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# RESPONSIBILITY OF FINANCIAL MARKET SUPERVISORY AUTHORITIES: CURRENT REGULATORY FRAMEWORK AND EXPECTATIONS

## *Annatosiya*

*Qlobal maliyyə böhranı baş verdikdə maliyyə bazarlarına nəzarət sahəsindəki tənzimləmə diqqət mərkəzində olur: maliyyə bazarlarının fəaliyyətini tənzimləyən və bu sahədə müvafiq nəzarəti həyata keçirən tənzimləyici qurumların fəaliyyətindəki boşluqlar üzrə çıxır, dövlətlər tərəfindən bu sahədəki mövcud tənzimləmə təhlil edilir və zəruri islahatlar aparılır. Məqalədə maliyyə bazarları sahəsindəki tənzimləmə və nəzarəti təhlil edilir və bu fəaliyyətdən irəli gələn məsuliyyət araşdırılır. Məqalənin məqsədi müqayisəli təhlil vasitəsilə maliyyə bazarlarını tənzimləyən və bu sahəyə nəzarət edən qurumların öz fəaliyyətindən irəli gələrək bazarın peşəkar iştirakçıları, o cümlədən onların səhmdarları və vətəndaşlar-istehlakçılar qarşısındakı məsuliyyət dərəcəsini müəyyən etməkdir.*

## *Abstract*

*Regulation of financial markets come into the spotlight after the global financial crisis: gaps in the activities of the regulators<sup>1</sup> supervising financial markets and exercising proper oversight in this area becomes apparent, the existing regulations are analyzed and necessary reforms are made by the states. This article analyzes the regulation and supervision of financial markets and examines the responsibilities<sup>2</sup> arisen out of these activities. The purpose of the article is to conduct a comparative analysis to determine the degree of responsibility of the authorities that regulate and supervise the financial markets before professional market participants, their shareholders, as well as citizens – consumers.*

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<sup>1</sup> For the purposes of this article “agency”, “supervisory authority” and “regulator” should be interpreted in the same meaning.

<sup>2</sup> For the purposes of this article, “responsibility”, “liability” and “accountability” should be interpreted in the same meaning.

## Introduction

Can the financial market supervisory authority incur liability before the participants of the market hereof because of a failure of the supervised institution? How the activity of the regulator is governed? Is it necessary to consider the role of the immunity of the financial market regulator from third party liability and if it is subject to challenge or not?

Financial Market supervisors' accountability is widely accepted as a *sine qua non* condition<sup>3</sup> of good governance and as a guarantor of supervisory independence. Some European Union (EU) Member States have statutory protections in place, giving their financial supervisors immunity from third party liability, while others submit them to their regular, civil liability rules.<sup>4</sup> While the general right to damages for losses arising from civil wrongs is well established, liability for faulty supervisory acts or omissions is in many respects, limited in scope. The liability of supervisory/public authorities is varied in the standard of care.<sup>5</sup>

The topic is complex as liability falls in the area where tort law meets administrative law. Administrative law is concerned with the exercise of public powers, and tort law provides private law remedies. Citizens rely upon governments and regulators to protect us from harm and understandably look for compensation when public authorities fail to deliver. <sup>6</sup>Another reason is that claims against financial market supervisory authorities give rise to a range of conceptual difficulties, including the principle of the protective purpose of the norm, liability for the exercise of judicial or quasi-judicial functions, liability for economic loss, liability for omissions, and deliberate acts of third parties.

In all, there is always an enormous need for financial supervisor to balance potentially conflicting interests of consumers and supervised institutions itself and the broad public interest in the stability of the financial system as a whole. The design of regulatory and supervisory responsibilities is one the most important matters affecting the future course of financial market policy.

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<sup>3</sup> A description of a requisite or condition that is indispensable.

<sup>4</sup> Phoebus Athanassiou, *Financial Sector Supervisors' Accountability, European Perspective*, Legal working paper series, 13 (2011).

<sup>5</sup> Donal Nolan, *Varying the Standard of Care in Negligence*, 72 *Cambridge Law Journal* 651, 651 (2013).

<sup>6</sup> Freya Kristjanson and Stephen Moreau, *Regulatory Negligence and Administrative Law*, 25 *C.J.A.L.P.* 103, 104 (2012).

## I. Existing Regulation on Financial Markets and Its Supervision: Republic of Azerbaijan

Financial Market Supervisory Authority of the Republic of Azerbaijan (hereinafter referred to as “FIMSA”) was established on February 03, 2016 in the organizational legal form of a public legal entity and later was abolished on November 28, 2019. Concurrently, the State Committee for Securities, State Insurance Supervisory Service under the Ministry of Finance of the Republic of Azerbaijan, and Financial Monitoring Service under the Central Bank of the Republic of Azerbaijan were abolished and their powers were assigned to a single agency - FIMSA.<sup>7</sup> The FIMSA aimed to ensure flexibility and transparency of the securities market, investment funds, banking and insurance activities, payment systems in the Republic of Azerbaijan, and to improve the regulatory and supervisory system.<sup>8</sup>

Abolished FIMSA,<sup>9</sup> also assumed banking supervisory\*<sup>10</sup> functions of the Central Bank of the Republic of Azerbaijan (hereinafter referred to as “Central Bank”) whereas Central Bank had remained to maintain certain functions as well. Therefore, during this period, the supervision over the financial markets was in the hands of both Central Bank and FIMSA. However, since the FIMSA is abolished, financial markets are now regulated by the Central Bank.

