Regulating Through Financial Firms as Surrogate Regulators: Rationale and Limitations

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Christopher Chao-hung Chen
National Taiwan University

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Keywords: Financial regulation, ESG, sustainability, surrogate regulator, corporate governance, indirect regulation, surrogate regulator

Christopher Chao-hung Chen
Associate Professor
National Taiwan University
No.1, Sec. 4, Roosevelt Road
Taipei City, 10617, Taiwan
phone: +886 2 33668960
e-mail: chchen01@ntu.edu.tw

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Associate Professor, College of Law, National Taiwan University

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This article examines the rationale and limitations of employing financial firms to act as regulators, which is referred to as the financial surrogate regulatory approach. This approach is based on the highly regulated nature of financial services and the market's demand for finance, allowing the state to achieve certain policy objectives or to enforce laws via financial firms. This article identifies limitations to the financial surrogate regulatory approach, including regulatory intensity, elasticity of market demand, and transaction costs associated with acquisition of information, monitoring and enforcement. These factors may undermine financial firms' compliance with the state's request to be surrogate regulators and their ability to influence customers' conduct. This article examines abstractly three models of observed financial surrogate regulatory approach: private ordering, mandatory, and voluntary code models. Given the restraints of transaction costs, this article predicts that financial firms may be less inclined to comply with the state's demand unless when their business interests happen to coincide those of the state. Even with mandated compliance, financial firms may not fully implement the requirements beyond the extent of their business interests. Given potential transaction costs, financial firms may choose to be passive regulators rather than active regulating customers' behavior. Moreover, transaction costs may be passed to their customers, created negative externalities associated with the financial surrogate regulatory approach. This could lead to superficial compliance or window-dressing activities if firms and customers cannot fully absorb the costs. Thus, the state should avoid relying excessively on financial firms to play some regulatory function. For the financial surrogate regulatory approach to be effective, the state should align regulatory objective with a financial firm's business interests and consider ways to reduce overall information and monitoring costs.

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I. Introduction

This article examines the phenomenon of using financial firms as surrogate regulators to achieve specific policy objectives. As Part II will discuss, this approach is possible given the highly regulated nature of the financial services sector and market participants' demand for financial in the market. Since financial firms play an important role in the market to provide and allocate fundings, they could have a significant impact on their customers.[1] In other words, this article considers an approach to indirectly regulate market participants through provision of financial services and conduct of financial firms, which this article will broadly cover to include not only traditional financial services providers (such as commercial banks, insurers and stock brokers) but also fund management firms and some institutional investors who may have significant power in the capital market.

Finance could be weaponized as a tool for certain goals. In the international context, this has been exemplified by sanctions against Russia due to the Russia-Ukraine conflict[2]. In another example, more recently, it has been reported in 2024 that Ghana might lose fundings from the International Monetary Fund and World Bank due to its anti-LBGQT law.[3]

A similar approach may also be adopted in the domestic context. The state could deploy financial firms to play some degrees of regulatory function to influence or modify people's behaviors to meet various policy goals, which may include enhancing law enforcement efforts (e.g. anti-money laundering and tax avoidance) and promoting environmental sustainability (e.g. reducing carbon emission) or social goals (e.g. equal pay among genders). The state could farm out or outsource some regulatory function to financial firms.[4] Hence, financial firms could become

[1] Sarah E. Light & Christina P. Skinner, *Banks and Climate Governance*, 121 COLUMBIA L. REV. 1895, 1911 (2021)(focusing on the role of banks).
[2] For instance, the U.S. Office of Foreign Assets Control has programs for Russia-related sanctions, including sanctions related to financial services. See Office of Foreign Assets Control, *Ukraine-/Russia-related Sanctions*, https://ofac.treasury.gov/sanctions-programs-and-country-information/ukraine-russia-related-sanctions (last visited Feb. 3, 2025).
[3] Aanu, Adeoye, *Anti-LBGT+ Law Puts Ghana' IMF and World Bank Funding at Risk, Finance Ministry Warns*, FINANCIAL TIMES, Mar. 5, 2024, https://www.ft.com/content/22eefd82-5edb-4b30-868b-ed6bce67242d (last visited Feb. 3, 2025).
[4] Omri Ben-Shahar & Kyle D. Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard*, 111 MICH. L. REV. 197, 200 (2012) (considering regulation through insurance).

surrogate regulators.[5] This article refers to this phenomenon as the “financial surrogate regulatory approach”. The approach could also be seen as an alternative regulatory tool. [6]

The purpose of this article is to examine the rationale of and limitations to the financial surrogate regulatory approach through an examination of different models of using financial firms as surrogate regulators. There have been scholars promoting the ideas of regulating through insurance (especially liability insurance) in several areas.[7] This article advances existing literature by extending the concept of surrogate regulator to other financial sectors, including banking, capital market, and non-liability insurance. To clarify, this article defines the term “surrogate regulator” in a broader sense when financial firms carry out some of the state’s regulatory function from standard setting to law enforcement.

The financial surrogate regulatory approach may appeal to policymakers. On the one hand, the approach may have some power of moral persuasion. Financial firms, given their pivotal role in funding economic activities through banks or capital markets, should arguably bear some responsibility for environmental and social issues. Therefore, banks should comply with anti-money laundering and countering the finance of terrorism (AML\CFT) rules and stop illicit money that infiltrating the financial systems to sponsor crimes or illegal conduct. By extension, this line of reasoning could impose a moral obligation on financial firms to pursue certain environmental, social, and governance (ESG) or sustainability objectives when providing financial services.

On the other hand, the financial surrogate regulatory approach could be more a cost-efficient method for the state to achieve policy objectives. For example, regarding AML\CFT[8], the state could face significant costs to identify and capture cash flows of criminals and terrorist activities. The state also needs to gather information to enforce AML\CFT laws and there could be other associated law enforcement costs such as time-spent, human resources, and evidence collection, etc. In contrast, banks already possess a lot of customer information and are well-positioned to inquire further about a customer and a transaction (e.g. identify of a payee, purpose

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[5] The term “surrogate regulator” was first introduced by Gunningham *et al*. in a paper published in 1999. Neil Gunningham, Martin Phillipson & Peter Grabosky, *Harnessing Third Parties as Surrogate Regulators: Achieving Environmental Outcomes by Alternative Means*, 8 BUSINESS STRATEGY AND THE ENVIRONMENT BUS. STRAT. ENV 211, 211 (1999).

[6] *Id.*

[7] Ben-Shahar and Logue, *supra* note 4, at 200-201.

[8] See *infra* Part III.B for more discussion of AML\CFT rules.

of a transaction, etc.). By requiring banks to conduct know-your-customer exercise and continuous transaction monitoring, the state might reduce law enforcement and information costs. If the overall costs incurred by banks and other market participants can outweigh direct law enforcement costs incurred by the state without asking banks to be surrogate regulators, the approach might be more efficient overall.

The key question of this article is whether or on what conditions the financial surrogate regulatory approach is effective to achieve the state's policy goals. The purpose of this article is to examine the rationale behind the financial surrogate regulatory approach along with its costs, benefits, legitimacy and limitations by exploring different models of financial firm serving as surrogate regulators. This article argues that the effectiveness and efficiency of the financial surrogate regulatory approach depend certain conditions. There may be significant external costs for both financial firms and their stakeholders when firms are coerced into compliance with legal requirements that do not align with their main business interests. Non-compliance rate or some degrees of superficial compliance could arise due to the divergence of interests, resulting costs that may reduce market efficiency. Therefore, this article argues that policymakers should restrain temptation to over-use financial firms as surrogate regulators, though the financial surrogate regulatory approach should be used as a complimentary regulatory tool alongside other more direct regulations or law enforcement mechanism.

In the remainder of this article, Part II will present a general theory of exploiting financial firms as surrogate regulators. Section A of Part II will introduce the underlying premises of the state deploying financial firms to perform some degrees of regulatory function: highly regulated nature of the financial market and financial service providers, and the market demand for finance. Section B will then examine potential limitations to the financial surrogate regulatory approach, including intensity of regulation, the choice of legal device, elasticity of demand for financial services, and transaction costs (including information, monitoring and enforcement costs). Section C will explore how financial firms might respond to regulatory pressure if they are asked or forced to be surrogate regulators beyond what their businesses typically involve.

Part III then examines various models of financial surrogate regulatory approach identified in this article and assesses their pros and cons. First, this Part considers the role of insurers, particularly liability insurers, in regulating the behaviors of insureds. This article calls this approach the private ordering model, where the state could leverage insurers to regulate insureds based on their contractual relationship. Second, in contrast, financial firms could be mandated by law to play a regulatory or law enforcement role. This is the mandatory model, and this article uses AML\CFT rules as examples. Third, a new trend involves encouraging or requiring financial firms to influence market participants to reach better ESG or sustainability goals based on voluntary codes, such as the Equator Principles or the Stewardship Code. This article refers to as the voluntary code model. For each model, this article will analyze its function and factors that may affect its effectiveness. Based on the discussion in Parts II and III, Part VI provides reflection on the general theory and current examples of financial firms being surrogate regulators and two major conditions to make the financial surrogate regulatory approach effective. This article argues that the state should not overly rely on financial firms surrogate regulators. For the financial surrogate regulatory approach to be effective, the state should ensure that its regulatory objectives are aligned with a financial firms' business interests. The state should also consider regimes to reduce information and monitoring costs especially when state's objectives and firm interests diverge. Part V concludes this article.

For clarification, this article focuses on the phenomenon where the state seeks to exploit financial firms to play some regulatory function. It is granted that financial regulatory rules often have the effect of changing the market and people's conduct through financial firms. For instance, stringent capital adequacy standards may restrict banks' willingness to lend.[9] Studies also show that the implementation of Basel III negatively affect the Gross Domestic Product of the U.S., Euro Zone and Japan[10] or have negative impact on the economy of poor or developing countries. [11] This article recognizes the indirect effect of financial regulations on the overall society and economy, but it is not the subject of this article.

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[9] Aurelio Gurrea-Martinez and Nydia Remolina, *The Dark Side of Implementing Basel Capital Requirements: Theory, Evidence and Policy*, 22 JOURNAL OF INTERNATIONAL ECONOMIC LAW 125, 144 (2019).
[10] Patrick Slovik and Boris Cournède, *Macroeconomic Impact of Basel III* (ECO/WKP(2011)13), at 2, https://www.oecd-ilibrary.org/economics/macroeconomic-impact-of-basel-iii_5kghwnhkkjs8-en (last visited Jan. 13, 2025).
[11] Gurrea-Martinez and Remolina, *supra* note 9, at 125.

II. Financial Firms to Be Surrogate Regulators: Rationale and Limitations

This Part examines the foundation for the financial surrogate regulatory approach as well as its limitations. Section A introduces the general rationale behind the approach: highly regulated nature of the financial market, and demand for finance. Section B will analyze factors that may limit the effectiveness of the financial surrogate regulatory approach. Section C will consider how financial firms and other market participants might react to the state's requirement of financial firms to play a regulatory role. Section D summarizes this part.

A. General Premises

The ability of the state to cause financial firms to be surrogate regulators (compared with most other industries) hinges upon two premises: (1) the highly regulated nature of the financial market and (2) the demand for financial by individuals and enterprises. The two premises place the state in a powerful position to influence financial firms' conduct when providing financial services. Section B will further considerations limitations to the two premises.

1. The Power Structure between the State and a Financial Firm

High intensity and breadth of financial regulations over financial firms provide the state with powerful tools to influence financial businesses and conducts of financial firms. First, licensing requirements enable the state to control market entry of financial services providers and impose further regulatory requirements, thereby enhancing the authority of regulators over financial firms. For instance, the Office of the Comptroller of Currency (OCC) in the U.S. has the power to determine if an association can commence business as a national bank.[12] This in turn allows the OCC to regulate the establishment of a national bank within the U.S. In the U.K., for another example, no person should carry on a regulated activity (e.g. taking deposit) unless one has been authorized by the financial regulator.[13]

[12] 12 U.S.C. 26.
[13] Financial Services and Markets Act 2000, c. 8, s 19(1) (FSMA 2000). For the list of regulated activities, see FSMA 2000 Schedule 2.

Second, there could be further regulatory approvals required throughout the lifespan of a financial firm, allowing financial regulators to intervene into the management and operation of a financial firm. For instance, a U.S., national bank in principle needs to have the OCC's prior approval before establishing and operating a new branch.[14] Banking regulations may mandate prior regulatory approval before merger of two banks.[15] Moreover, a national bank in the U.S. "must provide written notice to the OCC at least 90 calendar days before adding or replacing any member of its board of directors, employing any individual as a senior executive officer of the national bank …, or changing the responsibilities of any senior executive officer …"[16] Regulatory approval or non-objection may be required for a bank to appoint a new chief executive officer at a bank.[17] The OCC has the power to disapprove a proposed appointment of an individual to a certain position "if the OCC determines on the basis of the individual's competence, experience, character, or integrity that it would not be in the best interests of the depositors of the [bank]."[18] In addition, regulatory approvals may also be necessary for a bank's compliance with capital adequacy requirements. For instance, a U.S. national bank in principle "must receive OCC prior approval to include a capital element … in its common equity tier 1 capital, additional tier 1 capital, or tier 2 capital …"[19].

This article cannot provide an exhaustive list all the regulatory requirements, as they differ country by country and sector by sector. However, it is common that financial regulators enjoy a variety of legal authority to intervene into operation of a financial firms on variety of matters. Similar requirements also exist for other financial business in different countries to varying degrees and details, though this article does not discuss them in detail.

