiations between the states

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[853] M. Michelle Gallant, *Money Laundering and Proceeds of Crime* (Edward Elgar 2005) 9-10.
[854] Jae-Myong Koh, *Suppressing Terrorist Financing and Money Laundering* (Springer 2006) 156.
[855] Mark Pieth&Gemma Aiolfi,'The Private Sector Becomes Active: The Wolfsberg Process' (2003) 10(4) Journal of Financial Crime 359. Also see the Wolfsberg Group (accessed March 4,2016) http://www.wolfsberg-principles.com.
[856] The main focus of FATF was to fight against misuse of financial systems through ML in 1990, the time when the FATF Forty Recommendations were set out. With advent of changing methods of money laundering, the FATF reconsidered the Recommendations in 1996 and

and they set out the collective intent in establishing common standards to combat ML.[857] Voluntary adoption of international soft laws, treaties and conventions starting from the 1988 United Nations Vienna Convention[858] to the present have far-reaching effects on the mechanisms to combat ML.[859] National AML laws together with international agencies such as FATF put particular emphasis on the control of information related to capital movements and identification of persons and institutions with suspicious transactions. FATF, FATF-style regional bodies[860] and its observer organizations, including the IMF, World Bank and the UN have provided strict standards on jurisdictions including prevention, detection and punishment of ML.

Preventive measures are interwoven with the FI secrecy laws and customer due diligence and record-keeping requirements imposed on them. Recommendation 9 provides a very clear reference to secrecy laws and establishes that 'countries should ensure that FI secrecy laws do not inhibit implementation of the FATF Recommendations'.[861] Along

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gradually broadened its scope to include thwarting of TF, financing of proliferation of weapons of mass destruction, corruption and financial crimes. FATF (accessed Nov 22, 2018) http://www.fatf-gafi.org/faq/moneylaundering/.

[857] As mentioned at Section 4.1, there could be a tension between national laws or standards countries adopted (ie FATCA's effects on Swiss bank secrecy).

[858] The United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances Article 3(1)(b).

[859] Kern Alexander,'The Legalization of the International Anti-Money Laundering Regime:The Role of FATF' (2000) ESRC Centre for Business Research No:177(accessed March 7,2016) https://www.cbr.cam.ac.uk/fileadmin/user_upload/centre-for-business-research/downloads/working-papers/wp177.pdf.

[860] FATF, http://www.fatf-gafi.org/media/fatf/documents/High-Level%20Principles%20and%20Objectives%20for%20FATF%20and%20FSRBs.pdf (accessed March 27, 2016).

[861] FATF,'International Standards on Combating Money Laundering and the Financing of Terrorism&Proliferation' (Oct 2018)(accessed Nov 23,2018)http://www.fatf-

the same lines, Recommendations 10 and 11 accommodate customer due diligence and record keeping as preventive policies.[862] Under those measures, on-going tracking of transactions and business relationships, collection of data and identification of the beneficial owner require active participation of FIs.

The term ML has been used interchangeably with other types of financial crimes such as TF.[863] In the case of TF, funds can come from both legal and illegal sources.[864] The fight against TF is a non-military element of the war on terror and banks surely do not want to find themselves in a situation that requires them to protect their reputation and auditability. Though ML and TF are different activities, linking them has provided a wider framework of measures to combat those crimes.[865] Prevention of the misuse of financial markets does not only cover TF, it includes other types of acts such as drug trafficking, insider trading and fraud.

4.1.1. Bank Reporting Requirements under Anti-Money Laundering and Counter Terrorism Financing Regimes

Banks have a role in mitigating financial crimes through their intelligence units that oversee suspicious activities which must then report these to the authorities.[866]

gafi.org/media/fatf/documents/recommendations/pdfs/FATF%20Recommendations%202012.pdf.

[862] Ibid.

[863] See the International Convention for the Suppression of Financing of Terrorism 1999.

[864] Stephen Dawe,'Conducting National Money Laundering or Financing of Terrorism Risk Assessment' in Brigitte Unger and Daan van der Linde (eds), *Research Handbook on Money Laundering* (Edward Elgar 2013) 111.

[865] For example, the FATF also engages in the war on terror.

[866] In the US this requirement comes from the USA Patriot Act and the Bank Secrecy Act(BSA) 1970. See 31 CFR§103.18(a). BSA provides a safe harbour provision for banks, which protects

Information is of significance to understand and mitigate the risk of ML and TF and analysed information is valuable as actionable intelligence both for banks and law enforcement. This means that banks are required to participate in information sharing to mitigate the risk of financial crimes and work like a law enforcement agency. Suspicion-based reporting therefore overrides the bank's duty of confidentiality, with banks being required to establish adequate and effective measures to protect themselves from the risk of facilitating crimes. What is noticeable is that banks are required to make difficult judgment calls and bear heavy administrative burdens in fulfilling their obligations.[867] Banks undertake costly screening, monitoring and reporting due to the threat of sanctions.

The role and effectiveness of banks in lessening the vulnerability of markets to attempts at ML or TF can be analysed under two subheadings: information and incentive. Such crimes are conducted in markets in which information asymmetries are inherent and banks play a role in lessening them.[868] This means that banks have the information capital and authorities do not. Therefore, banks are delegated as agents by the state to identify and report anomalies for the state in order to underpin its financial stability and its efficient, uncorrupted financial system efforts.[869] This analytical framework sets out that AML or CTF laws should be tailored to the distinct behaviours of at least two agents, one of them is a bank and the other is a regulator/supervisor.[870]

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banks from civil liability related to sharing suspicious activity and related account information with the relevant authorities. 31 USC§5318(g)(3). For the UK see Proceeds of Crime Act 2002, s 330-33. Also see Crime and Courts Act 2013,s 7 and Money Laundering Regulations SI 2007/2157. For the CTF, see Terrorism Act 2000,s 21A.

[867] Bacarese, Levy and Mulukutla (n 847) 510.

[868] Chapter 1.

[869] Donato Masciandaro,Elod Takats and Brigitte Unger, *Black Finance: The Economics of Money Laundering* (Edward Elgar 2007) 35.

[870] And law enforcement and government agencies.

As the regulators are unable to control all information collected by banks, they give this task to banks and force them to report abnormal situations. This responsibility comes with the incentive problem of producing necessary information and actively collaborating with the regulators because it brings extra administrative costs and prevents them pursuing other objectives like confidentiality. A cost-benefit analysis of regulation is therefore crucial as the regulation should consider anticipated costs and gains and discourage distortions and disincentives in the system to prevent the risk of deviant conduct.[871] As such, a balance is required to be struck between different tasks.

The process started with the Vienna Convention's requirement to criminalise ML and developed through establishment of suspicion-based reporting by the FATF's 40 Recommendations.[872] This concluded that a bank's traditional duty of confidentiality should have exemptions for confidentiality breaches and for international demands for mutual assistance.[873] This indicates that the private law duty is not solely a domestic matter where it is required to be interpreted with global measures regarding CTF, suspicious transactions, anti-corruption and anti-sanctions avoidance. This means there has been a new reworking of the bank's duty of confidentiality which can possibly go beyond the AML-CTF framework. It also implies that this duty is shaped by global concerns.

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[871] Donato Masciandaro and Umberto Filetto,'Money Laundering Regulation and Bank Compliance Costs: What Do Your Customers Know?'(2001) 5(2) Journal of Money Laundering Control 133,135.