FIMSA’s goals were further elaborated in the Strategic Road Map On the Development of Financial Services in the Republic of Azerbaijan (hereinafter referred to as “Strategic Roadmap”) approved in 2016.<sup>11</sup> According to the Strategic Roadmap below-mentioned strategic targets should have been achieved by FIMSA during 2017-2020:

- 1) Increase in profitability of the banking sector by 7 percent compared to 2015 and 130 million Azerbaijani manats increase in real GDP in 2020 (directly 115 million Azerbaijani manats, indirectly 15 million Azerbaijani manats);
- 2) 1.4 percent insurance penetration (ratio of insurance premium volume to non-oil GDP), 125 million Azerbaijani manats impact on real GDP in 2020 and creation of 1600 new jobs;
- 3) Improving the provision of financial services;
- 4) Entrance of 5 additional companies from significant sectors to stock exchange;

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<sup>7</sup> Decree of the President of Azerbaijan Republic, 03.02.2016, No. 760.

<sup>8</sup> *Ibid.*

<sup>9</sup> Order of the President of Republic of Azerbaijan, 28.11.2019.

<sup>10</sup> The act of monitoring the financial performance and operations of banks to ensure that they are operating safely and soundly and following rules and regulations.

<sup>11</sup> Decree of President of the Republic of Azerbaijan, 06.12.2016, No. 1138.

5) 7 percent increase in profitability of the banking sector compared to 2015, Real GDP growth of 130 million manats in 2020 (direct 110 million manats, indirect 15 million manats).

6) Reduction of non-performing loan ratio up to 8 percent, increase of financial depth by 60 percent,

7) Ensuring the participation of all retail banks in digitalization initiatives, an additional 20 percent increase in the merged profitability of retail banks in 2020 due to digitalization.

In 2018, the organizational structure of the FIMSA has been changed under the Decree of the President of the Republic of Azerbaijan On additional measures to ensure the activities of the FIMSA of the Republic of Azerbaijan.<sup>12</sup> This reform could be evaluated as an attempt to improve the functioning of FIMSA.

Subsequently, FIMSA failed to achieve the majority of the goals outlined in the Strategic Roadmap was abolished by Order of the President of the Republic of Azerbaijan dated November 28, 2019. The order indicated that improvement of the management of the regulatory and supervisory system in the financial services market as a reason for the abolition of FIMSA. Generally, The regulator exists to achieve objectives considered by the government to be in the public interest<sup>13</sup>. Unlike the situation before the establishment of the FIMSA, the Central Bank exercises control not only over the banking sector but also over the financial markets as a whole.

In these contexts, some questions arise: Is regulation and supervision by a single supervisor is more efficient? How should the supervisor's responsibility degree be measured? In the next headings, these issues will be analyzed.

## II. Types of Regulation and Supervision

The mere meaning of the regulation and supervision, although looking very similar to each other, differs. While regulation involves the decision-making and law-making processes, supervision involves the monitoring, auditing the transactions, and business issues based on the regulative legal acts.<sup>14</sup>

The supervisory regimes are grouped taking into account the three dominant models of supervision proposed so far: <sup>15</sup>

1) Vertical model (silos model), where every sector is supervised by each different authorities, following the boundaries of the financial system

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<sup>12</sup> Decree of the President of Republic of Azerbaijan, 04.10.2018, No. 288.

<sup>13</sup> OECD, Principles for the Governance of Regulation, Public Consultation Draft, 50 (2013).

<sup>14</sup> Sotiris I Demegiotis, The Hard- to drive Tandem of Immunity and Liability of Supervisory Authorities: Legal Framework and Corresponding Legal Issues, 9 Journal of Banking Regulation 131, 132 (2008).

<sup>15</sup> Donato Masciandaro and Marc Quintyn, The Architecture of Insurance Supervision before and after the Financial Crisis, Paolo Baffi Centre Research Paper No. 2010-79, 6 (2010).

in different spheres of business. For example, the banking sector, securities, and insurance sector is supervised by a separate supervisor;

2) Horizontal model (peaks model) in which every goal is supervised by different authority follows the difference between the public goals of regulation; For example, separate supervisors are responsible for activities regarding the price stability target, licensing activity, transactions in securities market executed;

3) Unified model, where a single authority supervises the entire financial system in pursuing all public goals.<sup>16</sup>

The emerging literature on financial supervision architecture has also tried to shed some light on the impact of the supervisory structure on the performance of the banking and financial industry. Two major questions are:<sup>17</sup>

- Is a single supervisor to be preferred over multiple authorities?