Third, there are penalties, including potential criminal sanctions, for conducting illegal financial business or failure to comply with regulatory requirements. For instance, in late 2023, the U.S. Bank was fined US$21 million by the Consumer Financial Protection Bureau in addition to US$15 million fine by the OCC for "keeping out-of-work consumers from accessing

[14] 12 U.S.C. 36(c).
[15] E.g. Banking Act 1970 s 14 (Singapore), Banking Ordinance (Cap. 155) s 69 (Hong Kong).
[16] 12 C.F.R. 5.51(d).
[17] E.g. Banking Act 1970 s 53A (Singapore), Banking Ordinance (Cap. 155) s 71 (Hong Kong).
[18] 12 C.F.R. 5.51(e)(4).
[19] 12 C.F.R. 3.20(e).

unemployment benefits at the height of the COVID-19 pandemic".[20] In another example, Deutsche Bank was fined US$186 million for lapses in addressing anti-money laundering practices.[21] There were numerous other cases of heavy fines for violation of money laundering laws or other regulations. For instance, pursuant to Deloitte, an accounting firm, banks have been fined almost US$5 billion globally in 2022 alone for violating AML\CFT rules.[22]

Fourth, financial regulators may conduct on-site examination that imposes further costs on financial firms. For instance, the OCC should in principle perform a full-scope and on-site examination every 12 to 18 months to assess a bank's performance and risk profile.[23] On-site examination entail regulators sending inspectors to a firm's offices to review documents, check records and/or even interview some employees. Therefore, the frequency, scope, and magnitude of financial examination are likely to impact the operational efficiency of a financial firm. Such examination could press financial firms to adhere to regulators' requests.

The regulatory tools previously mentioned can influence ongoing interactions between financial firms and their regulators. This dynamic increases the chance that regulators may implicitly utilize one regulatory tool (e.g. delay approving a new chief executive officer) to assert its authority in a different instance (e.g. no takeover of another bank). Therefore, given the intensity and breadth of regulations, the state is in an advantageous position to influence a financial firm's decisions or behaviors. Instead of opposing the regulators, a financial firm may choose to succumb to the state's demand without further complications.

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[20] Consumer Financial Protection Bureau, *CFPB Orders U.S. Bank to Pay $21 Million for Illegal Conduct During COVID-19 Pandemic*, Dec. 19, 2023, https://www.consumerfinance.gov/about-us/newsroom/cfpb-orders-us-bank-to-pay-21-million-for-illegal-conduct-during-covid-19-pandemic/ (last visited February 5, 2024).

[21] Pete Schroeder and Chris Prentice, *US Fed fines Deutsche Bank $186 million for slow progress against money laundering*, REUTERS, July 20, 2023, https://www.reuters.com/business/finance/fed-fines-deutsche-bank-186-mln-insufficient-progress-addressing-anti-money-2023-07-19/.

[22] Deloitte Banking Alert (February 2023), https://www2.deloitte.com/content/dam/Deloitte/ro/Documents/MC_Alerta%20AML-v2.pdf?nc=42 (last visited Jan. 14, 2025).

[23] Office of the Comptroller of Currency, *Comptroller's Handbook – Examination Handbook - Large Bank Supervision* (2018), at 6, https://www.occ.gov/publications-and-resources/publications/comptrollers-handbook/files/large-bank-supervision/index-large-bank-supervision.html (last visited Jan. 16, 2025).

2. Demand for Financial Services and Market Competition

The second premise concerns the market demand for money and financial services. Such demand might enable financial firms to influence conducts of individuals and businesses through provision of financial services and contractual terms.

For instance, banks can influence a borrower's behaviors through decisions to granting credit facilities and imposing covenants, such as providing financial reports periodically or limiting the ability to raise additional debt.[24] The restrictiveness of loan covenants of course would vary bank by bank and transaction by transaction.[25] This is particularly relevant if the borrower relies heavily on bank loans as their primary source of funding. For those in need of finance, losing bank loans may signal financial troubles for an individual or business. Therefore, borrowers have incentives to maintain their credibility and to comply with loan covenants to acquire or retain credit facilities. The dynamics creates a room for banks to regulate a borrower's conduct. Of course, the ability of banks to regulate borrowers depend on various factors, such as a person's own financial resources and the ability to raise funds from the capital market or other sources (e.g. loan from a controlling shareholder). Businesses that do not rely heavily on bank loans for finance may be less impacted by bank and loan covenants, and *vice versa* for one that solely rely on banking facilities. This issue will be further examined in Section B below.

Second, individuals and businesses also need protection against financial losses arising from future uncertain events, raising the demand for insurance. This empowers insurers to be surrogate regulators. The demand for insurance may arise from legal requirements (e.g. mandatory third-party cover for driving a vehicle[26]) or simply from people's desire to manage risk exposure (e.g. expensive surgeries). To maintain affordable insurance coverage, an insured must behave responsibly (e.g. not driving recklessly), as insurance premiums for proper insurance protection depend in significant part upon an insured's behaviors and risk profile. In addition, to address asymmetric information and moral hazard in the insurance market, insurers have strong incentives

[24] Light and Skinner, *supra* note 1, at 1919-1920.
[25] Cem Demiroglu & Christopher M. James, *The Information Content of Bank Loan Covenants*, 23 THE REVIEW OF FINANCIAL STUDIES 3700, 3708 *et seq*. (2010).
[26] For example, the State of New York requires a driver of a vehicle to acquire minimum auto insurance coverage before driving. New York Department of Financial Services, *Minimum Auto Insurance Requirements*, https://www.dfs.ny.gov/consumers/auto_insurance/minimum_auto_insurance_requirements (last visited Jan. 16. 2025).

to control insureds' physical conduct.[27] This allows insurers to serve as an external regulator of the insureds at least for those who need insurance protection.[28] Otherwise, an insurer may exclude its liability when an insured behaves undesirably (e.g. driving under the influence of alcohol).[29] Thus, in addition to other regulatory tools, insurers could indirectly affect how people behave through the provision of insurance and policy terms. Such exclusion could be seen as a type of *ex post* regulation.[30]

The availability of financial services can influence people's conduct in other ways. For instance, it has been noted that the conclusion of the COVID-19 insurance scheme in 2022 could impact the production of films and television programs in the U.K.[31] In addition, as part of the sanction against Russia following its invasion of Ukraine, the U.K. and EU contemplated to apply an insurance ban on Russia oil cargoes.[32] Since the U.K. has the largest wholesale insurance market in the world, a ban against insuring Russian vessels might prevent Russia from shipping oil and gas to other countries.

3. Summary

In sum, this section outlines the premises of the state utilizing financial firms as surrogate regulators: the power imbalance between the state and regulated financial firms and the underlying demand for financial services. Consequently, the state is in a position to influence the conduct of financial firms, which in turn affect behaviors of their customers. When both premises are met, the state could be in a sufficiently powerful position *vis-à-vis* regulated financial firms to adopt the financial surrogate regulatory approach. In other words, the state could harness financial firms as

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[27] Steven A. Kunzman, *The Insurer as Surrogate Regulator of the Hazardous Waste Industry: Solution or Perversion?*, 20 THE FORUM 469, 478 (1985).
[28] Kunzman, *id*.; Gunningham, Phillipson, and Grabosky, *supra* note 5, at 217-218.
[29] NTUC Income, Policy Conditions: Motorcycle, General Exclusion provision 1, in https://www.income.com.sg/kcassets/4bfe89df-db6a-4d8d-a6e4-5322cae708e7/GMC%20T%26C%20Website%20--%20092022.pdf (last visited September 12, 2022).
[30] Ben-Shahar and Logue, *supra* note 4, at 215.
[31] Daniel Thomas and Ian Smith, *End of Covid Insurance Scheme sparks warnings over UK's Film Production*, FINANCIAL TIMES, Apr. 1, 2022, https://www.ft.com/content/084635b2-6f26-4dd2-abb6-bac0f016d2aa (last visited Sep. 22, 2022).
[32] Andy Bounds *et al*., *UK and EU Hit Russian Oil Cargoes with Insurance Ban*, FINANCIAL TIMES, Jun. 1, 2022, https://www.ft.com/content/10372dd3-be3c-42b9-982b-241a38efcc88 (last visited Feb. 6, 2025).

surrogate regulators.[33] This might also explain the growing use of financial firms as surrogate regulators in the past two decades that Part III will explore in more details.

B. Effectiveness and Limitations to Financial Firms as Surrogate Regulators

This section examines the limitations to the financial surrogate regulatory approach, considering the intensity of regulations, choice of legal device, elasticity of market demand and financial firms' business interests, and transaction costs.

1. Intensity of Financial Regulation and Legal Device

The intensity of financial regulations impacts the state's capacity to harness financial firms to be surrogate regulators. This could reflect in the business nature of different types of financial firms and their applicable regulations. In addition, regulatory intensity could also be affected by the state's choice of legal device to implement relevant requirements on financial firms.

First, not all financial firms are regulated in the same manner. For instance, commercial banks are subject to higher level of regulations than stockbrokers or insurance agents. Without delving into details, commercial banks in the U.S. are subject to sophisticated capital adequacy requirements imposed by the Federal Reserve.[34] In contrast, capital requirements for stockbrokers are much simpler compared with banks.[35] This distinction reflects the critical role that some financial firms, such as banks, play in the financial market and the overall economy. Moreover, the intensity of regulations can also vary among the same type of financial firms. For example, global or domestic systemically important banks are subject to higher capital requirements and greater regulatory scrutiny than smaller banks.[36] Given the difference in regulatory intensity, the state's ability to influence different types of financial firm should also vary.

In addition, even for critical financial institutions such as banks, the imbalance of regulatory power is not necessarily absolute. For instance, large U.S. banks attempted to push back

[33] Gunningham, Phillipson, and Grabosky, *supra* note 5, at 212.
[34] See The Board of the Governors of the Federal Reserve System, *Capital Adequacy*, https://www.federalreserve.gov/supervisionreg/topics/capital.htm (last visited Jan. 17, 2025).
[35] See Financial Industry Regulatory Authority, *Net Capital Requirements for Brokers or Dealers*, https://www.finra.org/sites/default/files/InterpretationsFOR/p037763.pdf (last visited Jan. 17, 2025).
[36] For example, the Federal Reserve imposes additional capital surcharge for global systemically important banks. See 12 C.F.R. part 217 (Regulation Q).

against the Federal Reserve's implementation of so-called "Basel Endgame"[37] (in short, more stringent capital standards)[38]. It has also been reported that the number of lobbyists hired by U.S. banks reached a new height after the global financial crisis of 2008.[39] In September 2024, an official from the Federal Reserve indicated that the regulator would review the Basel Endgame.[40] Therefore, how far regulators might impose their authority on financial firms must also depend on the political environment and practices in a given market.

Moreover, regulatory intensity varies country by country. Different countries may adopt different regulatory philosophies across various market sectors, resulting in differing levels of state pressure. In general, the state could adopt a more principle-based regulatory approach in an area, while it could be more "command-and-control" in another area.[41] Certain rules are often applied on a "comply or explain" basis notably for corporate governance codes to offer more regulatory flexibility,[42] whereas others could be more mandatory in nature.

Hence, in some markets, financial firms may face a relatively weak state. Some regulators could be prone to regulatory capture by financial firms to pursue their own interests.[43] In contrast, in some places, the state could be in a much more powerful position *vis-a-vis* financial firm. For instance, since large Chinese banks are all state-owned, they must oblige with the demand by the Chinese government through regulatory actions, stock ownership, and even political intervention. For instance, it has been reported that Chinese state-owned banks were ordered by the Chinese

[37] Board of Governors of the Federal Reserve System, *Agencies Request Comment on the Proposed Rules to Strengthen Capital Requirements for Large Banks*, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230727a.htm (last visited Jan. 16, 2025).
[38] Laura Noonan, Claire Jones and Joshua Franklin, *The US Pushback against 'Basel Endgame'*, FINANCIAL TIMES, Mar. 19, 2024, https://www.ft.com/content/48555d55-ca6d-4ab8-ae29-aba4d4f10f13 (last visited Jan. 16, 2025).
[39] Douglas Gillison, *US Bank Lobbyists Ranks Swell to Post-crisis High amid Regulatory Pushback*, REUTERS, Feb. 8, 2024, https://www.reuters.com/business/finance/us-bank-lobbyists-ranks-swell-post-crisis-high-amid-regulatory-pushback-2024-02-08/ (last visited Jan. 16, 2025).
[40] Michael Barr, *The Next Steps on Capital*, https://www.federalreserve.gov/newsevents/speech/barr20240910a.htm (last visited Jan. 16, 2025).
[41] See generally Julia Black, *Paradoxes and Failures: 'New Governance' Techniques and the Financial Crisis*, 75 MODERN L. REV. 1037, 1041 *et seq.* (2012)(discussing various governance techniques in addition to traditional command-and-control regulatory philosophy).
[42] David Seidl, Paul Sanderson & John Roberts, *Applying the 'Comply-or-Explain' Principle: Discursive Legitimacy Tactics with Regard to Codes of Corporate Governance*, 17 J. OF MANAGEMENT & GOVERNANCE 791, 795-796 (2013).
[43] Daniel C. Hardy, *Regulatory Capture in Banking*, (2006), at 4-6, https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Regulatory-Capture-in-Banking-18798 (last visited Feb 3, 2025).

government to extend credit facilities to save its economy during the global financial crisis.[44] In summary, the level of power that the state could exert on financial firms varies significantly depending on the context. Due to the limit of space, this article does not venture further on this topic.