[872] FATF,'The Forty Recommendations of the FATF on ML' (1990) Article 16(accessed May 14,2015) www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF%20Recommendations%201990.pdf.

[873] Graham Greenleaf and Alan Tyree,'Banker's Duties and Data Privacy Principles' in Sandra Booysen and Dora Neo (eds), *Can Banks Still Keep a Secret?* (CUP 2017) 31.

Know-your-customer and reporting requirements bring about two distinct costs to banks. The first one is tangible compliance costs and the other an intangible cost that encompasses customer trust and reputation. Suspicious activity report (SAR) is an integral part of AML reporting regimes and each bank decides whether there is suspicious activity or not. SARs link the suspected crime with the client/customer's identifiable information. Reporting requirements for transactions over a relatively low prescribed amount or suspicious transactions necessitate active monitoring. This turns banks into informers and detectives.

The threat of heavy sanctions and reputation loss plays an important role in making banks share information but the problem of overcompliance to avoid potential fines might occur and damages the efficiency of AML and CTF regimes.[874] The opposing view is that the disincentive problem does not emanate from convictions or fines but is related to the customer base of banks in that the bank deposits mostly come from a large number of small customers. [875] Thus, the incentive problem is mostly an economic one. In this regard, sharing information with authorities becomes more pertinent when it relates to a small number of high-wealth customers.

In addition to the issues discussed above, there is another challenge for banks when they seek to comply with ML and TF legislation. The conflict between the requirement to

[874] This is the 'crying wolf' problem which is when there is too much reporting and fewer convictions; and it should be solved by lessening the fines. E Takats,'A Theory of Crying Wolf: The Economics of Money Laundering Enforcement'(2011) 27(1)The Journal of Law, Economics, and Organisation 32.

[875] Valpy FitzGerald,'Global Financial Information, Compliance Incentives and Terrorist Funding' (2004) 20 European Journal of Political Economy 387,399.

report suspicions and the bankers' duty of confidentiality is already addressed in law.[876] Yet, banks face a dilemma between tipping-off their customers about an operation launched against them and facing a potential liability as constructive trustees for the funds they hold.[877] When a bank becomes suspicious about a customer's account and allows the customer access to that account without reporting its suspicions, it might be criminally liable for allowing the offence.[878] So, failure to report is an offence. In addition to criminal liability, banks may face a civil liability when it allows the payment of funds because this might mean liability as an accessory.[879] In this scheme, when banks need to wait for appropriate consent from the crime agency and then freeze an account, what happens if the customer wants to access his/her funds? The customer is likely to understand that there is a criminal investigation if they cannot use their account and here the bank faces the risk of tipping the customer off. If the bank allows the customer to use their account, it might be held liable for knowingly assisting a breach of trust.[880]

This conundrum was discussed in *Governor & Company of The Bank of Scotland v. A Ltd,*[881] where the Court of Appeal provided limited guidance about future dilemmas as its advice appears to be general, in that cooperation between the authorities (it was the Serious Fraud Office in this case) and the bank should take place prior to any court

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[876] Proceeds of Crime Act 2002, s 337 and 338(4).
[877] Michael Isaacs, 'Money Laundering Dilemmas for Banks' (2004) 19 Journal of International Banking Law and Regulation 284. For a discussion of use of the term 'constructive trustee', see Ellinger, Lomnicka and Hare (n 778) 273-91.
[878] Ibid. 112.
[879] Norman Mugarura, 'The Jeopardy of the Bank in Enforcement of Normative Anti-Money Laundering and Countering Financing of Terrorism Regimes' (2015) 18(3) JMLC 352, 355.
[880] Isaacs (n 877) 8.
[881] [2001] EWCA Civ. 52, [2001] 1 WLR 751, [2001] All ER(D) 81.

applications and injunctions, rather than an interim declaration being sought.[882] The difficult position of banks was later revisited in *Squirrell v National Westminster Bank Plc and Her Majesty Customs and Excise,*[883] and it was accepted that the bank had followed the correct procedure in freezing the account and not explaining the reasons why it did so. The decision provides comfort to banks that freeze accounts on relevant suspicion when their actions are brought before the court.

4.2.Access to Bank Information for Tax Purposes

Another statutory inroad to bank confidentiality where public policy overrides the need to preserve bank confidence and where banks are required to reconcile a number of different rights and obligations is tax regulatory and legal requirements. International efforts to tackle revenue losses, to fight harmful tax competition and to spot tax fraud and evasion have led to international tax cooperation on the global level to the point that there has been a considerable move from a bilateral to multilateral approach and from an 'exchange upon request' to 'automatic exchange of information'.[884]

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[882] Michael Chan, 'Banks Caught in the Middle' (2001) 22(8) Company Lawyer 1, 4. For a recent case about the tension between a bank and its customer, see *Shah v HSBC [2012] EWHC 1283(QB),* where it is held that the bank does not have an obligation to explain the reasons for its inability to act.

[883][2005] EWCH 664 (Ch).

[884] Since 1998, the OECD includes tax cooperation and further transparency in its agenda. See Article 26 of the OECD Model Tax Convention. Also, the G8, G20, EU and the UN (Committee of Experts on International Cooperation in Tax Matters) have supported globally coordinated tax cooperation and exchange of information. See OECD, 'Multilateral Convention on Mutual Administrative Assistance in Tax Matters and the Multilateral Competent Authority Agreement' (Accessed May 14, 2015) http://www.oecd.org/tax/automatic-exchange/international-framework-for-the-crs/multilateral-competent-authority-agreement.pdf. See Carlos de Almeida,'International Tax Cooperation, Taxpayers' Rights and Bank Secrecy' (2015) 21 Law and Business Review of the Americas 217.

The international agenda on fiscal transparency and information exchange puts an emphasis on timely accessibility to reliable information, specifically bank information.[885] For example, the OECD report established as far back as 2001 that ‘governmental authorities should have access … to bank information that may be relevant to criminal and civil tax matters. This information should also be available when requested via the exchange of information mechanism’.[886] Information disclosure and sharing mechanisms established for AML and CTF are linked to tax evasion since it is seen as one of the predicate offences of ML.[887] Overall, it is possible to mention a globally ever-expanding expectation from banks to share information with authorities.

In the UK, HM Revenue & Customs has extensive investigatory powers including to compel banks to share information.[888] Greater access to information between authorities is also borne out by the recent development of the HMRC working in collaboration with the National Crime Agency and accessing SAR data for tax evasion purposes.[889] A bank

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[885] Alicja Brodzka,‘The Future of Automatic Tax Information Exchange in EU Countries’(2015) 12 US-China Law Review 352.

[886] OECD,‘The OECD’s Project on Harmful Tax Practices’ (2001) at 11(accessed May 13,2015) https://www.oecd.org/ctp/harmful/2664450.pdf.

[887] Chizu Nakajima,‘The International Pressures on Banks to Disclose Information’ in Booysen and Neo (n 873) 115.

[888] Finance Act 2011, schedule 23; Reporting of Savings Income Information Regulations 2003 SI 2003/3297(as of December 2017).