The unified model creates synergies among different supervisory functions and expertise (supervisory efficiency) and eliminates duplicated controls and regulatory gaps (supervisory neutrality). Additionally, an unified supervisory structure might increase the effort of the supervisor, since the unified structure makes it absolutely evident where the responsibilities are clear (supervisory responsibility).<sup>18</sup>

While pros of unified supervision are that it is easier to achieve efficiency in supervising financial market, to eliminate duplications of efforts, and to ensure possibly improved accountability, cons are that if the objectives of supervision are not clearly specified may be less effective than unified supervisors, additionally, possible diseconomies of the scale.<sup>19</sup> For example, there can be a gap that if the banks are engaged in activities related to the securities market, the matter should be solved whether this type of actives should be supervised by the supervisor over the banking sector or supervisor over the securities market or both of them.

However, it has been claimed that no superior model of supervision exists.<sup>20</sup> and universally valid answer to the question of how should be done. For example, if the objectives are not clearly specified in the unified model, it may be less effective than specialized supervisors or if the objectives are not clearly communicated, the moral hazard problems may be extended across

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<sup>16</sup> *Ibid.*

<sup>17</sup> Donato Masciandaro and Marc Quintyn, Reforming financial supervision and the role of central banks: a review of global trends, causes and effects (1998-2009), CEPR Policy Insight No.30, 8 (2009).

<sup>18</sup> Lucia Dalla Pellegrina and Donato Masciandro, Politicians and Financial Supervision Architectures: Trends and the Italian case, 3 (2007).

<sup>19</sup> *Id.*, 4.

<sup>20</sup> Donato Masciandaro, Maria J. Nieto and Marc Quintyn, Will They Sing the Same Tune? Measuring Convergence in the new European System of Financial Supervisors, IMF Working Paper, WP/09/142, 9 (2009).

the whole financial system regarding the supervised institutions, stakeholder and ultimately consumers.<sup>21</sup>

- Should the central bank be involved in supervision?<sup>22</sup>

From the banking point of view, central banks are in a position to identify the problems within the financial system earlier than supervisors only in the banking sector are able as the main function of the central bank is to implement monetary policy. Moreover, central banks can perform the necessary interpretation of prudential data within the context of the economy as a whole.<sup>23</sup>

### III. Accountability of Financial Market Supervisors

Accountability can be defined as a social relationship between a participant/actor and a forum in which the participant is obliged to explain and justify his/her conduct.<sup>24</sup> Accountability together with the transparency based on the instrument of soft law-regulators are not held accountable to political agents but mainly to national and international economic participants. It rules involve legal procedures and parameters for monetary actions.<sup>25</sup>

Before examining the essence of supervisors' accountability, the liability standards arising out of accountability should be examined. Five different liability standards are differentiated depending on the policies and legislation:<sup>26</sup>

- 1) Illegality;
- 2) Ordinary fault/negligence (in the absence of specific provision for the liability of financial supervisor)
- 3) Gross fault;
- 4) Bad faith;
- 5) Complete immunity;

1) Illegal means not allowed by law/ illicit /unlawful/ contrary to law.<sup>27</sup> Sometimes this term means merely that supervisor lacks authority.<sup>28</sup> Where the illegality standard is employed, consumer need to establish that act or omission of the supervisor was unlawful as a matter of public law, it is

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<sup>21</sup> *Supra* note 18, 4.

<sup>22</sup> *Supra* note 17.

<sup>23</sup> Edgar Meister, How should regulatory and supervisory responsibilities be shared among the national functional regulators, Lecture Paper, Multinational Banking Seminar, New York, 09.06.2001, 1.

<sup>24</sup> Mark Bovens, Analyzing and Assessing Accountability: Conceptual Frameworks, 13 *European Law Journal* 447, 447 (2007).

<sup>25</sup> Mark Bovens, Two Concepts of Accountability: Accountability as a Virtue and as a Mechanism, 33 *West European Politics* 946, 946 (2010).

<sup>26</sup> Donal Nolan, Liability of Financial Supervisory Authorities, 190 (2010).

<sup>27</sup> The Law Dictionary, <https://thelawdictionary.org/illegal/> (last seen Jan. 14, 2020).

<sup>28</sup> *Ibid.*

unnecessary to demonstrate that the conduct was negligent or bad faith. For example in the Czech Republic, cases brought against the State for allegedly unlawful conduct of the Czech National Bank have been decided under the State Liability Act whereby the State is liable for any damage caused by unlawful decisions or improper actions by a person or legal entity in the course of the exercise of public functions on the State's behalf.<sup>29</sup>

2) Negligence is failing to use the level of care and caution that an ordinary person would use in similar circumstances. It often involves a careless mistake or inattention that causes an injury<sup>30</sup>. In ordinary fault, the liability of the financial supervisor is governed by an ordinary fault/negligence standard (for example, such practice exists in Denmark and Portugal). When this standard is applied, it results from the general principles of civil responsibility in the absence of specific provision for the liability of financial supervisors. There should be four elements for presence of negligence: duty, breach, causation, and damage.<sup>31</sup>