Second, the choice of legal device reflects the degree of regulatory intensity. On the one hand, the state can use mandatory laws to force financial firms to be surrogate regulators. The obvious example is AML\CFT rules, non-compliance of which could result in financial firms facing harsh regulatory responses and heavy penalties. On the other hand, the state could also use voluntary codes, such as Equator Principles and Stewardship Codes, to encourage firms to sign up and to comply with the requirements. Another option for the state is creating a market for certain financial services, where financial firms can play a regulatory role through private ordering based on their business interests. For instance, directors facing potential lawsuits for breach of his fiduciary duties might be inclined to acquire liability insurance for protection, allowing insurers to be a monitor of their conduct. In theory, the more mandatory a rule is, the more likely financial firms are forced to comply with the requirements to be surrogate regulators. However, it does not necessarily mean that the mandatory approach is always desirable for the purpose of financial surrogate regulatory approach. This must be analyzed in a specific context.

In sum, despite the financial markets generally being more heavily regulated compared toother industries, the intensity of regulation can vary depending on financial sectors, political environment, and the choice of legal device in a country among other factors. Consequently, one might develop a matrix that combines those factors to determine the level of regulatory intensity and potential for the state to compel financial firms to be surrogate regulators. Part III will discuss these approaches further.

2. Elasticity of Demand for Financial Services

The effectiveness of financial surrogate regulatory approach is contingent upon the market's demand for finance. The demand determines the extent of influence that a financial firms may exert on a client. For instance, if a borrower does not depend heavily on bank finance, the

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[44] *Giant Reality-Check*, THE ECONOMIST (Aug. 31, 2013), http://www.economist.com/news/finance-and-economics/21584331-four-worlds-biggest-lenders-must-face-some-nasty-truths-giant-reality-check (last visited Feb. 3, 2025).

bank's ability to affect the borrower's behavior through loan agreements diminishes. Similarly, an insurer is less likely to regulate the conduct of an insured person if the latter has higher risk appetite or greater capacity to absorb losses without insurance protection. Market competition also means that insured persons would prefer insurance policies that offer the most desirable combination of price (premiums) and product (protection).[45] This implies that insurers may not want to impose costly and stricter requirements on insured persons if doing so may hurt their businesses. Thus, the more elastic a client's demand is, the less effectively a financial firm can serve as a surrogate regulator in the context. In contrast, insurers are in a good position to have *de facto* control over an insured if he cannot undertake some activities without insurance.[46] As the elasticity of demand for financial services varies depending on the individual characteristics of a person or business, industries, and country, the efficacy of financial surrogate regulatory approach must also be contingent upon specific market conditions and individual's preference.

Consumers' demand can be influenced by the value of consideration exchanged for a specific financial service. For instance, it has been argued that insureds could be lured by discount of insurance premiums as long as conduct standards imposed by insurers (e.g. safety) are efficient, thereby increasing the pool of clientele and the size of market.[47] Hence, insurers have to strike a balance between risk management in terms of controlling customers behaviors and the premiums charged for a particular insurance product. A detrimental cycle may occur if insurers have to charge high premiums due to heightened risk or even leaving the market once and for all (e.g. wildfire in certain areas of Los Angeles[48]), thereby reducing the market for such insurance (due to high price) and hinders the ability of insurers to change the conduct of their customers when they cannot afford to acquire insurance. It is of course subject to the state's regulatory objective and the elasticity of market demand. If the aim is to prevent people from staying in wildfire-prone areas due to lack of fire insurance, higher premiums may work for those who have less risk appetite of fire risk, but it may not work as efficiently for those who are willing to take the chance even if there is no proper insurance protection among other factors (e.g. housing price and its availability).

[45] Ben-Shahar and Logue, *supra* note 4, at 204.
[46] Ben-Shahar and Logue, *supra* note 4, at 209.
[47] Ben-Shahar and Logue, *supra* note 4, at 202.
[48] Sarah Kaplan & Anna Phillips, *How the LA Wildfires Will Affect Home Insurance in California - The Washington Post*, WASHINGTON POST, Jan. 9, 2025, https://www.washingtonpost.com/climate-environment/2025/01/09/california-wildfire-palisades-homeowners-insurance/ (last visited Feb 4, 2025).

In addition, market demand and the capacity of financial firms to regulate their customers may also be influenced by other competing or complimentary legal regimes. The existence of private insurance does not necessarily diminish the significance of government regulations.[49] Those other regulatory regimes may change market demand, people's behavior and their potential reactions to financial firms. It may also affect the role of financial firms in reaching a specific regulatory goal. Whether the financial surrogate regulatory approach may help to achieve regulatory goals must be measured in conjunction with other available tools.

For example, the ability of liability insurers to regulate the conduct of their customers (see *infra* Part III.A below for more discussion) hinges upon potential liability that customers may incur. Hence, market demand could be driven by another legal regime. For instance, from the company law's perspective, the board of directors and senior management may owe a duty to conduct enterprise risk management and to comply with laws and regulations.[50] Liability insurer (if any) may provide an extra cover to ensure that corporate management would not violate relevant laws or regulations. However, there is no role of a liability insurer if there is no underlying liability that needs insurance protection. Therefore, liability insurers should be in a supplementary role for a certain regulatory goal. It is also hard to imagine that liability insurers alone (or banks that makes loans) would be sufficient to enforce pollution standards and to regulate a company from making intolerable waster or pollution.

Similarly for reduction of carbon emission to address global warming, there could be a combination of regulation measures, such as carbon emission allowance and emission trading[51] or more straightforward prohibition or stringent regulations[52]. There could be public disclosure requirements of carbon emission data.[53] The Equator Principles (discussed in *infra* Part III.C.1) require signatory banks to take environmental or social concerns into the financing or services

[49] Ben-Shahar and Logue, *supra* note 4, at 228.
[50] Caremark International Inc. Derivative Litigation, Re, 698 A.2d 959 (1996).
[51] For example, the European Union has established the EU Emissions Trading System (ETS) to allow market participants to trade for their emissions allowance. European Commission, *What Is the EU ETS?*, https://climate.ec.europa.eu/eu-action/eu-emissions-trading-system-eu-ets/what-eu-ets_en (last visited Feb. 4, 2025).
[52] For instance, the European Environment Agency sets a target of carbon dioxide emission for fleets of vehicle. European Environment Agency, *CO2 Emissions Performance of New Passenger Cars in Europe*, https://www.eea.europa.eu/en/analysis/indicators/co2-performance-of-new-passenger (last visited Feb. 4, 2025).
[53] The Task Force on Climate-related Financial Disclosures (TCFD) recommends firms to disclose their scopes 1, scope 2, and if appropriate, scope 3 greenhouse gas emissions and related risks. TCFD, *TCFD Recommendations*, https://www.fsb-tcfd.org/recommendations/ (last visited Feb. 4, 2025).

related to project finance and then in theory indirectly nudge market participants to reduce carbon emission. However, it is also hard to imagine that Equator Principles alone would be sufficient to cause bank customers to significantly reduce carbon emission.

In other words, the financial surrogate regulatory approach could be an effective tool under some circumstances, but it may be complementary at times. Resources may be misplaced if the state relies on financial firms to fulfill their surrogate regulatory role when there are other more efficient regulatory tools. ow best to utilize the role of financial firms as regulatory tools alongside other government regulations in specific fields (e.g. global warming or food safety) should be subject to more in-depth and extensive studies in each field.[54]

3. Transaction Costs

Transaction costs affect the effectiveness of the financial surrogate regulatory approach. There could be significant information, monitoring, and enforcement costs. Those costs can restraint financial firms' resources and willingness to meet regulatory demands and how far they might play their expected regulatory function.

First, there could be information costs. As the state needs information to regulate the market effectively, financial firms also need information to effectively act as surrogate regulators. Information is critical to the insurance business[55], and it is also critical for other financial services. Without sufficient information, neither the state nor financial firms can determine appropriate measures to monitor and regulate other market participants. Sometimes, financial firms may require customers to provide their information (e.g. financial statement, medical records, etc.) for business purposes (e.g. for loan or insurance assessment). In this case, financial firms collect some information during the provision of financial services. Sometimes, the law even imposes an obligation on customers to provide information before entering into a contract (e.g. an insured person's obligation to disclose material information[56]), thereby reinforcing financial firms' ability to acquire necessary information.

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[54] For some general discussion of insurance regulation versus government regulation, see Ben-Shahar and Logue, *supra* note 4, at 228 *et seq*.
[55] Ben-Shahar and Logue, *supra* note 4, at 203.
[56] For instance, under English law, the Insurance Act 2015 requires an insured to make a fair presentation of risk. Insurance Act 2015 (c. 4) s 3(1) (UK).

However, it does not mean that financial firms could request for whatever information they desire. They are usually confined to collecting information that are relevant to their businesses. Thus, the law sometimes intervenes to oblige financial firms to collect additional information. For examples, an insurer may not normally inquire an insured company's beneficial owners when issuing an insurance policy to the company, unless such information is necessary for insurance assessment. Nonetheless, for AML\CFT purposes, the insurer has to conduct consumer due diligence (see *infra* Part III. B for more discussion) to know about the insured company. [57] When a financial firm is mandated by law to collect information that it would not usually seek, this requirement imposes additional information costs on financial firms.

Obtaining certain information can be expensive. For example, it is one thing to identify a customer's beneficial owners, as the customer should already possess that information. However, it is more complex when an insurer wants to know the customer's carbon footprint over the previous years. Generating such information may incur substantial costs.

In addition to acquisition of information, there are costs associated with updating and verifying information. Firms must ensure the authenticity and accuracy of collected information. False, misleading or inaccurate information may lead to incorrect decisions or ineffective monitoring by a financial firm. Moreover, information may need to be updated regularly to be precise (e.g. a customer's jobs or marital status). Again, verification and update of information implies transaction costs.

Moreover, there are enforcement costs. Assuming there could be lapse of compliance by a customer, financial firms may incur costs to ensure the customer fully complies with contractual or legal requirements. For instance, a loan agreement may prescribe that the loan money should only be used for a certain purpose (e.g. for green transition), but the lending bank may incur some costs to know and ensure that the requirement has been continuously fulfilled (and if not, to follow up with legal consequences).

Furthermore, the effectiveness of financial surrogate regulatory approach must also depend upon the robustness of firms' internal governance regime. There are two dimensions. The first

[57] FATF, *International Standards on Combatting Money Laundering and the Finance of Terrorism & Proliferation* (2012 version, updated in 2023), at 22, https://www.fatf-gafi.org/en/publications/Fatfrecommendations/Fatf-recommendations.html (last visited Feb. 8, 2025). (FATF Recommendations 2012)

dimension concerns the internal governance of a financial firm. For instance, a bank may decide voluntarily to follow the Equator Principles, which expect a signatory bank to consider a project's impact on the environment and community when assessment project finance (see *infra* Part III.C.1 for more discussion). However, the degree to which a bank effectively implements the Equator Principles into its practices and operation depends on its staff (from top management down to employees) and its internal governance system. It is unrealistic to believe that the bank will comply with the Equator Principles by simply becoming a signatory.

The second dimension concerns the internal governance of customers of financial firms. For instance, an aircraft is subject to stringent standards by the Federal Aviation Administration (FAA) in the U.S. to determine its airworthiness due to the importance of aviation safety.[58] Hypothetically, a liability insurer (of the manufacturer) may impose requirements on aircraft manufacturers to control potential legal liability resulting from any manufacturing defect of an aircraft. In this sense, the insurer could play some regulatory function for aircraft safety. However, the effectiveness of such requirements depends on how the manufacturer implements safety standards in practice. In turn, the insurer could incur significant costs to monitor internal compliance of an aircraft manufacturer.

In short, there could be information, monitoring, and enforcement costs no matter the state adopts direct regulations. Those costs shift to financial firms when the state adopts the financial surrogate regulatory approach. Then, transaction costs may restrict the extent of which financial firms would be an effective regulator and compliance by other market participants.

C. Potential Consequences of Forcing Financial Firms to be Surrogate Regulators

While the state may be tempted to regulate something through financial firms by controlling people's finance, it is essential to consider is how financial firms might respond to the state's request given the limitations to the financial surrogate regulatory approach. This section offers some suggestions based on the discussion above.

First, the alignment of the state's regulatory interest and a firm's business interest would determine the level of compliance, additional transaction costs, and potential externalities on other

[58] See 14 C.F.R. parts 21 to 49.

market participants from implementing financial surrogate regulatory approach. If financial surrogate regulator’s role is aligned with a firm’s business interests, financial firms may absorb some transaction costs as part of their business operations. Consequently, there would be fewer overall transaction costs when a financial firm simply performs actions it would have undertaken without any regulatory intervention. The question is then is whether the level of regulation or monitoring based on a financial firm’s existing business arrangements meets the state's expectations.

In contrast, when the business interests of firms and the regulatory interests of the state differ considerably, financial institutions may face substantial transaction costs to adhere to surrogate regulatory functions. As a result, market demand and transaction costs will likely influence the responses of financial firms and their clientele.

First, if the legal device chosen by the state is less mandatory, financial firms may exhibit a higher level of non-compliance if associated costs are too high and demand elasticity is significant. High transaction costs can hinder financial firms from efficiently comply with regulatory requirements. Higher elasticity indicates that a firm may lose customers if it imposes additional regulations on their conduct. Together, this article anticipates that financial firms are likely to comply at a lower level if the state forces them to be surrogate regulators when their business interests diverge from the state’s.

Second, if the legal device is more mandatory in nature when transaction costs are high, financial firms may transfer additional costs to customers. Since the law is more mandatory, financial firms have limited options to adjust their compliance levels. Given high transaction costs, financial firms can choose to absorb the costs (which would reduce their profits and possibly firm value) or pass all or part of the costs on to customers. In the latter’s case, regulatory costs are transferred from the state to financial firms and then to some extent to the market. If consumer demand is still highly elastic, financial firms may lose customers if they simply pass costs to the market, thereby reducing the impact of financial firms being surrogate regulators. If the demand has low elasticity, additional costs may become a burden on market participants, potentially causing market inefficiency if the overall costs exceed the benefits.