[889] NCA,‘SARs Annual Report 2014’ at 24 (accessed March 26,2016) http://www.nationalcrimeagency.gov.uk/publications/464-2014-sars-annual-report/file. However, information disclosed under a tax information exchange agreement is not disclosed by the HMRC to other regulators other than tax purposes. It was proved in the infamous HSBC tax evasion case where the HMRC did not share information that it received from French tax authority with the FCA.Financial Times, ‘UK Government Closes Ranks on HSBC Tax Issue’(accessed Oct 27,2016) https://www.ft.com/content/673c33c6-b12f-11e4-831b-00144feab7de.

has to provide information or produce a document if the HMRC requests it as a result of any reasonable potential liability at any time to UK tax or to tax payable in an EU member state or another state with which the UK has a tax information exchange agreement.[890] In the US, the law forces banks to collaborate in reporting and producing information. This has a high level of usefulness in criminal, tax or regulatory investigations or proceedings[891] as well as in the conduct of intelligence or counterintelligence activities.[892] FATCA, as one of the most controversial pieces of US legislation which requires foreign FIs to disclose information about their US citizen-account holders, has opened a new phase in the information sharing era by acting as a catalyst for the move towards lifting up bank secrecy requirements in different jurisdictions. The OECD sees the FATCA as a positive step for the furtherance of automatic exchange of information in a multilateral context. International pressures on banks to disclose information has therefore gone one-step further.[893]

As in the case of AML or CTF regulations, most of the discussion on disclosure of information for tax purposes revolves around the legal sphere of data protection and the right to privacy. The big data that tax authorities receive create data profiling concerns

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[890] Keith Stanton,'The United Kingdom'in Booysen and Neo (n 873) 356-57. Also see article 8 and 9 of the Directive 2003/48/EC of 3 June 2003 on Taxations of Saving Income in the Form of Interest Payments where banks, as paying agents, are required to inform the competent authorities about the transfer of interest payments **under its own initiative**.(emphasis added)

[891] 31 USC§5311.

[892] 12 USC§1829b(a).

[893] OECD,'Standard for Automatic Exchange of Financial Account Information in Tax Matters' (2014) at 326 (accessed Oct 26, 2016)http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/standard-f or-automatic-exchange-of-financial-account-information-in-tax-matters-second-edition_9789264267992-en#page326.

linked to privacy issues about personal and business data.[894] Considering that bilateral and multilateral tax agreements require transmission of information between states, the right of privacy of taxpayers in relation to the state comes into question.

However, the emphasis is on the source of information, namely persons, and not on the banks. This is seen in the difference between 'data of being' and 'data of having'. While data of having, such as information held by banks, is available for authorities, data of being is seen as a personal asset.[895] Undue access to personal assets by tax authorities is something related to public standards of privacy protection. Under the ever-growing transparency initiatives, protection of 'data of having' under bank confidentiality laws cannot seem to stand up to the contemporary approach.

4.3.Effects of Compliance-Specific Disclosures on Financial Stability

Economic, cultural and political consequences of ML and its detrimental effects on financial stability are well-known.[896] Substantial transmission of responsibility to the financial industry has already been accomplished and therefore basic elements such as KYC rules, monitoring client and customer activity, understanding the key risks about products and clients/customers, embracing controls appropriately and maintaining and developing the internal system to avoid enforcement actions, fines and concomitant reputational and other losses is now part of the everyday business of banks.

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[894] Filip Debelva & Irma Mosquera,'Privacy and Confidentiality in Exchange of Information Procedures' (2017) 45(5) Intertax 362, 364.

[895] This is the classification made by the Brazilian court. Almeida (n 884) 231.

[896] Mahmood Bagheri and Ayodeji Aluko,'The Impact of Money Laundering on Economic and Financial Stability and on Political Development in Developing Countries'(2012) 15(4) Journal of Money Laundering Control 442.

It is not only ML activities that contribute to financial instability and economic imbalance but also pursuance of charges for large and connected banks' involvement in financial crimes.[897] For example, the case involving HSBC shows that regulators still believe that a single institution can damage the economy. This incident created the term 'too big to indict/jail'.[898] This is one side of the coin that addresses a dilemma about the criminal charges against a bank and its impact on financial stability and systemic fragility. Surely, it also creates a confidence problem for the public, while protecting the trust of HSBC's counterparties in maintaining their business with the bank. This dilemma is interesting in terms of the trade-off between maintaining stability and sanctioning the crime nexus.[899] This argument would provide important feedback for maintenance of public confidence and understanding the limits of macroprudential objectives in protecting the financial stability.

Leaving this line of questioning aside, another issue is the potential effect of banks' AML/CTF related disclosures in contributing to instability. AML, CTF and other measures are designed to preserve the reputation, integrity and stability of the bank and

[897] For example, HSBC's poor AML checks prosecuted by the US Department of Justice in 2012 led to a behind the scenes discussions between authorities about the stability-destructive effects of criminal indictment against so large and interconnected banks. The FSA claimed that criminal proceedings against a systemically important bank, such as HSBC, would ultimately lead to financial contagion with further implications on economic and financial stability and even destabilise the whole global financial system. US House of Representatives,'Too Big to Jail:Inside the Obama Justice Department's Decision not to Hold Wall Street Accountable' 114th Congress,2nd Season(July 11,2016) at 14 (accessed Oct 21, 2016) https://financialservices.house.gov/uploadedfiles/07072016_oi_tbtj_sr.pdf.

[898] Patrick Hardouin,'Too Big to Fail, Too Big to Jail' (2017) 24(4) Journal of Financial Crime 513.

[899] Hannes Koster and Matthias Pelster,'Financial Penalties and the Systemic Risk of Banks' (2018) 19(2) The Journal of Risk Finance 154.

financial system. Disclosures, in this respect, might have a bearing on reputation and therefore public confidence that reflects itself in financial stability. As Harvey and Bosworth-Davies put:

> …[T]oo great a level of public knowledge of financial crime, somewhat perversely, can undermine public confidence. Conscious of the imperative to maintain confidence, regulators find themselves facing a moral dilemma whereby they may play down evidence of potential criminal activity to underpin integrity.[900]

Though they see the tension from a moral perspective, not a financial stability one; they imply the importance of the arrangement of the regulatory chairs. Yet, their critique is about an ethical challenge that a single authority, which is charged with reduction of financial crime and maintenance of market confidence responsibilities, faces in fulfilling its objectives. So, it recalls a similar discussion made in Chapter 2 about institutional structure of regulatory/supervisory authorities and in Chapter 4 about the pursuance of different regulatory objectives that are likely to create tension between authorities.

If one takes reputation as a synonym for being worthy of trust, then general arguments related to trust and public confidence are also applicable to cases where banks and the banking sector's reputation is at stake.[901] As Greenspan puts it: 'Service providers … usually can offer only their reputations'.[902] Banks are risk-oriented institutions[903] and

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900 Jackie Harvey and Rowan Bosworth-Davies,'Drawing the Line in the Sand: Trust, Integrity and Regulatory Misdemeanour' (2016) 29(3) Security Journal 367, 373.

901 Chapter 2.

902 Alan Greenspan, Commencement Address (June 10,1999)(Accessed March 19,2017) https://www.federalreserve.gov/boarddocs/speeches/1999/199906102.htm.