3) Gross fault/negligence. Gross Negligence means recklessness, or actions taken or omitted with conscious indifference or the complete disregard of consequences or rights of others affected.<sup>32</sup> The biggest difference is between negligence and gross negligence is in the severity of the consequences and the type of damages.<sup>33</sup> A person has fallen so far behind the reasonable standard of care that the negligence is now considered gross (for example, gross negligence standard is applied in France). In *Sieur Bapst*<sup>34</sup> case, the investors in a failed financial institution sought compensation for their losses and claimed that they were caused by the negligence of *Commission de Controle des Banques* (body exercising technical supervision over the banks' loan and investment operations) and argued that having discovered irregularities in the institutions' accounts. *The Conseil d'Etat* (a body that acts both as legal advisor of the executive branch and as the supreme court for administrative justice) held that damage would be payable only if *faute lourde*<sup>35</sup> could be established and since irregularities were commonplace in the accounts of small financial establishments, it had not been grossly negligent of the *Commission de Controle des Banques* not to investigate further.<sup>36</sup>

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<sup>29</sup> *Supra* note 26, 198 (2010).

<sup>30</sup> The Sawaya Law Firm Blog, <https://www.sawayalaw.com/blog/ordinary-negligence-vs-gross-negligence/> (last seen Jan. 12, 2020).

<sup>31</sup> *Ibid.*

<sup>32</sup> Law Insider Dictionary, <https://www.lawinsider.com/dictionary/gross-negligence> (last seen Jan. 15, 2020).

<sup>33</sup> McMinn Law Firm Blog, <https://www.mcminnlaw.com/difference-negligence-gross-negligence/> (last seen Jan. 15, 2020).

<sup>34</sup> See generally, *Sieur Bapst* case (28 June 1963).

<sup>35</sup> A desire to harm.

<sup>36</sup> *Ibid.*

4) Bad faith is an intentional dishonest act not fulfilling legal obligations.<sup>37</sup> Acting in bad faith is an act of intentional dishonesty that occurs from someone violating the basic principle of honesty in their dealings with others.<sup>38</sup> Also, bad faith conduct could include behavior that is seen as commercially unacceptable, improper, or unconscionable, but which is not actually dishonest.<sup>39</sup> In the United Kingdom, according to the Financial Services and Markets Act (FSMA) 2000, whereby neither the Financial Services Authority (FSA) nor any of its officers or members of staff are not liable for damages for anything done or omitted in the discharge, or purported discharge, of the FSA's functions, unless the act or omission is shown to have been in bad faith or to prevent an award of damages made in respect of an act or omission on the ground that the act or omission was unlawful because of Section 6.1 of the Human Rights Act 1998 approved by the Parliament of the United Kingdom.<sup>40</sup>

5) There are two types of immunity: Absolute immunity and qualified immunity. Absolute immunity is a complete bar to a lawsuit, with no exceptions. It generally applies to judicial officials like judges, prosecutors, jurors, and witnesses. The strong protection of absolute immunity is tempered by its limited application and duration. Absolute immunity is "strong medicine, reserved for comparatively few types of officials and only applies so long as the official is acting in their judicial capacity".<sup>41</sup> For example, a judge is acting in their judicial capacity when they are hearing a case, but when they hire and fire court employees they are not, and are thus entitled only to qualified immunity.<sup>42</sup> Qualified immunity is the defense that protects government officials from liability for civil damages insofar as their conduct doesn't violate constitutional rights.<sup>43</sup> Qualified immunity balances two important interests — the need to hold public officials accountable when they exercise power irresponsibly and the need to shield officials from harassment, distraction, and liability when they perform their duties reasonably.<sup>44</sup>

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<sup>37</sup> Law.com Dictionary, <https://dictionary.law.com/Default.aspx?selected=21> (last seen Jan. 14, 2020).

<sup>38</sup> Upcounsel, <https://www.upcounsel.com/acting-in-bad-faith> (last seen Jan. 14, 2020).

<sup>39</sup> Mayer Brown, Good faith – is there a new implied duty in English contract law?. Legal Update (July, 2013).

<sup>40</sup> *Supra* note 4.

<sup>41</sup> Helbraun Law Firm Blog, <https://www.helbraunlaw.com/basic-guide-to-immunity-for-government-officials.html> (last seen Jan. 25, 2020).

<sup>42</sup> *Ibid.*

<sup>43</sup> Upcounsel, <https://www.upcounsel.com/legal-def-qualified-immunity> (last seen Jan. 14, 2020).

<sup>44</sup> Legal Information Institute, Wex, [https://www.law.cornell.edu/wex/qualified\\_immunity](https://www.law.cornell.edu/wex/qualified_immunity) (last seen Jan. 17, 2020).



In the Republic of Azerbaijan, qualified immunity standard is applied.<sup>45</sup> We will examine the regulation of the Azerbaijani legislation in this area.

Additionally, accountability-inspired control instruments can be divided into five types:<sup>46</sup>

- Parliamentary accountability (reporting to the parliament);
- Ministerial accountability (reporting to a relevant ministry);
- Judicial accountability ;
- Market-based accountability;

In this article, market-based accountability will be analyzed in detail.