Financial firms might engage in window-dressing their compliance with the new surrogate regulatory function if they cannot reduce compliance levels and/or transfer a significant portion of additional transaction costs to customers. In other words, it is possible that a firm may overstate its compliance with the financial surrogate regulatory approach more than what it has actually achieved (e.g. ESG-washing).[59] For example, if banks are forced to review a borrower's carbon emission reduction, the potentially high costs (not only to the bank but also the borrower) to verify carbon emission and to ensure its authenticity on an ongoing basis may result in the bank and the borrower to conduct so-called greenwashing[60] to meet minimum regulatory requirements. It might compromise the regulatory goal (e.g. reduction of carbon emission) if greenwashing has reached a large scale.

D.Summary

In summary, this part begins by introducing the two foundational premises to the financial surrogate regulatory approach: the highly regulated nature of the financial market and the underlying demand for financial services. However, there are limitations to this approach. First, financial firms are not homogenous; some are subject to more stringent regulations than others. In addition, some regulatory requirements are more mandatory while some are less intrusive. Therefore, the degree that the state control over a financial firm differs depending on the type of financial firms and intensity of regulation. Second, market demand for finance is not constant. The elasticity of underlying demand influences how far financial firms can fulfill surrogate regulatory function. Third, the effectiveness of financial surrogate regulatory approach is contingent upon transaction costs, including those related to information, monitoring, and enforcement costs. High costs may impact the quality of compliance by both financial firms and other market participants.

Given those limitations, this article argues that financial firms may lower its compliance level to meet market demands and transaction costs or to pass costs to customers and the market. Financial firms may also engage in superficial compliance measures. Hence, the efficacy of the financial surrogate regulatory approach must be placed in conjunction with other competing or

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[59] Venturelli *et al*. defines ESG-washing as "a disparity between a bank's environmental and social disclosure level and the practical implementation of the relative measures". Valeria Venturelli et al., *Assessing the Influence of ESG Washing on Bank Reputational Exposure: A Cross-Country Analysis*, BUSINESS ETHICS, THE ENVIRONMENT & RESPONSIBILITY 1, 1 (2024), https://onlinelibrary.wiley.com/doi/full/10.1111/beer.12727 (last visited Jan 15, 2025).

[60] There is no universal definition of "greenwashing", but it is commonly used to refer to activities that involve providing false or misleading information regarding a firm's environmental actions or making green promises that it cannot fulfil. Soh Young In and Kim Schumacher, *Carbonwashing: A New Type of Carbon Data-related ESG Greenwashing*, Stanford Sustainable Finance Initiative Working Paper (2021), at 5, https://sfi.stanford.edu/publications/risk-metrics-and-management/carbonwashing-new-type-carbon-data-related-esg (last visited Feb 8, 2025).

complimentary regulatory regimes. Based on the discussion above, Part III below will examine three different models of using deploying financial firms as surrogate regulators. Part IV will reflect on the general theory and the various models.

III. Existing Models of Financial Firms as Surrogate Regulators

This part explores various models of the financial surrogate regulatory approach. Part A considers private ordering model, exemplifying with the role of insurers in regulating insured persons. Sections B examines the opposite: forcing financial firms to act as surrogate regulators through mandatory rules, illustrating with AML\CFT rules. Section C discusses a rising phenomenon: the use of voluntary codes to achieve "Environmental, Social and Governance" (ESG) or sustainability goals through financial services.

A. Private Ordering Model

A financial firm may naturally act as a surrogate regulator under its business model and commercial interests. To protect its interests and manage transactional risks, the firm may regulate behaviors of its customers through the decision to provide certain financial services and their contractual terms. As a result, a financial firm can assume a surrogate regulatory role through private ordering when the firm's business interests align with state's regulatory interests.

Scholars have argued that liability insurers could serve as a monitor of people's behavior in the market, such as liability insurance against delinquent corporate directors. Holderness observed that insurers offering directors' and officers' (D&O) liability insurance policies may monitor the managerial team of a company.[61] To mitigate the risk insured, D&O insurers might investigate and review an insured company's past records before issuing a policy.[62] They may also exclude certain coverage (e.g. potential hazards from resistance to takeovers)[63] and use policy terms to control the risk of corporate directors and executives being held liable for breach of their fiduciary duties,

[61] Clifford G. Holderness, *Liability Insurers as Corporate Monitors*, 10 INT'L REV. OF L. AND ECON. 115, 116 (1990).
[62] Holderness, *supra* note 61, at 119.
[63] Holderness, *supra* note 61, at 118-119.

even if they cannot perfectly monitor insured persons[64]. Through various monitoring regimes, D&O insurers could manage an insured person's moral hazard after issuance of a policy.[65] They then can constrain the conduct of corporate managers or even influence management's decisions to make specific organizational changes or to promote internal monitoring.[66] Potential legal liability, combined with the need to recruit talented directors from outside the company, may render a company reliant on offering suitable liability insurance to directors.[67] In this way, liability insurers could serve as a surrogate regulator for corporate governance of public listed companies.

A similar argument arises regarding insurance and liability against environmental waste. In early 1980s, the U.S. law sought to ensure that firms have adequate financial resources to address claims from victims of toxic environmental waste.[68] One method is to acquire insurance protection that in turn renders liability insurers to be a surrogate regulator for the Environment Protection Agency.[69] The idea could similarly be applied to other types of liability insurance, such as product liability insurance, workers' compensation, motor insurance, homeowners' insurance, and even tax liability insurance, etc.[70] Scholars also note that liability insurer can perform education function to help customers to avoid and reduce risks.[71]

In the digital era, insurers can influence people's conduct beyond liability insurance. For instance, life insurers may offer insured persons incentives to live a heathier life to reduce health risk, such as walking over an average of 10,000 steps daily over a period, monitored through wearable device or smartphones.[72] Motors insurers may encourage customers to use technology, like a dashcam or video recorder installed on a vehicle, to observe vehicle movement or to preserve

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[64] Roberta Romano, *Directors' and Officers' Liability Insurance: What Went Wrong?*, 37 PROCEEDINGS OF THE ACADEMY OF POLITICAL SCIENCE 67, 68 (1988).
[65] Kenneth S. Abraham, *Environmental Liability and the Limits of Insurance*, 88 COLUMBIA LAW REVIEW 942, 947 (1988); Tom Baker & Sean J Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEORGETOWN L. J. 1795, 1799 (2007).
[66] Holderness, *supra* note 61, at 116-119.
[67] Holderness, *supra* note 61, at 119.
[68] Kunzman, *supra* note 27, at 469.
[69] Kunzman, *supra* note 27, at 470.
[70] Ben-Shahar and Logue, *supra* note 4, at 217-228.
[71] Ben-Shahar and Logue, *supra* note 4, at 210.
[72] For example, it has been reported that Oscar Insurance in the U.S. reward fit customers using wearable device. Steven Bertoni, *Oscar Health Using Misfit Wearables To Reward Fit Customers*, FORBES, Dec. 2024, https://www.forbes.com/sites/stevenbertoni/2014/12/08/oscar-health-using-misfit-wearables-to-reward-fit-customers/ (last visited Feb 4, 2025).

evidence when there is an accident.[73] This in turn might result in people driving more cautiously to avoid accidents and maintain their insurance coverage. Motor insurers may also use data from tracking devices to reward those careful drivers with lower insurance premiums in the future.[74] Such differentiated premiums may offer incentives to insured persons to behave in the way insurers (and indirectly the state) prefer.[75] Thus, non-liability insurers may also function as surrogate regulators in a way to achieve certain policy goals (e.g. healthy population or reducing traffic accidents).

Nevertheless, the effectiveness of insurers as surrogate regulators has certain limitations. First, assuming that regulators do not interfere with how insurers set policy terms, the financial surrogate regulatory approach must be influenced by the demand for insurance and market conditions. The approach may be less effective in situations where is low market demand or for those with higher risk tolerance. A customer's risk appetite and perception of risk also impact the demand for certain types of insurance. For D&O insurance, its availability relates to the business environment and the volume of business transactions that invite litigations.[76] When the likelihood of litigation is low, the demand for D&O insurance may decrease, which affects the capacity of liability insurer to regulate corporate governance. Since the likelihood of lawsuits brought against delinquent directors and the function of relevant enforcement mechanisms (e.g. class action or derivative action) must vary country by country. The role that liability insurers can play regarding regulating corporate governance must also differ significant among countries.

In theory, the state could create demand for insurance through legal requirements such as mandatory third-party cover for drivers of motor vehicle.[77] This may invite insurers to play a regulatory role. However, a legal requirement does necessarily mean that a risk is insurable, which means that insurers can pool and re-distribute risk of losses.[78] It is also arguable whether the

[73] National Association of Insurance Commissioners, *Want Your Auto Insurer to Track Your Driving? Understanding Usage-based Insurance*, Consumer Insight (Sep. 8, 2021), https://content.naic.org/article/consumer-insight-want-your-auto-insurer-track-your-driving-understanding-usage-based-insurance (last visited Feb. 4, 2025).
[74] *Id*.
[75] Ben-Shahar and Logue, *supra* note 4, at 205-208.
[76] Romano, *supra* note 64, at 72.
[77] For example, the State of New York has a minimum auto insurance requirement before obtaining a plate and driving. Department of Financial Services, *Minimum Auto Insurance Requirements*, https://www.dfs.ny.gov/consumers/auto_insurance/minimum_auto_insurance_requirements (last visited Feb. 4, 2025).
[78] Abraham, *supra* note 65, at 945 *et seq*.

insurance industry has the capacity to absorb uninsurable losses and earn sufficient profits to make the market sustainable even with some legal requirements of mandatory insurance.[79] In addition, the level of legal uncertainties around being held liable in law may also negatively affect the availability of insurance in the market.[80] Therefore, market conditions would determine whether insurers can effective step in to provide some regulatory function. Without sustainable market demand and supporting market conditions, imposing mandatory insurance requirements on insurers to be surrogate regulators may hurt insurance industry and the market.

Second, the ability of insurers to regulate their customers also depend on the latter's bargaining power and their sensitivity to insurance premiums. Higher likelihood of legal liability may raise insurance premiums, thereby reducing demand for insurance.[81] Those who need to acquire insurance and those who are sensitive to higher insurance premiums may be more likely to comply with requirements set by their insurers. In contrast, those who have higher elasticity to insurance and those who have better capacity to absorb losses through other means may be less inclined to accept insurer's requirements.

Moreover, competition in insurance premiums and policy terms in a competitive insurance market may further affect the ability of insurers to regulate customer behaviors through provision of insurance protection and policy terms. Unless the market is highly standardized or if a certain requirement is common to all insurers (e.g. no driving under the influence of alcohol), it is probable that insurers would offer different terms in similar insurance policies. The diversity of policy terms can invite market competition among insurers in combination with other factors (e.g. policy coverage or premiums) to attract customers. Consequently, this might affect the extent to which an insurer includes certain warranties[82] or exclusion clauses in their policies. In other words, market competition might prevent insurers from inserting additional requirements if such actions are contrary to their business interests.

Third, insurers may still incur significant transaction costs to play an effective surrogate regulatory role, even if there is sufficient demand for certain insurance products. For example,

[79] Abraham, *supra* note 65, at 943.
[80] Abraham, *supra* note 65, at 944.
[81] Abraham, *supra* note 65, at 943.
[82] Under English law, an insurance warranty is a term that requires an insured person to undertake to do something or not to do something. Marine Insurance Act 1906 (c. 41) s 33(1) (UK).

regarding D&O insurance, due to potential information and monitoring costs, it may be more efficient for an insurer to exclude unaccepted conduct from insurance coverage rather than to actively require a customer to improve corporate governance standards. Baker and Griffith found that D&O insurers neither monitor corporate governance nor manage litigation defense costs.[83] Corporate managers acquiring D&O insurance might be more for self-serving reasons.[84] Moreover, insurers may lack sufficient knowledge, expertise or information to be an effective monitor.[85] It may also be too costly to conduct company-specific supervision.[86] Therefore, insurers may not actively behave like a surrogate regulator due to potential transaction costs.

In sum, insurers' capacity as surrogate regulators is constrained by market competition, underlying demand for insurance, and transaction costs. This article does not challenge the views that insurers could play some regulatory function. However, as outlined in Part II, this article could explain why insurers have not assumed a more active role as surrogate regulators on a larger scale. Nonetheless, given that the state's regulatory interests (to improve corporate governance standards) are in line with insurers' business interests (to minimize potential insurance liability), the state could enable insurers to act as surrogate regulators through private ordering. However, when the state's interest diverge from those of insurers, the approach may be ineffective.[87] In other words, there could be a discrepancy between legislative or policy goals and insurers' actions without the law standardizing insurance coverage and policy terms. Hence, insurers may choose to be passive regulators up to the limit of their business interests.

Beyond insurance, it is uncertain how effectively other financial firms can regulate their customers through private ordering. A similar argument may apply to banks using loan covenants to regulate the conduct of a borrower (e.g. using loan covenants to force borrowers). However, banks' main interests primarily focus on managing the borrower's ability to repay the loan. It may not align with a bank's interest to regulate the borrower conduct if it does not impact a borrower's ability's to repay. For instance, a bank may use a loan covenant to require the borrower to acquire fire insurance for the mortgaged property, but it may not incline to include a covenant to require the borrower to have a sound "diversity, equality and inclusion" policy unless related to credit risk

[83] Baker and Griffith, *supra* note 65, at 1808 and 1814.
[84] Baker and Griffith, *supra* note 65, at 1800.
[85] Baker and Griffith, *supra* note 65, at 1835.
[86] Baker and Griffith, *supra* note 65, at 1836.
[87] Kunzman, *supra* note 27, at 484.

of loans. Thus, like in the case of insurance, this article argues that private ordering approach may work for banks or other non-insurance financial firms if the state's regulatory objective is at least in line with their business interest in part. However, when the state's objective does not pertain to core concerns for the business models of banks or other non-insurance financial firms, it is unlikely that the private ordering approach will be effective in turning them into surrogate regulators.