903 Chapter 1.

direct and joint effects of risk management policies can be seen in banks' reputational standing that is related to their confidence production roles. Reputational risk is:

> …[T]he risk arising from negative perception on the part of customers, counterparties, shareholders, investors, debt-holders, market analysts, other relevant parties or regulators that can adversely affect a bank's ability to maintain existing, or establish new business relationships and continued access to sources of funding.[904]

Therefore, reputation is part of confidence and it has economic value. Reputation risk is generally positioned as the frontrunner in the explanations why reporting firms like banks should welcome AML and CTF measures. It is not only related to the reputation of the state as being a clean financial market for investments but also of the institutions and the way they maintain their business in it. Given this framework, what is the potential for bank disclosures to have a substantial impact on the safety and soundness of banks or even on the financial stability of the system?

As discussed in Chapter 2, trust is a matter of perception and mostly subjective. This means that disclosure about a bank's involvement in AML or related crimes (intentionally or not) is likely to result in decreasing business due to clients, shareholders, bank counterparties and other stakeholders' incentives to withdraw their support from the bank and to move their funds to a clean bank that is not under the risk of paying heavy penalties or losing its charter. This might especially be the case for investors as adverse information reflects itself in stock prices. Such market reaction is even more visible for large banks.[905]

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[904] BCBS,Consultative Document (17 March 2016) at 2.2(accessed March 30, 2017) https://www.bis.org/bcbs/publ/d349.pdf.

[905] Franco Fiordelisi, Maria-Gaia Soana, Paola Schwizer,'The Determinants of Reputational Risk in the Banking Sector' (2013) 37 Journal of Banking&Finance 1359,1369.

Having said that, there are arguments about the real value of reputation in cases of bank involvement in misconduct, ML or TF or when information about a major customer being engaged in illegal activities becomes known to the public. However, within the financial crime concept, loss of public confidence and the triggering of a systemic move similar to the case discussed in Chapter 4 might not necessarily happen. Maybe it is because people do not want their banks to engage in criminal activities but at the same time they are not interested in moving their funds or making it a public issue unless there is a real threat to their money because of that activity.[906] Yet, the information about charter cancellation due to a bank's inefficient compliance with AML or CTF rules or large amounts of money flowing out of the banking system, with concomitant changes to market prices of bank stocks, have a big negative impact on public perception and therefore public confidence. As such, it is in bank's interest to secure its reputation so that it can continue to produce confidence. This also means banks are expected to have a proactive approach rather than a reactive one in establishing effective controls to avoid fines (deficit model of compliance) and to maintain its reputation (enhancement model of compliance).[907] This implies a further problem with the results of fear-driven compliance in the form of bank de-risking strategies.

Drivers of de-risking include a bank's reaction to civil, criminal or regulatory actions based on compliance failures; the re-evaluation of its business plans; the desire to prevent higher costs of compliance due to higher-risk customers; or the bank choosing to de-risk

[906] Peter Reuter and Edwin M. Truman,'Anti-Money Laundering Overkill?' [2005] The International Economy 56.
[907] 'There is little to suggest that compliance is linked to reputation.' Harvey and Lau (n 721) 70.

itself simply because of the reputational risk of working with higher-risk customers.[908] Embracing a broad-based de-risking approach rather than evaluating the relationship risk on a case-by-case basis might exclude some businesses and persons from the global regulated financial system and affect local economies.[909]

5. Final Observations

Starting with a conceptual and theoretical analysis, this chapter establishes that there is a tension between the public, societal function of banks and their profit-seeking nature. It discusses this tension through the lens of banks' private law duty of confidentiality and their disclosures to public authorities, also referred to as tension on a private law-public law level.

Bank confidentiality, as discussed here, has long been seen as one of the constitutional legal constructions in bank-customer relationships. It has traditionally appeared as a private law institution in different jurisdictions[910] and the recent global emphasis on bank transparency value attributed to bank secrecy has been associated with concealment of crimes and the vessel or facilitator role of banks in wrongdoings.

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908 Guy Wilkes and David Harrison,'Do FCA De-Risking Warnings Raise More Questions Than They Answer?' [2016] Compliance Monitor 1.

909 James A. Haley,'De-Risking Effects,Drivers and Mitigation' (2017)CIGI Papers No.137 (accessed Aug 21, 2017)https://www.cigionline.org/sites/default/files/documents/Paper%20no.137web.pdf.

910 Even in Switzerland, the bank's duty of confidentiality is a private law institution, which is developed out of an implied contract between the bank-customer and later established as a statutory rule with the protection of criminal sanctions.

Yet, legal scholarship argues that a bank's duty of confidentiality in a traditional sense is almost extinct due to the increasing number of bodies having access to bank information and the banks' obligation to report their customers to the authorities without any request.[911] This heralds the changing role of banks and the state in the way that reporting requirements give a task to banks to decide, for example, whether to report and exclude some customers from the financial system.[912] This role of banks in the AML/CTF drive means private economic actors like banks share state sovereignty on a theoretical level.

The global move towards more transparency comes with concerns regarding independence from interference and secrecy in banking, which in turn leaves room for the legal scholarship to respond to the fear of a seemingly unending trend towards open access to personal account, transaction and identification information. Yet, most of the discussions revolve around the one-sided approach to bank confidentiality which assumes that it is the information that persons provide to banks under contract law (or agency) provisions, and therefore the concept is generally discussed as information that belongs to customers. This means that banks' position in information disclosure is generally overlooked in the face of the enshrined concept of right to privacy and data protection of legal entities.

From a positivistic legal theory, it is true that the private law duty of bank confidentiality has been altered by public law penetration and its limits have changed compared to the past. However, from a different perspective, it might represent the new optimal balance

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911 Levi (n 727).

912 Gilles Favarel-Garrigues, Thierry Godefroy, Pierre Lascoumes, 'Reluctant Partners? Banks in the Fight Against Money Laundering and Terrorism Financing in France' (2011) 42(2) Security Dialogue 179.

between private and public interests where, as public interest theory suggests, the law, as a living and reflecting body, adapts and calibrates itself to this new need for transparency. In so doing, it treats banks as semi-public institutions in the sense that they serve wider public goals such as prevention of ML, TF and tax evasion.

Banks, like other private firms with a profit maximisation objective, lack private interests in sharing bank customer information with the authorities. Intrusion of public mandatory rules into bank secrecy, therefore, appears to be a necessary tool for authorities that otherwise would not obtain the same information from somewhere else or have access to the same information by devoting extra time and funds. This comes with a cost.

In the wider context of regulatory missions, bank confidentiality as a private law institution and the public interest disturbed by this institution brings to the fore questions about whether the banks' private interests in information and the public's confidence in banks are balanced against public law interests and whether the changing boundaries of bank confidentiality are a product of the banks' forcible alignment with the public interest as a result of growing bank transparency demands. Such questions also appear to imply that bank confidentiality mostly serves private interests as value for the customer only, not the banks.[913] As such, modern transparency initiatives directed towards banks and their reflection in the law need to establish a balance between public and private interests not only from a customer point of view but also from a bank point of view. Private and public law aspects of bank secrecy in the future might necessitate a step back from where the modern transparency-driven financial world stands and a change to the one-sided approach, either via a customer-based or state-based approach.

[913] Alexander Vishnevskiy, 'Bank Secrecy: A Look at Modern Trends from a Theoretical Standpoint' (2015) 4 Journal of Higher School of Economics 140, 145.