According to the general approach, the legislature confers powers on the regulator and the regulator should report on its outcomes to the legislature.<sup>47</sup> Independent regulators should report on the performance annually to the legislature.<sup>48</sup> Reporting to a parliament as a whole may not be optimal for effective parliamentary monitoring. So, many jurisdictions have, therefore, instituted a parliamentary committee system in order to ensure a greater degree of monitoring and reporting function.<sup>49</sup> Parliamentary committees are potentially effective and powerful accountability mechanisms<sup>50</sup>.

Upon initial examination, ministerial accountability can be understood as the accountability of the Ministers, but for the purposes of this article, it should be interpreted as reporting to relevant ministry or ministries. Some supervisors are an integral part of the government and are accountable directly to the executive.<sup>51</sup> A government composed of Ministers plays an active role in the management and financial system. So, upon the request, they may have access to the information on all activities of the financial supervisor. In this context, an administrative review of the decisions of the supervisor is also allowed. Under the Italian Banking Law, decisions by the Bank of Italy could be appealed to the Interministerial Committee for Credit and Savings.<sup>52</sup>

An independent supervisor must be accountable to those who are affected by its decisions, so the participants who have been affected should have the right of legal redress in court. In the United States, the Administrative Procedures Act explicitly provides a right of judicial review of regulator`s

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<sup>45</sup> Law on the Banks of the Republic of Azerbaijan No. 590-IIQ, Law on the Securities of the Republic of Azerbaijan No. 1284-IVQ and Law on Insurance activity of the Republic of Azerbaijan No. 519-IIIQ.

<sup>46</sup> *Supra* note 4, 12.

<sup>47</sup> *Supra* note 13, 51 (2013).

<sup>48</sup> *Id.*, 52.

<sup>49</sup> Marc Quintyn and Michael W. Taylor, Eva Hüpkes, The Accountability of Financial Sector Supervisors: Principles and Practice, IMF Working Paper, 22 (2006).

<sup>50</sup> Gareth Griffith Briefing, Parliament and Accountability: The Role of Parliamentary Oversight Committees, NSW PAarliamentary Library Research Service, Paper No. 12/05, 11 (2005).

<sup>51</sup> Basel Committee on Banking Supervision, Report on the impact and accountability of banking supervision, 28 (2015).

<sup>52</sup> *Supra* note 49, 27.

decision “A person suffering legal wrong because of agency action or adversely affected or aggrieved by agency action within the meaning of relevant statute is entitled to judicial review”<sup>53</sup>

In addition to the above, an element of personal responsibility is also seen where the senior management of supervised authority is appointed by or through whom.<sup>54</sup>

The purpose of parliamentary accountability, ministerial accountability, and judicial accountability is ensuring the supervisor acting as decision-maker acts within its powers.

Market-based (stakeholder) accountability stems from the financial sector supervisors’ duties vis-à-vis their two main constituencies: supervised and investors/depositors – that is, the consumers of regulated financial services – on the one hand, and the public – on the other. Supervisory disclosures (through reports on supervisory practices, general publications hosted by supervisors’ websites, press conferences, or the publication of the outcomes of regulatory and/or administrative decision-making) and public consultations (often as part of the supervisory regulatory process) are amongst the main stakeholder accountability (and supervisory legitimation).<sup>55</sup>

For instance, in the UK, the FSA operates a ‘Financial Services Consumer Panel’, which functions independently from the FSA. The FSA is required to inform the Panel of all policy initiatives and to give public written responses to the Panel’s comments on consultation proposals. Similarly, in France, the Autorité des marchés financiers (the stock market regulator) operates a ‘Retail Investors Consultative Commission’.<sup>56</sup>

Market-based accountability is a relationship whose forum comprises consumers and investors (equity and bondholders), so monetary accountability and relationships include not only national but also international.<sup>57</sup> Supervisory actions often involve issues that become highly politicalized - such as the decision to intervene or close a bank and which can also have a significant impact on individual property rights.<sup>58</sup> As a result, supervisors must be independent and accountable, they should have legal protection.<sup>59</sup> At first sight, accountability is often seen as inimical to independence, but properly structured accountability arrangements are fully consistent with autonomy.<sup>60</sup>

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<sup>53</sup> USA 5 U.S.C., para. 703.

<sup>54</sup> *Supra* note 49, 30.

<sup>55</sup> *Id.*, 8.

<sup>56</sup> *Ibid.*

<sup>57</sup> Camila Villard Duran, Framework for the Social Accountability of the Central Banks: Growing Relevance of Soft Law in Central Banking, 8 *European Journal of Legal Studies* 97, 106 (2015).

<sup>58</sup> *Supra* note 49, 2.

<sup>59</sup> Basel Committee on Banking Supervision, Core Principles for effective Banking Supervision, 10 (2011).

<sup>60</sup> *Supra* note 49, 4.

Depending on the form of accountability whether before parliament, ministries, judicial or market-based accountability, in general, the liability of the supervisor is conceived in two ways: liability towards third parties, mainly depositors/investors/shareholder of financial institution; a liability towards the financial institution subject to supervision.<sup>61</sup> Third party supervisory accountability can arise by shareholders of financial institutions, for example, withdrawal of financial institution's license on the ground of prudence, where the supervisor knew or should know the institution's financial situation.