B. Mandatory Model

The state could mandatorily force financial firms to be surrogate regulators. One prominent example is AML/CFT regulations. The demand for AML/CFT rose alongside efforts to combat drug dealers, organized crimes, and terrorists (notably after the 9/11 attack in the U.S.). Among other legal regimes (e.g. criminal charges for drug offences), one important law enforcement mechanism is to disrupt criminals' and terrorists' finance and monetary flows to prevent them from taking benefit of illegal proceeds and to conduct further unlawful conduct.

A critical challenge is determining how law enforcement agencies can trace the flow of illicit funds, obtain information on suspicious activities, and identify criminals or terrorists to prevent future crimes. In this context, the role of financial firms, which are the center of money and monetary flows (e.g. taking deposits and processing wire transfer), play a crucial role. Although AML/CFT rules might apply to a wide range of institutions and businesses, financial firms are essential due to their expertise in managing money, tracking financial transactions, and maintaining detailed customer information. Consequently, AML/CFT laws require financial firms to assume a significant role in enforcing these regulations. The state leverages the expertise of financial firms in handling monetary flows and the information they possess about their clients to enhance the enforcement of AML/CFT rules. In essence, financial firms function as surrogate regulators, aiding in the implementation and enforcement of AML/CFT regulations.

Compliance with AML\CFT rules is based on the so-called risk-based approach[88], which requires financial firms to assess AML\CFT risk of a client or a transaction after conducting consumer due diligence and transaction monitoring. Financial firms should pay more attention to customers or transactions (e.g. those from North Korea) that are deemed to be of higher AML/CFT risk. Therefore, financial firms must carry out consumer due diligence exercise to collect

[88] FATF Recommendations 2012, *supra* note 57, at 10.

information about their customers and about a particular transaction (e.g. purpose of a payment instruction and nature of recipient).[89] Moreover, financial firms are required to perform transaction monitoring to determine if transaction may be suspicious for money laundering or terrorism finance. If a red flag is raised as a result, banks should notify law enforcement agencies and likely suspend the customer's accounts or a transaction. To continuously monitoring and identifying AML\CFT risks, financial firms must establish appropriate internal control systems and measures.

The application of AML\CFT rules on financial firms (especially banks) is mandated by the state and enforced by financial regulators. Non-compliance with AML\CFT rules can pose significant legal risk. Over the past decade, commercial banks have been subject to hefty penalties in the world for breach or lapse in compliance of AML\CFT rules. For example, Deutsche Bank was reportedly fined by the Federal Reserve in the U.S. for US$186 million in July 2023 due to the bank's failure to address shortcomings of its money laundering control system.[90] Moreover, non-monetary sanctions may also occur. For instance, N26, a German online-only bank, was only allowed to take up to a certain number of new customers a month due to its lapse in tackling financial crimes.[91] Hence, there is little doubt that the state force highly regulated financial firms to pick up their roles as AML\CFT enforcers.

This article does not challenge the purpose of AML\CFT rules to stop crimes and terrorism. This article agrees that financial firms should not proceed with a transaction (and should notify law enforcement agencies) if it is clear that a customer is a criminal/terrorist or a transaction is for illegal purpose (e.g. fraud or money laundering). However, this article is more reserved how far financial firms should do beyond what they normally would have done without legal intervention, considering the costs and potential detrimental impact to the market discussed below.

Compliance with AML\CFT rules entail significant transaction costs. Despite financial firms already possessing extensive customers' information necessary for financial services, AML\CFT rules require more information that firms must collect specifically from customers. For instance, a

[89] FATF Recommendations 2012, *supra* note 57, at 14-15.
[90] Peter Schroeder and Chris Prentice, *US Fed Fines Deutsche Bank $186 Million for Slow Progress against Money Laundering*, REUTERS, July 20, 2023, https://www.reuters.com/business/finance/fed-fines-deutsche-bank-186-mln-insufficient-progress-addressing-anti-money-2023-07-19/ (last visited Feb. 8, 2025).
[91] Olaf Storbeck, *Online-only Bank N26 Expects Profit Next Year after Customer Limit Eased*, Financial Times (November 30, 2023), https://www.ft.com/content/a1b865a7-97ca-425c-b4e0-3c10f0ed72e9 (last visited December 28, 2023).

bank naturally should know a borrower company's registration status and financial records. However, without AML/CFT regulations, a bank does not necessarily have to inquire the company's ultimate beneficial owners for the purpose of opening a bank account or issuing a loan. As a result, there could be excessive labor costs to conduct consumer due diligence even in a developed market like the U.K.[92] In addition, there are also considerable costs to acquire, establish, and maintain a sound system to conduct transaction monitoring, including subscription and maintenance of data (e.g. updated lists or a list of politically exposed persons[93]) and costs to follow up with any red flag (including false alerts) on a continuous basis. There could also costs to hire experienced AML\CFT officers from the market.

Given that financial firms may process thousands of transactions daily, the associate compliance costs cannot be ignored. Although there is no official figure, one firm estimates that the annual costs to comply with laws related to financial crimes (including AML\CFT) amounted to over AUD$ 5.3 billion in Australia, over AUD$ 30 billion in Japan, and over AUD$ 2.6 billion in China.[94] The National Crime Agency in the U.K. estimates that AML\CFT practices cost hundreds of billion pounds to the U.K.'s economy annually.[95]

Higher costs may lead to non-compliance, potentially resulting in more legal sanctions. Of course, the larger a bank is, the higher the risk of money laundering and terrorism finance. Nonetheless, AML\CFT risk still exists for smaller banks. Some criminals may exploit lapse in AML\CFT compliance in smaller banks to launder money.[96] The sunk costs for AML\CFT compliance could be prohibitive for smaller banks compared to larger ones. This may potentially affect market competition in favor of larger financial firms with more resources to comply with AML\CFT rules.

High compliance costs and stringent legal sanction may affect a financial firms' operation and reduce its profits, subsequently affecting returns to shareholders. A customer limit, such as that

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[92] Chenyang Liu, *Effectiveness of the UK AML System and Strategies for Improvement*, 7 ECONOMICS, LAW AND POLICY 43, 45 (2024).
[93] FATF Recommendations 2012, *supra* note 57, at 16.
[94] LexisNexis, *True Costs of Financial Crime Compliance Study, 2023 (Australia Edition)*, https://risk.lexisnexis.com/global/en/insights-resources/infographic/true-cost-of-financial-crime-compliance-study-anz (last visited Feb. 8, 2025).
[95] National Crime Agency, *Money Laundering and Illicit Finance*, https://www.nationalcrimeagency.gov.uk/what-we-do/crime-threats/money-laundering-and-illicit-finance (last visited Jan. 16, 2025).
[96] *Smaller Banks, Higher Risks?*, ACAMS TODAY, Mar. 10, 2010, https://www.acamstoday.org/smaller-banks-higher-risks/ (last visited Feb. 6, 2025).

imposed on N26 in Germany, can restrict a bank's potential growth. Eventually, those costs might be passed on to consumers and shareholders. For instance, the requirements to conduct consumer due diligence naturally results in a bank spending more time to collect, verify and review information about new customers, who may have to spend time to gather information and provide necessary documentation (e.g. proof of income). This process inevitably leads to longer time spent on tasks as simple as opening a new bank account. In less developed markets where a large part of financial system could be informal and unregulated, strict enforcement of AML\CFT rules could arguably contribute to some degrees of financial exclusion.[97] Even in a developed market like the U.K., the financial regulator has found that "financial crime due diligence, and suspicions of financial crime, are the key drivers for account declines, terminations and suspensions".[98]

If AML\CFT risk is deemed too high, a bank may simply choose to reject a new customer to avoid future monitoring costs and legal risk for lapse of compliance. For instance, some crypto firms still found it challenging to open a bank account even in 2023.[99] The necessity to comply with AML\CFT rules ironically may deny crypto firms mainstream banking services, thus excluding them from the traditional financial system that has more state oversight. Moreover, the demand of AML\CFT may also affect regulatory process. In Singapore, for example, the time required to acquire regulatory approval to register a family office for wealth management could take up to 18 months as in late 2023 due to concerns of money laundering, compared with less than 6 months in 2020.[100]

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[97] Abdullahi Y. Shehu, *Promoting Financial Inclusion for Effective Anti-Money Laundering and Counter Financing of Terrorism (AML/CFT)*, 57 CRIME, LAW, AND SOCIAL CHANGE 305, 315-316 (2012).

[98] FINANCIAL CONDUCT AUTHORITY, *UK Payment Accounts: Access and Closures*, at 16 (2023), https://www.fca.org.uk/publication/corporate/uk-payment-accounts-access-and-closures.pdf (last visited Feb. 6, 2025).

[99] Lavender Au, *Even Licensed Firms Say Opening Bank Account in Hong Kong is Hard*, https://www.coindesk.com/policy/2023/05/17/even-licensed-firms-say-opening-bank-accounts-is-hard-in-hong-kong/ （last visited Jan. 9, 2025）; *Dutch Bank Refuse Accounts for Cryptocurrency Businesses*, https://nltimes.nl/2018/02/02/dutch-banks-refuse-accounts-cryptocurrency-businesses （last visited Jan. 9, 2025）; Liam 'Abika" Wright, *Even Crypto Friendly UK Banks Freeze Accounts in Fear of Crypto Transactions*, https://cryptoslate.com/even-crypto-friendly-banks-are-seemingly-scared-of-crypto-transactions/ （last visited Jan. 9, 2025）

[100] Mercedes Ruehl and Leo Lewis, *Singapore Family Office Applicants Face 18-month Wait amid Tighter Scrutiny*, FINANCIAL TIMES, November 19, 2023, https://www.ft.com/content/6df7c15d-2733-4178-8207-1ccc11b84018 (last visited Feb 8, 2025).

The issue is further exacerbated by the fact that AML\CFT compliance programs do not bring direct revenue for financial firms. The main challenge is that compliance with AML\CFT is not one of a financial firm's major services. While a financial firm may earn good reputation for being clean and free from financial crimes, quantifying the value of such good reputation is difficult. Thus, financial firms are most likely to be affected negatively than to benefit directly from AML\CFT practices.

Ultimately, a critical question is the extent to which stringent AML\CFT rules imposed on financial firms could effectively detect and deter money laundering and terrorism finance. In other words, does the benefits brought by AML\CFT rules outweigh the direct and external costs incurred by banks and other stakeholders, such as bank customers or shareholders, for their compliance? This should be subject to further studies in a specific market.

This article contends that imposing AML\CFT compliance obligation on financial firms is only part of the solution to money laundering and terrorism finance. At most, a financial firm can halt monetary flows, freeze a customer's assets, and inform law enforcement agencies about a potential wrongdoing. It is not, however, their responsibility to conduct criminal investigation or penalize criminals and terrorists. Simply put, financial firms can play its role to facilitate law enforcement to some extent, but they are not the primary enforcer against crimes and terrorism.

C. Voluntary Code Model

1. The Rise of Voluntary Codes for ESG and Sustainability

In the past two decades, there has been an emerging trend towards using voluntary codes to encourage financial firms to facilitate the achievement of the environmental (e.g. climate change), social (e.g. gender equality), governance issues (e.g. business integrity or corporate governance) (together, ESG) goals or other sustainability objectives. Since the launch of the Equator Principles in 2023, international organizations or national governments have introduced initiatives to promote participation by financial firms and market participants in the form of voluntary codes. These initiatives are usually designed to be voluntary in nature. Therefore, financial firms are not legally obliged to sign up to those initiatives unless mandated by the law or the regulator in a specific country.

The Equator Principles intends to create a "risk management framework for financial institutions to identify, assess and manage environmental and social risks when financing [large infrastructure and industrial projects]."[101] The Equator Principles focus on project finance (including project-related loans, bridge loans and refinance, etc.) and related services (e.g. advisory services).[102] It is in principle voluntary for financial firms to sign up to the Equator Principles unless legally required by law in a country. Once becoming a signatory, a firm commits to implement the 10 Equator Principles[103] in its practice related to project finance. The 10 principles require a signatory bank to have "review and categorization" process (Principle 1) and conduct "environmental and social assessment" (Principle 2) of a project with "applicable environmental and social standards" (Principle 3).[104] A signatory bank should also require customer to establish "environmental and social management system and Equator Principles action plan" (Principle 4) for certain projects and demonstrate effective "stakeholder engagement" (Principle 5)[105] in addition to imposing further client reporting requirements (Principle 10)[106]. Moreover, a signatory should require a customer to establish effective grievance mechanism (Principle 6).[107] A customer's compliance should be subject to independent review (Principle 7)[108] and independent monitoring and reporting (Principle 9)[109]. The Equator Principles also expect signatory banks to incorporate covenants linked to compliance with the principles (Principle 8).[110] Those principles aim to encourage financial firms to incorporate more environmental and social risk assessment when offering project finance or related services (e.g. the environmental impact of a new dam) and to cause a large industrial project to be more environmental or social friendly through the influence of project finance.