Overall, the gap between transparency in the domestic and international spheres has been reduced by global initiatives and it is likely that the bank's duty of confidentiality will evolve over time. The current larger picture provides that the private law duty of confidentiality gives way to the superior concern of fighting crime. This duty still survives, but global movements for the prevention of and combatting crimes and technological advances in the transmission of funds and information herald a new relationship between banks and regulators/ criminal law enforcement agencies. Increasing legislation is making inroads into this duty in more expansive ways, as it is an area heavily influenced by the public interest. So, this chapter acknowledges this tension, yet accepts that any solution to it is necessarily tentative because, from a pragmatic point of view, a worldwide trend towards more transparency places pressure on the banks to disclose information and it is not possible to pinpoint a direct and precise level of optimal bank information disclosure that satisfies the banks, customers and law enforcement agencies/ regulators.

CHAPTER 6

CONCLUSION: BALANCING AND RECONCILING CONFLICTING LEGAL REQUIREMENTS

A normative investigation of 'what financial regulation aims to accomplish' is generally discussed under the headings of financial stability, market efficiency, competition and consumer protection; yet, as this thesis argues, concurrent attainment of some these objectives can cause conflict. This potential conflict is generally a logical by-product of differences in regulatory bodies/ agencies' assigned duties. The policies and regulations adopted by one regulator intended to achieve a particular objective might have unintended outcomes for another body and interfere with its regulatory objective. Following this line of thought, this thesis exemplifies this position by examining the simultaneous application of the maximum transparency objective of capital markets regulators and the micro- and macro- stability focused approach of stability regulators by placing banks and their disclosures at the centre of the argument. It argues that bank information disclosure creates tensions in both the relationship between the banks and the regulators and in the interactions between the regulators that simultaneously regulate the banks.

Under the lens of the market discipline approach, what makes bank information cardinal is related to the systemic approach to financial stability which requires an abundant and continuous flow of market and institutional knowledge. The conclusions that see market discipline as complementary to bank capital requirements and supervision have merits as bank transparency is a value not only for those who have a financial interest in the safety and soundness of the bank but also for the general public. An optimistic view of bank transparency approach banks as passive agents that share the information for scrutiny by external stakeholders including governments, investors, depositors, employees, competitors and general public. It also sees banks as active agents that disclose information because they have financial and reputational interests in voluntarily sharing information. Yet, the GFC revealed that market discipline is not a cure-all and besides it has limitations. Further, among other things, the very nature of banking business (that builds upon the opaque nature of contracting process and of the quality of loans) and its systemic place in the socio-economic and financial system might be a limitation in itself. Also, explicit and implicit protection of creditors and compensation schemes implies that banks' incentives for transparency are largely motivated by private interests.

In this financial regulatory environment where market discipline and maximum bank transparency are highly valued, banks have provided well-established and fertile ground to reappraise or at least be more sceptical about the goal of achieving a maximum level of bank transparency. This questioning, however, should be interpreted beyond pro- and anti-bank transparency positions. It is more about compromising and the need for balance. The first point is that the aim of greater transparency, with regulations requiring more detailed and outnumbering disclosures, might not necessarily deliver their ultimate objective of more efficient, productive, resilient and stable banks and markets. It is part of the general discussion about the efficiency of disclosure rules. The second is that banks are confidence-driven FIs and disclosure of adverse information during a time of crisis does not necessarily produce the expected beneficial results from bank transparency. In fact, it can be the sole or complementary factor in financial or systemic instability. Based on these arguments, this thesis started from the basic premise that banks are informational intermediaries and quasi-public FIs. This should be simply interpreted by the fact that they run on information. Therefore, its disclosure matters.

Banks are 'at the centre of the process of financing capital accumulation'[914] which makes them vital players in analysing economic growth and fluctuations. This means that banks are providers of liquidity and confidence which have feedback effects on the real economy. They also operate on confidence and reputation. Aside from the sophistication and complexity of the financial machinery that underlies banks' involvement in financial markets, the simple reality is that there is a social and psychological aspect of banking business. As this thesis discussed, if the public perception about the liquidity position of banks changes negatively, the potential for an unstable chain reaction of withdrawals increases. The role of the deposit insurance scheme is important here. Although it is criticised as serving the private interests of the bank and disadvantageous to the public interest, it is a fundamental tool for alleviating systemic risk in the financial system by reducting the liquidity risk; and therefore, as a confidence-bolstering measure, it serves the public interest by mitigating the concerns of depositors. Yet, the design of bank liability insurance[915] and its effectiveness[916] are also crucial, due to the cognitive aspect of creditor behaviour. As the case of NR exemplifies, it can tend to undermine trust.

So, lack of confidence about a bank's safety and soundness might eventually turn into a systemic crisis due to the connectedness of banks and bank counterparties, including peer-banks, other FIs and non-financial firms. If the spillover effect or contagion is strong

[914] Jan Kregel,'Political Economy Approaches to Financial Crisis:Hyman Minsky's Financial Fragility Hypothesis' in Martin H. Wolfson and Gerald A. Epstein(eds),*The Handbook of the Political Economy of Financial Crises* (OUP 2013) 163.

[915] Such as whether it provides full coverage up to a certain amount or if it endorses a co-insurance system.

[916] Whether the system ensures depositors receive the protected amount without any disruption and on time.

enough, the whole system might be destabilised. That was the case during the GFC which meant that governments had to make numerous interventions.

This short summary of banking business highlights the links between public confidence, financial stability, systemic risk and the maturity transformation function of banks. Yet, as this thesis discussed, bank information is vital in establishing this link. There is a multidimensional side of bank information. Regulators need information to regulate the financial system. Investor and other creditor protection requires disclosure of a sufficient degree of information. The market itself and financial gatekeepers (such as CRAs, auditors and financial analysts) need information to function. Further, banks need information about their counterparties (including other banks, FIs and firms). Finally, on the broader context, the public needs information to continue to trust the system and regulators. Thus, bank information, which includes various kinds of information with different rulings and treatments, is much needed for different reasons. Yet, underlying economic and informational conditions also link bank information disclosure with the risk of contagion. Network approaches submit a comprehensive framework for explaining the dynamics of contagion processes. For example, an idiosyncratic or aggregate shock can be transmitted through counterparty defaults in a credit relationship, liquidity hoarding behaviour or via commonalities or specific characteristics of risk portfolios of financial agents (such as holding correlated assets). Lack of confidence, in this frame, can be the main reason or a catalyser of furtherance of the shocks. It might happen in the form of a bank run that is expedited by behavioural motives of depositors or interbank freeze or counterparty defaults. This is what happened during the GFC and this thesis therefore examines the disclosure-mandating environment surrounding banks by attempting to shed light on several contemporary legal and theoretical issues.

The run on NR illustrated that there is an interesting interaction between transparency and public provision of liquidity to the banking system. It is a dilemma that regulators experience in allowing the disclosure of particular information that has an impact on the magnitude of the turbulence. There is no capital markets law term equivalent to safety and soundness, which is the main concept of banking regulation.