Qualified immunity is governmental (or sovereign) immunity, which protects government agencies from lawsuits unless the government agreed to be sued.<sup>62</sup>

#### **IV. Accountability and Immunity Provisions in the Legislation of the Republic of Azerbaijan**

The Legal basis of the mandate of the Central Bank of the Republic of Azerbaijan is the Constitution of Republic of Azerbaijan.<sup>63</sup> As the Constitution of the Republic of Azerbaijan and its amendments hereof enters into force by referendum, the legal basis of the mandate of the Central Bank is the direct will of the people.

As a general theory, a person/agency is accountable to the person/agency from which the mandate has been received.<sup>64</sup> On the contrary it Central Bank reports only to the President of the Republic of Azerbaijan on its activities.<sup>65</sup>

Additionally, as per the Constitution of the Republic of Azerbaijan, the appointment and dismissal of members of the Board of the Central Bank on the recommendation of the President of the Republic of Azerbaijan is under the authority of the Parliament (Milli Majlis) of the Republic of Azerbaijan.<sup>66</sup> In this case reporting on the activity of Central Bank could be required by the Parliament.

The legislative basis of the Republic of Azerbaijan provides supervisory immunity by restricting its responsibility towards third parties as well.<sup>67</sup>

In the Republic of Azerbaijan, Financial Market's regulator has statutory protections from being sued.

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<sup>61</sup> Michel Tison, Challenging the Prudential Supervisor: Liability versus Regulatory Immunity, Financial Law Institute Working Paper No. 2003-04, 4 (2003).

<sup>62</sup> Law.com Dictionary, <https://dictionary.law.com/Default.aspx?selected=897> (last seen Jan. 15, 2020).

<sup>63</sup> Constitution of Republic of Azerbaijan (1995).

<sup>64</sup> *Supra* note 49, 5.

<sup>65</sup> Law on the Central Bank of Republic of Azerbaijan, 10.12.2004, № 802-IIQ.

<sup>66</sup> *Supra* note 63, art. 65.

<sup>67</sup> The law "on the Banks, Law on Insurance Activity and Law on Securities of the Republic of Azerbaijan".

According to Article 92 of the Law of the Republic of Azerbaijan on Banks, “the Central Bank of the Republic of Azerbaijan, members of its executive board and other officials thereof, as well as the temporary administrators and liquidators appointed pursuant to law shall not bear any liability for any damage or loss caused by any act or omission in the performance of its duties within the implementation of regulatory, supervisory and liquidation functions unless it is proved that the act or omission was the result of unlawful acts or omissions and mala fide.” The title of the article is defined as “protection from being sued”.

From the banking point of view regarding the consumers the above-mentioned approach can be reasoned that deposits are fully insured under the relevant interest rate and amount as agreed with Central Bank.

As per Article 87 of the Law of the Republic of Azerbaijan on Securities, “during regulation and exercising supervision, Central Bank and its employees shall bear liability for damages inflicted on an individual or legal entity as a result of illegal actions (omission) in accordance with the Civil Code of the Republic of Azerbaijan.”

Under Article 95.2 of the Law of the Republic of Azerbaijan on Insurance of Activity of Financial Market Supervisor, its employees and other officials thereof, shall not bear any responsibility for damage incurred as a result of unlawful action (inaction) in violation of law and intentional infliction of harm being non-provable on the basis of law while exercising its regulatory and supervisory functions in the insurance sector, as well as its liquidation functions.

Regarding the consumers, the more strict supervision (not regulation) is exercised by the financial markets supervisory agency, the more important immunity becomes.

From the supervised institution’s point of view, the immunity clause is more important in order to protect the stability among the supervised institutions and supervisors. Otherwise, there is the likelihood that any action can be appealed in court even they are legitimate. For example, an act may aggravate the position of the supervised institution, but if the act’s ultimate purpose is to protect the consumers as a weaker party in financial markets, the act shouldn’t be contested in court.

It is crucial to take into consideration that in order for the financial market to operate efficiently, it is critical that governments’ regulatory immunity is not extended any further than it is needed.<sup>68</sup>

Legal protection for financial supervisors is furthermore highlighted in the Basel Core Principles. According to the second principle (independence, accountability, resourcing, and legal protection for supervisors) the supervisor possesses operational independence, transparent processes,

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<sup>68</sup> Jeffrey Carmichael, *The Framework for financial supervision macro and micro issues*, 143.

sound governance, and budgetary processes that do not undermine autonomy and adequate resources, and is accountable for the discharge of its duties and use of its resources. The legal framework for banking supervision includes legal protection for the supervisor.<sup>69</sup>

Some court cases should also be examined regarding accountability. Is the immunity of supervisory proportional to the protection of the weak party of the relationship of the legal relationship hereof? Can we consider it fair?