In 2004, the United Nations (UN) established the Principles for Responsible Investment (PRI) to "understand the investment implications of [ESG] factors" and "to support an

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[101] The Equator Principles, *The Equator Principles*, https://equator-principles.com/about-the-equator-principles/ (last visited Feb. 5, 2025).
[102] *Id*.
[103] *Id*.
[104] The Equator Principles, *EP4* (July 2020), at 8-10, https://equator-principles.com/app/uploads/The-Equator-Principles_EP4_July2020.pdf (last visited Feb. 5, 2025).
[105] *Id*. at 11-13.
[106] *Id*. at 13.
[107] *Id*. at 13.
[108] *Id*. at 13.
[109] *Id*. at 13.
[110] *Id*. at 15-16. In theory, banks may also use loan covenants to require a borrower to fulfil its environmental or social commitments. Light and Skinner, *supra* note 1, at 1921.

international network of investor signatories in incorporation these factors into their investment and ownership decisions."[111] In addition to laying the key principles, the PRI Association, based in London, U.K., was incorporated to manage signatory firms and to promote responsible investment. By agreeing to be a signatory of the PRI, a firm acknowledges that applying PRI principles "may better align investors with broader objectives of society"[112] and commits to the following six principles: incorporate ESG issues into investment analysis and decision-making processes (Principle 1); be active owners and incorporate ESG issues into our ownership policies and practices (Principle 2); seek appropriate disclosure on ESG issues by the entities in which we invest (Principle 3); promote acceptance and implementation of the Principles within the investment industry (Principle 4); work together to enhance our effectiveness in implementing the Principles (Principle 5); and report on our activities and progress towards implementing the Principles (Principle 6).[113] In other words, the PRI advocates institutional investors and financial institutions to incorporate ESG factors into their investment and ownership decisions (e.g. to buy shares of a company or voting in a company's general meeting), thereby indirectly cause investee companies to take more ESG consideration into their business operations. As in February 2025, the PRI claims to have over 5,300 signatories.[114]

There are similar global initiatives in other financial sectors. In the insurance sector, the UN published the Principles of Sustainable Insurance in 2012 to "address environmental, social and governance risks and opportunities.[115] In 2019, the UN also established the Principles for Responsible Banking to encourage signatory banks to "take action to align their core strategy, decision-making, lending and investment with the UN Sustainable Development Goals, and international agreements such as the Paris Climate Agreement."[116] Also in 2019, several banks

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[111] Principles of Responsible Investment, *About the PRI*, https://www.unpri.org/about-us/about-the-pri (last visited Feb. 8, 2025).
[112] Principles of Responsible Investment, *What are the Principles for Responsible Investment?*, https://www.unpri.org/about-us/what-are-the-principles-for-responsible-investment (last visited Feb. 8, 2025).
[113] *Id*.
[114] Principles of Responsible Investment, *Quarterly Signatory Update*, https://www.unpri.org/signatories/signatory-resources/quarterly-signatory-update (last visited Feb. 8, 2025).
[115] UN Environment Programme Finance Initiative, *Principles for Sustainable Insurance*, https://www.unepfi.org/insurance/insurance/ (last visited Jan. 10, 2024).
[116] UN Environmental Programme Finance Initiative, *Principles for Responsible Banking*, https://www.unepfi.org/banking/bankingprinciples/ (last visited Feb. 3, 2024).

globally established the Poseidon Principles[117] and Poseidon Principles Association[118] to create a framework for incorporating environmental concerns (over climate change) into decisions for shipping finance, which may impact the finance for global trade. This article does not delve into in retails of the Principles of Sustainable Insurance, Principles for Responsible Banking, and Poseidon Principles. These codes align with those established in the Equator Principles and the Principles for Responsible Investment, aiming to include ESG factors in the assessment of financial decisions like loans, insurance, or investments, and to enhance transparency and accountability.

In addition, the use of voluntary codes is not limited to global initiatives. A similar approach is the U.K.'s Stewardship Code (the UK Code) to enhance the role of institutional investors, many of which are licensed financial firms. Initially released in 2010 by the Financial Reporting Council, the most recent iteration is the Stewardship Code 2020, which was published in October 2019.[119] The primary objective of the Code is to enhance "the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society."[120] The UK Code specifically targets asset owners and asset managers,[121] thereby influencing the conduct of fund management firms when managing assets and investments.

The UK Code urges asset and fund management firms to act as a "steward" to achieve long-term sustainability or ESG goals. Generally, the Code requires a signatory firm to have "purpose, investment beliefs, strategy and culture [to] enable stewardship that creates long-term value for clients and beneficiaries"[122]. Such long-term value is expected to result in "sustainable benefits for the economy, the environment and society".[123]

[117] Poseidon Principles, *How Did We Get There*, https://www.poseidonprinciples.org/finance/about/how-did-we-get-there/ (last visited Aug. 27, 2024).
[118] Poseidon Principles, *Governance*, https://www.poseidonprinciples.org/finance/about/governance/ (last visited Aug. 27, 2024).
[119] UK Stewardship Code 2020, https://www.frc.org.uk/library/standards-codes-policy/stewardship/uk-stewardship-code/ (last visited Feb. 5, 2025). (UK Stewardship Code 2020)
[120] UK Stewardship Code 2020 at 4.
[121] *Id*.
[122] UK Stewardship Code 2020 at 8 (Principle 1).
[123] *Id*. (Principle 1)

To support the stewardship role, a signatory firm must establish sufficient governance structure, resources and incentives.[124] In addition to taking care of the interests of clients and beneficiaries[125], the Code ushers in ESG factors by requiring a signatory firm to "systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfill their responsibilities."[126] Moreover, apart from establishing internal policy and governance structure, the Code expects a signatory firm not only to "engage with issuers to maintain or enhance the value of assets"[127] but also to "escalate stewardship activities to influence issuers".[128] A signatory firm should also "actively exercise their rights and responsibilities".[129] In essence, the Code require signatory firms not only to manage assets for the long-term interests of their investors but also sustainable benefits for the environment and society, thereby incorporating ESG factors into their stewardship mandate.

Those investee companies that worry about losing an angel investor or external fundings may choose to be more ESG-friendly for Principles of Responsible Investment or national Stewardship Codes to be effective. Hypothetically, if a company cares about the perception of institutional investors (assuming they share similar views) and those investors care about ESG, it may push the board and senior management of the company to take care of better ESG, sustainability or corporate governance. Therefore, similar to the global initiatives mentioned above, the UK Code also has the effect of nudging investee companies toward better ESG practices through financial firms and other institutional investors.

The UK Code is designed to be "comply or explain"[130] in nature. Hence, the structure of the Code emphasizes how a signatory firm should explain and disclosure information regarding the principles stated in the Code. This approach differentiates the Code from initiatives like the Equator Principles or Principles of Responsive Investment. Under the "comply or explain" approach, the fundamental expectation is a signatory firm should comply with the principles stated in the Code. In cases of non-compliance, enhanced transparency through disclosure should inform the market and may potentially generate market pressure for fund management firms to improve

[124] UK Stewardship Code 2020 Principle 2 (at 9).
[125] UK Stewardship Code 2020 Principle 3 to 6.
[126] UK Stewardship Code 2020 Principle 7 (at 15).
[127] UK Stewardship Code 2020 Principle 9 (at 17).
[128] UK Stewardship Code 2020 Principle 11 (at 20).
[129] UK Stewardship Code 2020 Principle 12 (at 11).
[130] UK Stewardship Code 2020 at 4.

their stewardship practices for the long-term sustainability of the economy, environment, and society.

In sum, this article highlights an emerging trend of creating regulatory initiatives in the form of voluntary codes to encourage financial firms to integrate ESG and sustainability considerations into their business decisions. Examples include Equator Principles (for project finance), Poseidon Principles (for shipping finance), Principles for Sustainable Insurance (for insurance sector), Principles for Responsible Investment and Stewardship Code (investment in the capital market). They also aim to require participating financial firms (banks, insurers, and other institutional investors) to incorporate some degrees of ESG or sustainability factors into their conduct and decisions, thereby potentially influencing the behaviors of other market participants (e.g. borrowers, insureds, investee companies, etc.). Thus, those codes seek to leverage signatory financial firms as surrogate regulators.[131]

The subsequent question is whether the voluntary code approach is an effective means to improve ESG and sustainability, assuming they are policy goals that the state aims to achieve. To clarify, this article does not delve into debates surrounding the justification the pursuing ESG and sustainability goals, though this article acknowledges that the legitimacy and rationale behind these concepts would affect how the state pursue these goals. Moreover, multiple voluntary codes may achieve the same goals (e.g. addressing climate change) through different financial services (e.g. the Equator Principles through project finance and Stewardship Code through corporate governance). Whichever voluntary code is more effective may be an issue worth exploring[132] but is beyond the scope of this article. On this basis, the next section will examine limitation of using financial firms as a kind of surrogate regulator for ESG and sustainability goals.

2. Limitation to the Voluntary Approach for ESG and Sustainability

The voluntary codes described in the previous section may look promising at least on ethical grounds, questions remain: "why are they structured as voluntary codes rather than

[131] Nonetheless, a state can introduce voluntary codes for other purposes. For instance, it has been argued that Singapore's transplantation of the UK Stewardship Code is a form of "halo signaling" to attract foreign investment. Dan W Puchniak & Samantha S Tang, *Singapore's Puzzling Embrace of Shareholder Stewardship: A Successful Secret*, 53 VAND. J. OF TRANSNATIONAL L. 989, 1004-1005 (2020).
[132] Light and Skinner, *supra* note 1, at 1946-1948.

mandatory rules?" and "how effective can they be"? Answers to those questions depend on some intertwining factors. This article has some observations based on the general theory in Part II.

i. Intensity of Regulatory Pressure and Legal Device

The global initiatives mentioned above are currently applicable on a voluntary basis. While issued by the government, the UK Code is also designed to be "comply or explain" in nature and it does not bind all the authorized asset management firms in the UK. None are so far made compulsory internationally through any treaty. As the intensity of regulatory pressure may vary based on the choice of legal device and the nature of financial firms, this article argues that non-adoption or non-compliance rate should be lower due to the voluntary or comply-or-explain nature.

On the one hand, given limitations of market demand and transaction costs (discussed below), this article expects that many financial firms may not sign up to those initiatives in the absence of sufficient regulatory pressure, potentially undermining their impact in the market. On the other hand, signatory firms may not fully comply with the requirements in these codes due to transaction costs (discussed below). Hence, compared with the private ordering model (where financial firms at least have some vested interests to play some degrees of regulatory function) and mandatory model (where firms are obliged to comply with legal requirements under all circumstances), this article argues that adoption and compliance rate should be lower when the state adopts the voluntary code model to turn financial firms into surrogate regulators.

For instance, in the case of Equator Principles, the Equator Principles Association reports that there are 129 financial institution that are signatories from all over the world as in February 2025.[133] However, pursuant to data provided by the Federal Deposit Insurance Corporation (FDIC), there were 4,036 commercial banks insured by the FDIC in 2023 in the U.S alone.[134] In the U.K., pursuant to the list of Monetary Financial Institutions compiled by the Bank of England, there are 107 banks, building societies or firms that are licensed to accept deposits in the U.K in addition to

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[133] Equator Principles Association, *Signatories & EPFI Reporting*, https://equator-principles.com/signatories-epfis-reporting/ (last visited Feb. 5, 2025).
[134] FDIC, *BankFind Suite: Find Annual Historical Bank Data*, https://banks.data.fdic.gov/explore/historical/?displayFields=STNAME%2CTOTAL%2CBRANCHES%2CNew_Char&selectedEndDate=2024&selectedReport=CBS&selectedStartDate=1934&selectedStates=0&sortField=YEAR&sortOrder=desc (last visited Feb. 5, 2025).

211 firms from other countries as on September 9, 2024.[135] Therefore, it is obvious that only a small number of banks in the U.S. and U.K. and in the world signing up to the Equator Principles. The relatively small number of banks signing up to the Equator Principles may be because large banks are more likely to participate in project finance. Thus, small banks have no incentives to adopt the Equator Principles. However, it worth noting that U.S. banks are absent in the list signatories of the Equator Principles,[136] though many large non-U.S. banks have signed up to the Equator Principles. This naturally limits the impact of the Equator Principles on the global market.

In another example, as on February 21, 2024, there were a total of 286 firms being signatories of UK Stewardship Code,[137] out of estimated around 1,000 asset management firms in the country[138]. This indicates that only approximately a quarter of asset management firms in U.K. have committed to the Stewardship Code. There is no further data on the total assets under management by signatory firms compared to non-signatories. Therefore, this article cannot provide a more precisely assessment of the effect of Stewardship Code on the overall asset management market in the U.K.

The state, of course, can introduce measures to make voluntary codes mandatory or partially mandatory if the purpose is to improve adoption and compliance rate. For instance, in Taiwan (which neither is a member of the UN and nor share legal heritage with the U.K.), the financial regulator actively promotes stewardship for institutional investors[139] and encourages banks to sign up to the Equator Principles.[140] Moreover, Taiwan's financial regulator incorporates compliance with the Equator Principles into guidelines regarding offering of credit facilities made

[135] Bank of England, *Institutions in the UK Banking Sector*, https://www.bankofengland.co.uk/statistics/data-collection/institutions-in-the-uk-banking-sector (last visited Jan. 23, 2025).
[136] See the list in *supra* note 133. Signatory banks of the Equator Principles from North American are mainly from Canada.
[137] Financial Reporting Council, *UK Stewardship Code Signatories*, https://www.frc.org.uk/library/standards-codes-policy/stewardship/uk-stewardship-code-signatories/ (last visited Jan. 23, 2025).
[138] The data is quoted in a letter by the Financial Conduct Authority on February 3, 2023. See Financial Conduct Authority website: https://www.fca.org.uk/publication/correspondence/portfolio-letter-asset-management-2023.pdf (last visited Jan. 23, 2025).
[139] Financial Supervisory Commission, *Institutional Investors Stewardship Code*, https://esg.fsc.gov.tw/SinglePage/Action/Control/ (last visited Feb. 5, 2025).
[140] The Banking Bureau under the Financial Supervisory Commission has a dedicated webpage for the Equator Principles. See website of Banking Bureau: https://www.banking.gov.tw/ch/home.jsp?id=793&parentpath=0,8 (last visited Jan. 23, 2025).

by the Bankers Association, a self-regulatory organization.[141] Although these guidelines are issued by a self-regulatory body, they hold significant binding influence on commercial banks in Taiwan, as adherence is probably expected by the financial regulator. Moreover, the guidelines potentially broaden the scope of the Equator Principles from project finance to commercial loans. Thus, voluntary codes could have *de facto* mandatory effect on financial firms in a given market (like in Taiwan). However, even in Taiwan, only 21 domestic banks (out of a total of 31 banks[142]) have signed up to the Equator Principles pursuant to the Banking Bureau.[143] The approach taken in Taiwan may indicate that semi-mandatory implementation of the Equator Principles in domestic regulations may have some effect, but there are still a significant proportion of banks failing to officially adopt the Equator Principles.