As detailed in the thesis, banks and capital markets process information in different ways. Capital markets aggregate public and private information and transform it into market prices and therefore create liquidity. This ability of price formation is a product of disclosure practices and competition between expert traders where in theory information asymmetry between economic agents is ameliorated between all agents. Yet, as mentioned, banks engage in bilateral transactions of which outsiders cannot know the underlying information establishing the transaction in the first place, which means there is no aggregate information available as capital markets produce.[917] This informational inefficiency and opacity is inherent and also somehow valuable in banking. From the theoretical point of view, the basic idea suggests that banks subject to capital markets transparency rules are not as information-revealing as other firms due to *ex ante* natural restrictions to their asset structures. This is simply because of the characteristics of their business. Yet, 'opacity to some degree is inherent to the banking business' approach is about the ability of disclosure regimes in capturing this informational challenge and it is not about potential negative post-effects of disclosure. As discussed in the different parts of the thesis, there is a strong case for bank transparency and this thesis does not attempt to challenge all grounds underpinning the transparency-stability view. Rather, it submits

[917] Tri Vi Dang, Gary Gorton, Bengt Holmstrom and Guillermo Ordonez, 'Banks as Secret Keepers' (2017) 107(4) American Economic Review 1005.

that the problem arises during the financial turbulence and it addresses the optimality problem about bank information disclosures.

In tailoring regulatory responses to the inherent conflict highlighted in the thesis, the aim should always be to strike a reasonable balance and there is a challenge to develop optimality without sacrificing the benefits and reputation-boosting externality of bank transparency. Designing an effective mechanism that satisfies regulatory agencies pursuing diversified regulatory objectives for banks is not an easy task. The GFC has revealed a weakness regarding in the double aim of financial regulation in a way that the absence of a clear hierarchy between regulatory objectives in protecting financial stability and ensuring consumer protection (together with other goals in pursuing market transparency) has addressed an inherent institutional tension between bank prudential regulators and securities markets regulators.

Authorities' policies in managing and resolving bank problems are also an important part of the transparency initiatives. Economic agents expect authorities to be more transparent by making their interventions public. At present, strong governance and accountability mechanisms ensure *ex ante* safeguards with *ex post* transparency for authorities. The function of *ex post* transparency was revisited after the GFC and the regulators' disclosures about the sanctions, enforcement orders or other decisions given for the bank, even if they do not signal a drastic downturn regarding the financial standing of the bank, stand as either confidence-production or confidence-destruction factors depending on the circumstances. For example, what can be more material than information showing that a bank needs urgent liquidity help? NR is a clear example of how unplanned disclosure of adverse information is inimical to public confidence. Information management, in this respect, should be a part of the bank prudential regulation tool to deal with potential negative reactions *ex ante*. If the laws provide the stability regulator space to solve the bank problems discreetly and accept that it is the regulator that produces the bank-related information and owns and controls the flow of information, then one can assert that other laws forcing banks to disclose the same information should accordingly be tailored for the banks as well.

At present, the methods used within securities regulation and management of the risks in the banking system do not seem to be conflicting. Both bank regulators and securities markets regulators rely on public disclosures to achieve their goals. So, disclosure is a well-acknowledged regulatory tool for bank prudential and securities regulators. A bridge between the two regulatory philosophies, as one represents the stability/ safety and soundness of banks and another transparency, has started to be established, and rules underpinning market transparency and competitive equality in securities regulation have also been transferred to bank prudential regulation. Accordingly, there is an undeniable impression that most of the discussion about bank regulation approves the premise that bank transparency is crucial to forestall the recurrence of the banking crisis. In this sense, philosophical divergence between banking and securities regulation seems to be narrowed by the rising importance of market discipline approach. This means that it is likely that there will be more demand for bank information in the future as the institutional conflict between prudential regulation and capital markets regulation mentioned here appears in difficult times.

In examining how financial regulation should address the conflict discussed in this thesis, one must consider what financial regulation seeks to achieve. Characterisation of the regulatory objectives under different bodies should not be understood in isolation but should be comprehended in context. It means that the overarching goals of financial regulation should contribute to the efficient functioning of the financial system. These objectives might overlap to some extent; they might complement to each other; or as this thesis establishes through examining different philosophies between bank prudential regulation and capital markets regulation, they might even conflict with each other during unexpected events such as financial crises. How to rank these goals in case of conflict is a difficult task that is bound to value judgment and societal inclinations of each specific jurisdiction. Nevertheless, this thesis discusses that the static nature of regulatory regimes framed with pre-defined and limited mandates might not fully align with the dynamic character of financial markets. It is because unforeseen circumstances might alter the value attributed to particular regulatory imperative and call for a more accommodative and flexible approach in the pursuance of different mandates. The law and regulation should respond to these unexpected cases and establish accommodative and reconciling mechanisms to forestall negative consequences arising out of the simultaneous application of competing regulatory objectives.

The regulatory structure for the optimal resolution of conflicts is related to a choice of priorities between conflicting goals. Preference for the institutional design of regulatory chairs and conflict resolution is jurisdiction-bound and it varies. For example, it can be done externally or internally; or similarly, formulation of a horizontal or vertical organisational system can be one of the options.

A straightforward solution would be to have a single/ unified regulator to avoid tension and solve a short-term conflict away from the public gaze. This type of internal decision-making through a single agency was the case in the UK. Yet, as Chapter 2 discusses, the FSA was unsuccessful in delivering a good balance of conduct and prudential regulation, and the internal resolution of the disclosure problem of NR under the FSA was also part of the discussion about the application of the MAD.

Another approach to resolve tension through organisational structure would require the (i) establishment of an external committee/ body which sets priorities (horizontal organisational structure/ external resolution of conflicts), or (ii) the creation of a hierarchical structure that facilitates and orchestrates interactions between agencies (vertical organisational structure).

The former is about the delegation of conflict to a super committee specifically created for resolving conflicts. Such a coordinating board would only operate on an *ad hoc* basis when conflicts arise. As this thesis reveals, conflict between the securities markets regulator and the stability regulator only manifests itself in truly rare circumstances, such as a financial crisis; therefore, an independent coordinating board that takes rapid decisions during a crisis by assessing the public interest in the trade-offs involved in the pursuance of different regulatory missions by different agencies would be one of the options. Nevertheless, such external resolution also creates further complexity. Questions about who should be on the board, how this committee would operate, its technical capacity, decision-making process and accountability should be answered. Also, it should be noted that it is the disclosure laws that raise such tensions in the first place, so unless the disclosure laws applicable to banks are not tailored to permit the operation of such a problem-solving body, then the organisational structure has no meaning.

The latter hinges on the cooperation and responsiveness of agencies to resolve conflicts, not under a single agency like the FSA or a separate temporary problem-solving body.

Rather, this approach reflects system coordination, creates a communication channel and attempts to find a compromise between the divergent regulatory objectives of autonomous bodies simultaneously regulating the banks. This line of thought is a macro-approach to financial regulation and it means that goals of financial regulation should not be deemed as stand-alone but rather as an integrated system.

A macro approach to financial regulation accommodates smooth operation of competing imperatives and respond to pluralistic interests of different regulatory bodies. It is related to the fact that regulatory bodies that rule different universes, even if they embrace divergent regulatory goals in their technical capacity, are in connection with each other not through a process of linear arrangement, but through a transformative and reflexive dynamic. As Chapter 2 discussed, the normative reasoning of financial regulation is to ensure both the financial system itself and components of the financial system, i.e. firms and markets, operate efficiently without disruption. Motivated by the overarching normative reasoning of financial regulation, one must consider how the conflicts between differing regulatory universes should operate in diverse contexts and what the long-term effects of competing imperatives are. In this thesis, these competing imperatives are formulated as long-term financial stability and short-term market inefficiency (and other attendant benefits of market transparency). These competing constituencies of financial regulation should be aligned in a way that conservative and clear-cut demarcation of regulatory goals (such as the divergence between bank prudential regulation and capital markets regulation) should transform into a more flexible and accommodative system that is transformative, cooperative and sustainable in the long term.