Since price stability is the main monetary goal and market communication is used as an instrument to manage inflation expectations.<sup>70</sup> In fact, the reduction in the volatility of inflation and economic activity observed since the mid-1990s can at least in part be attributed to the success in anchoring inflation expectations.<sup>71</sup> It is noteworthy that, despite the financial crisis<sup>72</sup> from each point (bubble, a stock market crash, a sovereign default, or a currency crisis) hits the insurance industry and securities market in a less dramatic way than the banking industry, the turmoil suggested the need of for reconsidering the overall picture of supervision. Banking is now an undeniably international business and insolvency of an institution will invariably have repercussions beyond its own national boundaries.<sup>73</sup> In its ruling in the Wetterstein case<sup>74</sup> and Herstatt case<sup>75</sup>, German Supreme Court rejected the argument that the aim of banking supervision was only to protect the stability and soundness of the banking system at large. In its view, the protection of individual creditors against risks arising from hazardous banking activities was also among the statutory objectives of the banking law. So as the court stated, banking supervisory authority could be liable for breach of its public duties under German Civil Code Paragraph 839.

Paragraph 839 of the German Civil Code, in conjunction with Article 34 of the German Constitution, suggests that for the State to be liable for any damage caused to third parties by public officials in the performance of their duties, the third party must be capable of being regarded as a beneficiary of an obligation that has been breached.<sup>76</sup>

The supervisor's immunity is disputable and is at stake from the point of the European Convention on Human Rights - Article 6. European Court of Human Rights accepted that meaning of rights cannot be determined

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<sup>69</sup> *Supra* note 59.

<sup>70</sup> *Supra* note 57, 99.

<sup>71</sup> Lucas Papademos, Price stability, financial stability and efficiency, and monetary policy, third conference of the Monetary Stability Foundation (Jul. 7, 2006).

<https://www.ecb.europa.eu/press/key/date/2006/html/sp060707.en.html> (last seen Jan. 29, 2020).

<sup>72</sup> Investopedia, <https://www.investopedia.com/terms/f/financial-crisis.asp> (last seen Feb. 10, 2020).

<sup>73</sup> Charles Proctor, *The Law and Practice of International Banking*, [§] 14.36 (2010).

<sup>74</sup> Wetterstein case (Feb. 15, 1979).

<sup>75</sup> Herstatt case (Jul. 12, 1979).

<sup>76</sup> *Supra* note 49, 16.

exclusively by reference to domestic law.<sup>77</sup> Article 6 (1) targets substantive as opposed to procedural rights, the existence, and scope of which are matters of domestic law.<sup>78</sup> According to Article 6, in the determination of his civil rights and obligations or of any criminal charge against him/her, he/she is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law.

According to a report from European Consumers Organization, the supervisor was already aware of that the Icelandic savings bank Landsbanki was facing difficulties in August 2008.<sup>79</sup> The supervisor justified their decision to take no action until October 2008, when the bank went bankrupt, by invoking their concern for the preservation of the stability of the financial system, and even it was a legitimate decision, had a significant adverse effect on depositors<sup>80</sup>. So, although the action is legal and within the authorities of the supervisor, if it is contrary to the public interest is not legitimate. The rules and actions of prudential supervision should serve their purported public interest aims.<sup>81</sup>

There are two types of regulators responsibility - ex post and ex ante. Ex-ante refers to the future and means "before the event."<sup>82</sup> In this sense, the financial market supervisor can estimate or should be aware events that would affect the market participants. Ex-post also refers to the past and means after the event. In this regard, the financial market supervisor bears responsibility that affected the market participants as a result of its actions and decisions. Ex-ante actions are explanatory actions.<sup>83</sup>

In ex post responsibility political powers and social actors evaluate if Central Bank attained its goals at the end of the targeted period. But in ex ante model by a prior definition and evaluation of the supervisors' powers and limitation, the current situation in the financial market, proportionality, and the goals and powers (limits) are evaluated in order to prevent the setting of unattainable goals.<sup>84</sup>

Ex-ante responsibility is also crucial for international consumers, investors, and depositors (investors). As they are not resident of the country where its rendered financial services, that results of the actions may affect negatively. If they were able to aware of these actions, possible decisions and changes that affect their position, they would be able to act differently.

Such a situation has happened in the Republic of Azerbaijan in the case of Angelo De Domenico (the plaintiff) v Bank Standart (being in the liquidation

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<sup>77</sup> See generally, *Kaplan v United Kingdom* (1980).

<sup>78</sup> See generally, *Z and others v United Kingdom* (2011).

<sup>79</sup> *Supra* note 4, 19.

<sup>80</sup> *Ibid.*

<sup>81</sup> *Supra* note 49, 31.

<sup>82</sup> *Id.*, 20.

<sup>83</sup> *Supra* note 49, 19.

<sup>84</sup> *Ibid.*

process, its license for banking activity has been revoked), although the final resolution of the court has not been adopted yet. On January 19, 2016, the Law on Full Deposit Insurance came into force in the Republic of Azerbaijan. According to this law, all deposits, which are within the annual interest rate set by the Board of Trustees of the Deposit Insurance Fund, are fully insured, regardless of the amount. Otherwise, deposits placed at higher interest rate are insured for a maximum of 30,000 Azerbaijani manats. The plaintiff filed a lawsuit against Bank Standard, which is in the process of liquidation, claiming that if the bank had informed the plaintiff about the requirements of the Law on Full Deposit Insurance and the interest rates set by the Board of Trustees, the plaintiff would not place a deposit higher than these interest rates. The plaintiff is a foreign citizen and was not aware of the changes in the legislation of the Republic of Azerbaijan. Although the first-instance court and the appellate court rejected the claim, the Supreme Court overturned the appellate court's decision and returned the case to the Court of Appeals for reconsideration. A final decision has not been made yet.