In addition, the effectiveness of initiatives may be influenced by the nature of targeted firms. Following the discussion in Part II, the state could exert more authority over highly regulated entities compared to those that are more lightly regulated or unregulated ones. Therefore, in theory, this article expects that financial firms that are subject to more regulatory intensity could be under more pressure to sign up to certain voluntary codes. For instance, the largest banks in the U.K.[144], which are presumably subject to more stringent supervision due to their size, have all signed up to the Equator Principles[145], whereas the rate is apparently much lower among other smaller banks. This may indicate that larger banks may be more inclined to sign up to the Equator Principles due to their size (which naturally attract more regulatory attention) and business interests (e.g. reputation), even in the absence of direct regulatory mandate.

In summary, the effectiveness of the voluntary code model is influenced by regulatory intensity. Limited evidence indicates that the adoption rate of voluntary codes, such as the Equator Principles or Stewardship Code, does not seem to be very high in the U.K. This aligns with this argument that the lack of mandatory pressure may compromise the impact of those voluntary codes,

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[141] See article 20-1 of the guidelines. See website of Bankers Association, https://www.ba.org.tw/Upload/Important/38c042e7-fa61-4bff-88c6-7dc5733f0d1e/授信準則全文 10701.pdf (last visited Feb. 5, 2025).
[142] See website of Financial Supervisory Commission for the full list of licensed financial institutions in Taiwan, https://www.banking.gov.tw/ch/home.jsp?id=642&parentpath=0,590,604 (last visited Feb. 6, 2025).
[143] See website of Banking Bureau under the Financial Supervisory Commission, *The Equator Principles*, https://www.banking.gov.tw/ch/home.jsp?id=793&parentpath=0,8 (last visited Feb. 6, 2025).
[144] The list includes Barclays Bank, HSBC, Lloyd's Banking Group, and National Westminster Bank.
[145] See *supra* note 133.

starting from the adoption rate by targeted financial firms. However, it does not necessarily imply that the state should adopt a more mandatory approach to implement those initiatives. The following sections will elaborate on the reasons.

ii. Market Demand and Business Interests

As Part II discusses, the decisions of financial firms to commit to the regulatory initiatives mentioned above, and their subsequent implementation to influence customer behavior, must also depend on the elasticity of market demand for financial services and the business interests of financial firms. First, as discussed in Part II, market demand may determine how effective financial firms can influence their customers' conduct regarding ESG and sustainability. This article argues that this is where different initiatives may face challenges. However, it is important to note that actual market demand for specific types of financial services can vary significantly based on prevailing market conditions, which this article does not delve into in detail.

For instance, the Equator Principles specifically target bank loans for project finance. However, project operators do not always depend on banks as the primary source of financing. Some firms may rely on their own funds or can tap the capital market to acquire fundings. In such cases, lower reliance on bank loans may translate into greater elasticity in consumer demand. Therefore, the ability of banks to impose more restrictions related to environmental and social concerns under the Equator Principles could be much compromised, as those restrictions may deter such project operator from borrowing from banks and encourage them to seek less restrictive financing alternatives.

If this argument holds true, it indicates that a single initiative, such as the Equator Principles, may not be effective unless the whole financial market (or at least a significant part of it) can have coordinated actions with most financial firms adopting the same practices in the market when offering different forms of finance. Conversely, it implies that the likes of Equator Principles should be most effective on project operators that need bank loans for finance. This naturally limits their effectiveness in practice. In fact, pursuant to website of International Renewable Energy Agency (IRENA)[146], among the 16,524 projects related to renewable energy in the world until July 2022, only 4,571 projects (27.66%) relied on debt financing, in contrast with 11,302 projects

[146] International Renewable Energy Agency, *Renewable Energy Finance Flows*, https://www.irena.org/Data/View-data-by-topic/Finance-and-Investment/Renewable-Energy-Finance-Flows (last visited Jan. 23, 2025).

(68.40%) dependent on government or private grants. Thus, the impact of the Equator Principles to exploit banks as a surrogate regulator to incorporate ESG factors into project finance for renewable projects could be limited, though there could still be many projects counting on bank loans or other debt instruments for finance.

Second, financial firms' business interests may influence their commitment to address ESG and sustainability issues. On the one hand, the financial surrogate regulatory approach may not be inherently an integral part of a financial firm's core business model if the purpose is to promote ESG and sustainability. Sometimes, they do have reasons to pursue some ESG goals on their own. For instance, banks and insurers should have an interest in addressing global warming and to manage risks to their mortgage or insurance portfolio. Such as more hurricanes or heatwaves could cause damage to mortgaged or insured properties that might result in losses of financial firms (e.g. insurance payments or losing collateral for bank loans). Financial regulators in the world also recognize the issue and currently working on better risk management[147] and disclosure practices, such as the Task Force on Climate-Related Financial Disclosures (TCFD) under the Financial Stability Board[148], for financial firms. Therefore, banks and insurers have natural interests to address global warming.

Nevertheless, it is also clear that not every ESG or sustainability issue relates to the business models of banks and insurers. For example, it is harder to see how biodiversity may affect quality of loans or insured properties without further scientific evidence. Simply put, the question is whether most investors prioritize making profits or advancing specific ESG goals when these objectives are not in alignment? It will need expansive empirical studies in different markets to know the answers, which would reveal the direction of market force that may in turn shape the conduct of institutional investors for a specific ESG issue. The potentially diverse interests of various financial firms and institutional investors in the market may also undermine the impact of a signatory firm of the voluntary codes on the market, unless the investor has a predominant influence over an investee company.

In addition, the shareholding structure of a company influences the interaction between corporate management, controlling shareholders, and institutional investors, even if the latter can

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[147] See e.g. BANK FOR INTERNATIONAL SETTLEMENTS, *Principles for the Effective Management and Supervision of Climate-Related Financial Risks*, (2022), https://www.bis.org/bcbs/publ/d532.htm (last visited Feb 6, 2025).
[148] TCFD, *TCFD Recommendations*, https://www.fsb-tcfd.org/recommendations/ (last visited Feb. 4, 2025).

act collectively. For example, assuming a majority shareholder controls over 50% of voting shares and more than half of the board, the shareholder/controller does not necessarily have to worry about pressure from institutional investors. In such case, efforts made by institutional investors to play some kind of surrogate regulatory function may be futile. In contrast, if a company is majority owned by a few institutional investors, they should be able to exert more authority over corporate management, assuming they can collectively decide to push the management of investee company to pursue ESG or sustainability goals. Similarly, regarding Stewardship Code, fragmentation of share ownership may make it unlikely to foster greater shareholder involvement in corporate governance.[149]

Ultimately, it comes down to how much the market values specific ESG or sustainability goals and whether the invisible hands are sufficient to influence corporate management decisions, despite all the rhetorics and moral persuasion. This article does not address the debates surrounding underlying values of ESG arguments and their justification. This article simply suggests that the market may respond differently given the range of issues under the umbrella or ESG or corporate social responsibility, "diversity, equality and inclusion", and Sustainable Development Goals (SDGs)[150], etc. It is likely that some ESG factors do not have discernible impact on a financial firm's business interests and decisions. In relation to bank loans, a bank's major concern is to recover the loan and interest income in the future. For fund management firms, the primary goal is to generate proceeds from their investments to meet the expectation of their investors. Unless specific ESG factors (e.g. efforts made to cut carbon emission or gender equality) correlate with business concerns of financial firms (e.g. the ability to repay a loan) with sufficient robustness[151], financial firms may not instinctively consider ESG factors when making normal business decisions.

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[149] Brian R. Cheffins, *The Stewardship Code's Achilles' Heel*, 73 MODERN LAW REVIEW 1004, 1023-1024 (2010).
[150] The United Nations Department of Economic and Social Affairs has set 17 Sustainable Development Goals (SDGs). See United Nations Department of Economic and Social Affairs, *The 17 Goals*, https://sdgs.un.org/goals (last visited Feb. 8, 2025).
[151] Citing some recent studies as examples, there are literature showing that better ESG performance may indicate less credit risk. Benjamin Hübel, *Do Markets Value ESG Risks in Sovereign Credit Curves?,* 85 THE QUARTERLY REVIEW OF ECONOMICS AND FINANCE 134 (2022)(a country's ESG performance meaning less sovereign credit risk); Christopher C. Bruno & Witold J. Henisz, *Environmental, Social, and Governance (ESG) Outcomes and Municipal Credit Risk,* 63 BUSINESS & SOCIETY 1709 (2024)(better ESG and less U.S. municipal credit risk); Mengze Wu & Dejun Xie, *The Impact of ESG Performance on the Credit Risk of Listed Companies in Shanghai and Shenzhen Stock Exchanges,* 6 GREEN FINANCE 199 (2024)(lower risk of default with better ESG among Chinese listed companies); Florian Barth, Benjamin Hübel & Hendrik Scholz, *ESG and Corporate Credit Spreads*, 23 THE JOURNAL OF RISK FINANCE 169 (2022)(finding a U-shape impact between ESG performance and reduction of credit risk). However, there are also more cautionary findings. For example, a study of Malaysian and Indonesian market

In other words, the financial surrogate regulatory approach should be more effective if there is a strong market demand pushing financial firms to be surrogate regulators for ESG and sustainability. Thus, it is overly simplistic to assume that financial firms and institutional investors can jointly influence the behavior of investee companies and their management. The initiatives mentioned in Section 1 above mostly impose obligations on financial firms to take additional and sometimes unrelated factors into a financing decision. It is still subject to longer-term research on the correlation between ESG factors (whatever they are) and risks or profitability of financial transactions. The state should carefully analyze the structure and conditions in a given market to understand the potential impact financial firms or institutional investors could have on the market and market participants in the short-, mid- or long-term.

iii. Transaction Costs

The voluntary code approach is not immune from potentially high transaction costs if a signatory firm aims to fully implement the principles in these codes. First, there are costs associated with acquiring information necessary to enable financial firms to effectively regulate their customers to achieve ESG goals. For instance, if the goal is to reduce emission of carbon dioxide to address global warming, financial firms must know the exact amount of carbon emission produced by a customer company, not only in a single year but also on a longer timeframe, to assess the company's carbon footprint and potential climate risks. Financial firms also need to know the client's strategy and concrete actions to cope with climate-change risk to assess a customer's future climate risk. Similarly, if the objective is to promote equal pay among genders, financial firms also need to know a customer's information related to its workforce and remuneration between genders for more comprehensive assessment.

In addition, there are costs associated with producing and verifying information. For instance, a bank may not have accurate carbon emission figures for a customer unless the customer provides data or grants full access to their business operations. Inevitably much information must be provided by the customer, who may have concerns over sharing information with financial

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shows that ESG scores may not impact the rate of non-performing loans. Annisa Fithria & Surya Darma, *ESG and Credit Risk: Evidence from Indonesian and Malaysian Banks*, 11 JURNAL REKSA (ONLINE) 193 (2024). Another study in Taiwan finds that better ESG performance may reduce credit risk but other than carbon emission and water consumption. Yu-Jia Ding, Jiunn-Liang Guo & Cai-Wen Tsai, *The Influence of ESG Performance on Credit Risk and Financial Distress: An Empirical Study on Taiwan Corporate Sustainability*, APPLIED ECONOMICS 1 (2024).

firms (e.g. business secrets or privacy). Measuring and verifying carbon emissions, including Scope 1 and Scope 2 emissions[152], incurs costs. The costs may increase further if scope 3[153] emission data is required, as a customer company must know the carbon footprint of its suppliers. In addition, like accounting information, carbon emission data also needs to be audited and verified by a qualified third-party to ensure credibility, implying more transaction costs. Although there seems to be no universal pricing of how much it may cost to measure a company's total carbon emission, a U.K. report estimated that absolute "monitoring, reporting and verification costs" (MRV costs) may range from a few pounds sterling per ton of carbon to over £200 per ton.[154] For larger companies, there could be significant costs simply to know the exact figures of carbon emission. For smaller companies, the costs could be prohibitive. When customer companies struggle to produce sufficient and credit information, it would be even more challenging for financial firms to acquire information to at least incorporate environmental factors into their business decisions to implement these regulatory initiatives.