It is difficult to define what the best regulatory policy is; but considering the wider social and economic welfare implications of macrostability, a macro approach to regulation through prioritisation of goals in certain circumstances could be a solution. So, this thesis acknowledges that a broader goal of financial stability should be given priority in certain circumstances. Nevertheless, prioritization should not mean ignoring the secondary regulator for the sake of macrostability because such a system would undermine one of the reasons for establishing that regulatory agency in the first place. So, the regulatory architecture should be designed to allow the securities markets regulator and the bank prudential regulator to operate in harmony and to contribute to the broader purposes of financial regulation.

Cross-fertilisation and synergy between regulatory institutions have a bearing on the structuring of the regulatory/ supervisory architecture. As Chapter 2 discussed, institutional arrangements (such as twin peaks, the single agency model or formalised cooperation via umbrella bodies) are very much an accident of history that reflect considerations about more effective and responsive supervision, rule- and decision-making and problem-solving. What needs to be asked is whether, if pursuance of financial stability, laudable as this might be, assuages concurrent fulfilment of other goals such as investor protection or ensuring competition, this might create highly powerful and perhaps unnecessarily political stability-seeking bodies, since the value attributed to systemic and financial stability has overly increased. As discussed, it is another dimension of the discussion related to stability-regulator accountability and therefore, the institutional segregation of agencies, such as in the case of bank prudential and capital markets regulators, should be a result of a thoughtful combination of both regulatory areas.

Even if the separation of bank regulators and securities regulators might be an abstraction considering the regulatory ends of each regulatory zones in the long-term, in the short-term the objectives might necessitate more prudent and covert collaboration between the regulators. Therefore, this thesis finds that there is no perfect organisational structure that fully eliminates conflicts. Nevertheless, the ideal solution for disclosure about a troubled bank could be prioritisation. This means that stakeholder behaviours in minimising their losses on the revelation of negative news or noisy signals implying an adverse situation can be controlled without disturbing the market. However, such a system based on prioritisation implies that it is not only the bank problem that should be kept secret but also discussions or signals concerning the solution. Macro approach to bank regulation and regulatory regimes is a necessity in establishing a solution to the concerns about negative externalities derived from immediate bank transparency. As incompatibility of regulatory philosophies shows itself during the crisis times, regulatory regimes should be seen in context, not in isolation and independent from each other. Rather, there should be regulatory arrangements to prevent regulatory underlaps or overlaps, reduce the complexity in handling bank information disclosure and to accommodate coordinative and communicative bridge between these two regulatory turfs. Strategic bank transparency, as the MAR s 17(5) exemplifies, identifies stability as a macro objective and refers that regulation should be taken together as a whole, not separately within its bounded regulatory turfs.

It should also be considered that regulatory bodies, which are responsible for taking the action, should be accountable to the public so that overly discretionary or political decisions can be prevented. Any public impression that the government withholds politically inconvenient information might do more harm to markets as it might undermine public confidence, dissuade investors from participating in the allocation of resources and provide uncertainty about future developments. It might also give an impression of regulatory favouritism or regulatory capture. So, a delicate balance is necessary to ensure governments are held accountable for their decisions with better sunshine policies. After the necessary measures are taken, the facts should be open to public scrutiny. This requires *ex-post* transparency of utilised measures by the regulators.

However, prioritisation suggested here should not be understood as the stability regulator installed as the king regulator due to its objective of greater public interest (maintaining overall stability) in the short-term. It is not a competition to designate which interests are more important on the scale of determining public interest. However, it is the ability of taking of urgent actions for preventing a possible wider breakdown which might give birth to more detrimental effects than delayed transparency in capital markets in the long term. As such, the term ‘collaboration’ and ‘strategic transparency’ rather than ‘real time transparency’ might be more accurate in setting a course for managing bank information flow to the outside.

At the heart of the prudential regulation of banks is an endeavour to make banks safe and sound for the purpose of overall stability. There is an inherent complication within the relationship of the regulator and the bank due to the fact that reputation and private information are the major assets of a bank in a market with information asymmetries. Therefore, the prudential regulator/supervisor is required to consider this aspect in pursuing transparency. Yet, one can say that a going-public decision is a financing decision made of the bank’s own accord and so, as a private firm, it has to bear the outcome of maximum transparency in capital markets like any other firms. Even if this assertion might be true in terms of equality, efficiency is accomplished by responding to the different needs of the players at the optimal level within the system. Private information embedded in balance sheets and other reports are parts of the trust placed in banks and its management and use should be efficient and economical. In terms of the present regulatory environment, the private law framework of bank transparency is driven by greater public interest needs. Even in rigorous bank secrecy jurisdictions there have been substantial steps taken to elasticise the bank’s private duty of confidentiality. Moreover, global pressures on bank information are heading towards more revelation and sharing of information to attain higher public goals. So, while banks’ authority over the information they hold under the private law framework is restricted by public law requirements for the sake of the greater public interest, banks’ authority over the information that they have to disclose as a result of being publicly-quoted firms becomes relevant to the financial stability of the state during times of financial distress. Lack of confidence and its volatile emotional consequences and ambiguous nature (extrinsic and intrinsic confidence produced by banks and by the financial system as a whole) within the financial system suggests that the confidence element cannot be detached and abstracted from actual socio-economic life. The change in economic culture that has occurred from seeing banks as conservative, prudence-displaying firms (whose disclosures are approached with suspicion for systemic reasons) to profit-maximising oriented ordinary firms in the face of deregulation and shadow banking has meant that bank disclosures are more necessary than before due to the complexity of the financial engineering and surrounding opacity. Yet, elements of confidence and trust in the fragile nature of the banking system and the difficulty of handling its sudden disappearance in a crisis reminds us of the popular saying ‘ignorance is bliss’.

Instead of putting regulators into a position that requires them not to apply existing regulations too strictly on banks, necessary legal arrangements should be made to enable the smooth functioning of the laws by responding to emergency circumstances with legal certainty. Any implication of forbearance towards banks emanating from the pressure of bank regulator over the securities regulator has the potential to undermine the regulators' credibility and authority, and also it carries the risk of sending the wrong signals to the market.

In this respect, post-crisis measures that have been applied differ and the EU and the US have experienced different recoveries. Models of regulation and structures of financial regulation and supervision bear the stamp of the economic, political and cultural characteristics of each jurisdiction, and the judicious mixture of transparency and prudential regulation changes depending on the regulatory and political agendas.

S 17(5) of MAR, even if it can be criticised for being drafted very broadly and vaguely by some, acknowledges the optimality problem on the disclosure of bank information and establishes the controlled disclosure of bank information. Such an overarching provision surely gives what banks and regulators need and paves the way for a smooth resolution for future tensions that might appear. It therefore helps to protect the resilience of the financial system in the long-term. Even the wording of the relevant provision is debatable, this thesis agrees with the EU approach in broad strokes.

The US, as the epicentre of the GFC, has not responded in a similar way to the EU with its MAR. Instead, it has strengthened macro-prudential measures and created new authorities to monitor SIFIs and develop policies for TBTF institutions. It should be noted that it is US laws (1933 and 1934 Acts) that accommodate specific provisions for bank-issued securities. Yet, as Chapter 4 examined, the dilemma experienced involved a BHC, which was both a TBTF and SIFI whose failure was likely to have detrimental effects on the whole economy. Therefore, considering the dispersed banking system in the US, for banking companies whose failure is likely to disturb the financial stability (ie TBTF and SIFI-class banking firms), there should be a specific law similar to MAR or a specific exemption provided for financial stability purposes so that the cases similar to the AIG Bailout or merger of BoA and ML would not happen. Adoption of a statutory resolution in the US would be a prudent approach to prevent a similar case to NR.

As MAR shows, *post hoc* transparency is advised for banks during times of financial difficulty and the maximum transparency goal embedded in the MD system in securities laws should accommodate an exemption or a safe harbour which responds to the need of both the banks and the financial system on non-disclosure. However, as addressed in Chapter 2, pinpointing the right criteria for interference in markets (such as in the form of a ban on short sales or LoLR) in order to enhance total welfare and maximise socio-economic benefits of markets is difficult. Paternalistically justified measures to protect financial stability and control systemic risk are consequentialist in the way they are based on the production of more good than harm, and from a more lenient point of view paternalism does not necessarily have to take place against the regulated's will and override its choices. Though it does not seem like politically correct language, MAR's delay provision for FIs has a paternalistic pattern as it protects bank stakeholders by imposing a delay in gaining access to bank information while protecting other bank stakeholders (such as depositors, peer banks and the public in general) as well.

There are indirect costs of intervention such as externalities. Limiting bank disclosures can weaken market competitiveness, cause loss of reputation and aggravate information asymmetries yet the collective good produced by financial stability as it is reflected in the MAR is also a compelling rationale. Financial stability is an overriding objective for regulators and it is an official acknowledgement that greater gains can be achieved by a synergistic relationship between securities regulators and bank and stability regulators.

So, in this thesis, praise of timely bank transparency is balanced with biting critique. Bank transparency should be balanced with appropriate secrecy so that both the government and the banking system can function. This view is based on the premise that trust and confidence is a very important lubricant of a social and financial system that has economic value, and as social capital it contributes to the efficient functioning of society. Analysing the implications of bank information interpretation in confidence production entails a challenge here in that there is a subjective and objective perception of information that challenges the very simplistic approach to information. Given the trust and confidence which comes from a sheer presumption, any adverse information could have multiple and magnified effects. Banks, compared to the extent that they create credit and confidence in the market, destroy the same confidence in a way that its effects follow a sequence in the system and create wider and more extensive damage to the whole system. The continuous tightening of rules or the maximisation of quantity and frequency of disclosed information does not necessarily and always ensure public confidence; rather, constant and open communication among regulators and banks is one of the pillars underpinning public confidence. So, rather than disclosing the information to the public immediately, it is necessary to fill knowledge gaps between the banks and regulators and build a better strategic approach such as developing an aggregated regulatory policy instead of a fragmented one. Yet, it is a big challenge because an optimal level of transparency is contingent on the culture and state of the financial system. This is where government accountability comes into play. Recommendations of delayed bank transparency for 'overall financial stability of the state' reasons for those states that are already well-known for corruption and low levels of accountability, does not seem efficient and advisable. These are interesting avenues for future research on how to build a more stable financial system.

While this thesis addresses the potential for a negative correlation between bank transparency and stability during a crisis by presenting a challenge within the realms of public law, a side but also related aspect of bank information disclosure is also explored in order to set the scene for how bank information disclosure creates a tension between the bank and its customers, and also between the bank and law enforcement agencies. This auxiliary challenge, as presented in Chapter 5, deals with the private law framework of bank confidentiality. The erosion of the bank's duty of confidentiality shows that there is an increasing public law penetration into this private law duty. The new global order for the sharing of bank information suggests that the tension between these domains is not as high as in the past because banks prefer to de-risk themselves and share customer information at the expense of losing the traditional concept of a bank's duty of confidentiality. The tension between private rights and public interest in the context of bank secrecy and confidential bank information indicates another paradigm albeit a similar dilemma. As it is established in Chapter 5, AML, tax evasion and CTF measures require banks to share information which signals the changing roles of banks and the state. An optimal level of information here, within the context of conflicting requirements residing in private and public laws, seems to be established on behalf of the state for public policy goals. The tension discussed in Chapter 5 is not as apparent as the one between bank prudential regulator and securities markets regulator. Yet, confidence is not an absolute concept that can be inculcated via laws, it is, rather, relative. Reputational loss, for example high profile losses due to non-compliance or links with disreputable persons or firms, might provoke a loss of confidence. These are areas for future research if such disclosures have a systemic risk or financial stability dimension. Similarly, it is not possible to offer a definite solution due to the growing interest in bank information.

To conclude, how best to deal with the conflict is the fundamental challenge for financial regulation, supervision and resolution. Once a crisis has emerged, it becomes more difficult to reestablish the macrostability and curb the adverse effects of the crisis. So, the solution to conflict should be based on prevention of the problem, regardless of how the regulatory chairs are organised, and bank information management during financial turbulence should be seen as part of macroprudential regulation.

1. Directions for Future Research

The overall argument of this thesis opens up discussions for further research. The principle of transparency necessitates that the decisions and actions of governments and regulatory /supervisory agencies should be open to public scrutiny, which addresses governmental legitimacy and accountability. Not all countries share the same level of accountability and values attributed to transparency. While pointing out the institutional dialectic between two regulatory areas by placing banks at the centre of questioning, a balance should be struck in such a way that black-and-white or binary thinking is avoided. The support for the EU solution to the tension highlighted here does not mean that the same solution is recommended and advisable under all jurisdictions. Sceptical thinking about maximum bank transparency should not offer a mask for corruption, inefficiency, fraud or political gains, and it should not give a public image about regulatory capture. Additionally, this thesis addresses the differences between normal times and times of financial stress, turbulence and crisis, and concludes that tension appears during difficult times. States have different interpretations regarding what difficult times means or what can be a threat to financial or systemic stability. So, the application of solutions should be tailored to each jurisdiction and what requires further research is if, for example, MAR s 17(5)'s application in practice will cause any challenges in different countries that have different economies, values, political and legal traditions and cultures.

Additionally, there is a psychological aspect of financial markets, behaviours of economic agents and the financial and economic system in general. It means that behavioural determinants of bank runs and failures and their ensuing results on public confidence require further exploration as collective memories of past crises can be lost or cognitive components triggering a self-fulfilling phenomenon of en masse depositor withdrawals and an inter-bank freeze might change. Behavioural finance still examines the behaviour of economic agents and produces feedback for the information paradigm in financial markets. As trust and confidence are one of the main pillars of economic decision-making, this needs to be addressed through further behavioural explanations.

Besides, as a post-crisis product, too much concentration on systemic and financial stability might lead to highly powerful agencies charged with the preservation of stability. Economic and political coalitions running financial industry policies and reforms bear the stamp of past experiences or anticipated threats to stability. So, the responses and precautions taken for more efficient financial and regulatory systems and structures take different forms in different times. As there is no standing best practice that pinpoints the most optimal regulatory structure or legal framework for crisis management and prevention capabilities, the concept of financial stability and instability is open to further discussion.

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