Comprehensive public disclosure may mitigate financial firms' information costs. The Carbon Disclosure Project (CDP), a non-profit organization, provides a platform for disclosure of carbon emission and some other environmental information, claiming participation from over 18,700 of world's largest companies disclosing their emission data as in October 2022.[155] Nonetheless, it is evident that there are far more companies of various sizes globally than those reporting to the CDP. This article has no access to the CDP dataset, as it is proprietary and not freely available to the public. Hence, this article cannot evaluate whether data from the CDP dataset is sufficient to cover information necessary for financial firms to assess environmental impact for a particular initiative (e.g. a large project following the Equator Principles or shipping companies following the Poseidon Principles). In theory, more disclosure through the TCFD and

[152] Scope 1 emission refers to carbon dioxide emission from sources owned or controlled by a company. Scope 2 refers to emission from generation of purchased electricity consumed by the company. WORLD RESOURCES INSTITUTE, T*he Greenhouse Gas Protocol: A Corporate Accounting and Reporting Standard (Revised Edition)*, at 25, https://ghgprotocol.org/sites/default/files/standards/ghg-protocol-revised.pdf (last visited Feb. 6, 2025).
[153] Scope 3 emission refers to other indirect emission due to a consequence of activities of a company from sources not owned by the company. *Id.*
[154] LEO MERCER, JOSH BURKE & SUE RODWAY-DYER, *Towards Improved Cost Estimates for Monitoring, Reporting and Verification of Carbon Dioxide Removal*, (2024), at 8 (Figure S1a), www.lse.ac.uk/granthaminstitute (last visited Jan 24, 2025).
[155] Carbon Disclosure Project, *CDP Media Factsheet*, https://cdn.cdp.net/cdp-production/comfy/cms/files/files/000/003/419/original/CDP-Media-Factsheet.pdf (last visited Feb. 6, 2025).

national efforts to help financial firms to gather information about carbon emission. Nevertheless, there remains measuring and verification costs borne by their customers.

The discussion above uses carbon emission data as the example. Considering the range of ESG or sustainability issues, the overall information costs could be much higher. A paper estimates that the costs to create sustainability reports in Europe may amount a reasonable estimate of 17,000 euros for a company with less than 1,000 employees in addition to a reasonable estimate of 7,200 euros for verification costs.[156] For a large company with over 5,000 employees, a reasonable estimate of preparation costs amounts to 197,000 euros and 30,000 euros for verifying the reports.[157] The sum could be quite significant.

Second, there are also monitoring costs. It is one thing when financial firms require customers to do something, but it is another to ensure the customers comply with the requirements. Not only continuous monitoring may incur significant costs, but financial firms may lack sufficient incentives to monitor at all. For instance, to implement requirements in a Stewardship Code, it may require significant manpower and resources for an index fund (e.g. a fund investing in all the firms in an index like S&P 500) to effectively monitor all its investee companies and to engage with their management on a regular basis. Even with the resources, there is no guarantee that the fund management company may be able to supervise and monitor corporate governance standards of all these investee companies.[158] A study in the U.S. has shown that the largest three fund management companies only engaged with less than 10% of investee companies in their portfolio.[159] In addition, for a large project, banks' monitoring capacity is limited by the fact that banks most likely can intervene only during the financing stage during a long lifespan of a project (from planning to financing and completion), compared with other interested groups (e.g. non-government organizations).[160]

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[156] Kristina Rudžionienė & Šarūnas Brazdžius, *Cost and Benefits of Sustainability Reporting: Literature Review*, *in* SUSTAINABLE PERFORMANCE IN BUSINESS ORGANISATIONS AND INSTITUTIONS: MEASUREMENT, REPORTING AND MANAGEMENT 58 (Table 3.1) (2023).
[157] *Id*.
[158] Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUMBIA LAW REVIEW 2029, 2051 (2019); Bobby V. Reddy, *The Emperor's New Code?: Time to Re-Evaluate the Nature of Stewardship Engagement under the UK's Stewardship Code*, 84 MODERN LAW REVIEW 842, 855 (2021).
[159] Bebchuk and Hirst, *supra* note 158, at 2088.
[160] Paul Q. Watchman, Angela Delfino & Juliette Addison, *EP 2: The Revised Equator Principles: Why Hard-Nosed Bankers Are Embracing Soft Law Principles*, 1 LAW AND FINANCIAL MARKETS REVIEW 85, 96 (2007).

High monitoring costs in combination with information costs may deter financial firms from conducting intensive monitoring, which in turn might compromise the role of financial firms as surrogate regulators for ESG and sustainability. Therefore, it has been argued that policymakers should focus more on issues that may cause systemic risk for stewardship rather than spreading resources to a wide range of ESG factors.[161] Another commentator also similarly suggests that "stewardship disclosure should focus on types of engagement that institutional investors are motivated to exercise in practice, such as engagement in response to hedge fund activism and on systemic risk.[162]

Furthermore, some of ESG issues may require collective action on a global scale. There may be a free-rider problem that could disincentivize some financial firms from fully and effectively implementing voluntary codes.[163] For example, global warming necessitates worldwide efforts to reduce carbon emission. There could be significant enforcement costs associated with ensuring that both financial and non-financial firms take actions to address climate change, and it is unlikely that any single financial firm, regardless of its size, can make a substantial impact alone. In addition, considering all the transaction costs, any benefit generated by a financial firm's regulation of its customers to reduce carbon emission would be shared by all market participants. This implies that some firms may choose to be a free rider rather than taking actions. If the problem of free riding persists, it may then deter a responsible financial firm to comply fully with the voluntary codes that it sings up to, thereby undermining the effectiveness of the financial surrogate regulatory approach for certain ESG or sustainability issues.

3. Summary

In summary, policymakers globally encourage financial firms to be surrogate regulators for ESG and sustainability goals through several regulatory initiatives like the Equator Principles or Stewardship Codes. This is against the backdrop that business models of financial firms do not naturally include many ESG or sustainability considerations, though some issues may deeply affect a financial firm's businesses. While adherence to those initiatives is mostly voluntary in nature, there can be significant information and monitoring costs for both financial firms and their

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161 Jeffrey N. Gordon, *Systematic Stewardship*, 47 THE J. OF CORP. L. 627, 627 & 647 (2022).
162 Bobby V. Reddy, *The Emperor's New Code?: Time to Re-Evaluate the Nature of Stewardship Engagement under the UK's Stewardship Code*, 84 MODERN LAW REVIEW 842, 842 (2021).
163 Bebchuk and Hirst, *supra* note 158, at 2052.

customers. This may explain why policymakers worldwide currently prefer a voluntary or comply-or-explain approach rather than a more mandatory one like AML\CFT rules. This method may help to avoid imposing high costs on all financial firms and their customers to shoulder potentially high costs at least initially. It is important to note that business interests of financial firms and high transaction costs may undermine their willingness and actions to act as surrogate regulators of a wide range of ESG and sustainability issues.

The discussion above has demonstrated that the voluntary approach model combined with potentially high costs may have led to relatively low participation rate for some of the initiatives mentioned above. This indicates that financial firms simply choose not to participate without sufficient regulatory pressure when their business interests and transaction costs do not justify. In addition, even among signatory firms or those who comply with the codes voluntarily without being a signatory, this article predicts that high transaction costs may increase the chance of greenwashing or more broadly, ESG-washing. It is also possible that firms only comply to the point where it is more cost effective (like the case of liability insurer for corporate governance) rather than taking a more active role. In this situation, it is arguably against the legislative purpose and policy goals. For the same reasons, this article is also against the idea of using mandatory rules to force financial firms to sign up to global initiatives mentioned above or the Stewardship Code.

IV. Reflection on Financial surrogate regulatory approach and Existing Models

This article explores the general rationale and limitations of the financial surrogate regulatory approach. As outlined in Part II, the state is positioned to regulate through financial firms due to the highly regulated nature of financial services and the market's demand for finance. The interaction of these factors enables the state to achieve certain policy objectives or to enforce an existing legal regime via financial firms.

However, there are limitations to the financial surrogate regulatory approach. Regulatory intensity may differ among different types of financial firms, and the choice of legal device may affect their willingness to comply with the state demands. Moreover, fluctuations of market demand can hamper a financial firm's ability to regulate its customers through provision of financial services and contractual terms. Transaction costs associated with acquisition of information, monitoring and enforcement. Those factors may undermine financial firms' compliance with the state's request to be surrogate regulators and their ability to influence customers' conduct. Consequently, it may impact the extent to which policy objectives are achieved, thereby diminishing the purpose of the financial surrogate regulatory approach.

Given those limitations, this article predicts that financial firms may be less inclined to comply with the state's demand unless compelled or when their business interests happen to coincide with those of the state. Even when compliance is mandated, financial firms may not fully implement the requirements beyond the extent of their business interests. In addition, transaction costs are likely to be passed to their customers, thereby generating externalities associated with the financial surrogate regulatory approach. Furthermore, it may incentivize superficial compliance if financial firms and/or their customers cannot fully absorb the associated costs.

On this basis, Part III examines three different models of employing financial firms as surrogate regulators. First, the private ordering model involves a financial firm acting as a surrogate regulator through its business operations. This is exemplified by the role of liability insurers in overseeing the conduct of their insured persons. The private ordering model does not count on intensive regulatory pressure but rather on the firm's own motivation to assess and manage risks associated with a customer or transaction. Thus, when the state's regulatory interests coincide with a firm's business interests, the firm naturally would play some degrees of regulatory role. The state can trigger demands for a particular type of financial service. Given their business interests, financial firms may request customers to provide information before and/or during a financial transaction (e.g. an insurance policy), thereby reducing the state's information costs. Otherwise, they may choose not to provide any service.

However, even the private ordering model is limited by other transaction costs. As discussed in Part III.A, it may be costly to monitor the conduct of insured persons on a regular basis. Hence, financial firms may simply choose not to transact with a customer. As a result, financial firms do not have to play any regulatory role. Financial firms could also choose to be passive regulators for behaviors that are below the minimum acceptable standards rather than acting as an active regulator to promote higher standards. This would reduce the effectiveness of relying on financial firms to be surrogate regulators.

In addition, in a competitive market, a financial firm may hesitate to impose more stringent requirements than other competitors to avoid losing business. Hence, market conditions can constrain their ability to regulate. While the state could potentially influence market demand for specific financial services to encourage financial firms to act as surrogate regulators, the sustainability of such regulatory interventions must depend on market conditions, such as the insurability of certain risks.

Second, the state may mandatorily require financial firms to act as surrogate regulators. This is exemplified by AML\CFT rules. Since the rules are mandated by law and fiercely enforced by most states, financial firms have little flexibility to maneuver compared with the private ordering model. However, mandatory legal requirements do not eliminate potential transaction costs such as information gathering and transaction monitoring. Given that mandatory application of AML\CFT rules can sometimes result in hefty penalties, those costs and penalties may eventually be transferred to the market, affecting investors and customers. This can lead to negative externalities. When a customer’s demand for certain financial services has high elasticity, the customer might opt for other available alternatives. Some customers may also be excluded from the financial system due to higher risk and transaction costs. If customers avoid engaging with financial firms for services due to high costs, it may then limit the impact of mandatorily using financial firms as a regulator or law enforcement vehicle.

Third, an emerging trend is to rely on financial firms committing to voluntary codes (e.g. the Equator Principles) to integrate certain ESG or sustainability factors into financial services and indirectly nudge their customers to have better ESG or sustainability practices. The voluntary code model stands between the private ordering model and the mandatory model. This underscore that ESG and sustainability are not always inherent in the business models of financial firms (so that private ordering may not work), and high transaction costs mean that mandatory rules are probably not suitable. However, high transaction costs may discourage financial firms from committing to these voluntary codes. Without adequate market participation, the impact of voluntary codes may be limited. In addition, even among participating financial firms, high transaction costs and fluctuations of market demand may hinder fully compliance and implementation of the requirements in these codes. Both financial firms and their customers may engage in some degrees of ESG-washing. This would undermine the efficacy of these voluntary codes.

Based on the discussion above, one policy question is the conditions to make financial surrogate regulatory approach work. Reflecting on the three models, this article has the following suggestions. First, this article argues that the financial surrogate regulatory approach is more likely to be effective if the state's regulatory objectives are aligned with financial firms' business interests. This may naturally induce financial firms to play surrogate regulatory function to the extent limited by their business interests through private ordering during the provision of financial services. This may also help financial firms to internalize at least some transaction costs into their business operations. In other words, the state should avoid adopting the mandatory model to force financial firms to act as surrogate regulators beyond a financial firms' inherent business interests. The voluntary code model may balance the private ordering and mandatory models to incentivize financial firms to take on some regulatory responsibilities. However, the approach still does not fully address the limitations posed by transaction costs.

Second, the state should aim to reduce transaction costs to encourage financial firms to actively act as surrogate regulators regardless the legal device chosen. Instead of outsourcing information and monitoring costs to financial firms (and then to the market) completely, the state should consider ways to reduce market participants to generate useful information to the market, thereby reducing overall information and monitoring costs. This may help to control negative externalities of the financial surrogate regulatory approach to the market and curb window-dressing, ESG- or greenwashing activities it financial firms and their customers can comply with the state's requirements at reasonable costs. Each context requires specific solutions due to diverse issues ranging from law enforcement to ESG concerns. This should be subject to future studies to substantiate in each individual field.

V. Conclusion

In conclusion, this article identifies an emerging trend in the past two decades of utilizing financial firms (including banks, insurers, and capital market firms) as proxy regulators through provision of various financial services. Essentially, the state can leverage finance as an instrument to accomplish policy objectives. However, this article contends that while the financial surrogate regulatory approach could be one of the methods to encourage market participants to meet specific regulatory goals, it may not be the most efficient approach comparing to other regulatory regimes, especially considering the potentially high transaction costs imposed on financial firms. Thus, the state should avoid excessively relying on financial firms to act as surrogate regulators and weaponizing finance as a regulatory tool simply because finance is essential to the economy and financial firms are generally highly regulated, especially when the regulatory objectives are as wide as the broad concepts of ESG or sustainability. Instead, the state perhaps might consider viewing financial firms as playing a more facilitative role in terms of regulating and achieving policy goals.

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