Accountability is and should be used together with transparency and autonomy (independence). In this meaning, transparency facilitates and integrates the political process of accountability. Social accountability in this context is equal to market-based responsibility. In this sense, independence helps to protect financial regulatory agencies from political interference. Accountability and independence affect each other vice versa. Too much accountability may reduce independence and too much independence may reduce accountability.<sup>85</sup>

Well defined statutory objectives based on which the agencies' performance can be measured are the key requirements for holding independent agencies accountable. In this sense, the key requirement for measurement for central banks' performance is price stability against which performance can generally be measured. Preservation of financial system soundness and the protection of ill-protected retail customers are the most obvious objectives of the financial market supervisory agency<sup>86</sup>.

Objectives also can be described with more precision by the principles of operation, procedures. For example, in the United Kingdom, Financial Services Authority has several principles of operation in order to bear in mind when discharging its regulatory functions such as proportionality of burdens or restrictions on the industry, economic and efficient use of its recourses.<sup>87</sup>

One of the most important issues to be evaluated regarding accountability in light of supervisors' responsibility is social accountability. The social

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<sup>85</sup> Michael S. Barr, Accountability and Independence in Financial Regulation: Checks and Balances, Public Engagement, and Other Innovation, 78 Law & Contemp. Probs. 119, 119 (2015).

<sup>86</sup> *Supra* note 49, 10.

<sup>87</sup> *Id.*, 13.

accountability mechanism is created in different ways by different countries. For example, in 2005, Brazilian Central Bank through the issuance of Circulars (Regulatory decision) created a new legal mechanism for social accountability, since it requires the agency to disclose its decision and motivations for policies. According to Article 5 of this Circular, the decision on interest rate policy taken by Brazilian Central Bank's monetary committee shall be publicly released.<sup>88</sup> These minutes provide the committee reasoning, the relevant date on which deliberation was based as well as the final decision indicated the number of votes since May 2012.<sup>89</sup> In 2010 in the aftermath of the economic crisis and given increased power acquired by the Fed (Federal Reserve System - the central banking system of the United States of America) to intervene in financial markets, the US Congress decided to amend the Federal Reserve Act to include a new mechanism for its social responsibility.<sup>90</sup> The two main mechanisms are: 1) Creation of a page on the Fed website entitled audit which became a repository of information on the Fed's performance. 2) Disclosure of information on emergency loans granted and on the open market operations concluded by the Fed during the crisis management.<sup>91</sup>

As evidenced above in this article transparency is a precondition to legitimate monetary policy and accountability.<sup>92</sup> Publicity reduces the scope for arbitrary decisions and ensures that actions are in accordance with preannounced policies.<sup>93</sup> Transparency encourages open administration and serves the function of enhancing public confidence in the financial sector.<sup>94</sup>

Accountability to the industry and consumers can also be achieved through appropriate representation on an oversight board. For example, in Germany, the financial industry is represented in the administration and advisory board. The advisory board also comprises representatives from academia, the central bank, and consumer associations. Additionally, in the Netherlands, the Bank Council which also counts representatives of the industry among its members advises on the general policy matters including supervision.<sup>95</sup> The abovementioned best practices also can be applied in the Republic of Azerbaijan. Public engagement is the key strategy to help independent agencies remain accountable and to help them stay focused on substantive regulation that meets the needs of households and businesses.<sup>96</sup> At least, public engagement will provide ex-ante responsibility of the

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<sup>88</sup> *Supra* note 57, 114.

<sup>89</sup> *Ibid.*

<sup>90</sup> *Id.*, 119.

<sup>91</sup> *See* generally, Federal Reserve act (1913).

<sup>92</sup> *Supra* note 57.

<sup>93</sup> *Supra* note 49, 10.

<sup>94</sup> *Id.*, 29.

<sup>95</sup> *Id.*, 30.

<sup>96</sup> *Supra* note 86, 126.



Central Bank before the supervised institutions and execution of market-based responsibility.

The last point to be mentioned is that regulator acting beyond the scope of its statutory powers will not necessarily be protected even if it has acted in good faith.<sup>97</sup> The *Gulf Insurance Limited v Central Bank of Trinidad and Tobago* is the landmark case from this point of view. In this case, the government and Central Bank of Trinidad and Tobago had become concerned about the stability of some financial institutions including Gulf Insurance. As a result of the actions taken by Central Bank of Trinidad and Tobago, it made an order transferring the business and assets of all these damaged institutions. However, the order did not include any provision for the valuation of assets by an independent third party, as a result, the central banks acted beyond its powers. Also legislative has imposed immunity provision on the central bank. The Privy Council (the highest court of appeal for certain British territories and Commonwealth countries) held that this provision was inapplicable because this provision would be applicable in case the regulator would be acting in the performance of its actions, but the regulator, in fact, overstepped the boundary of its statutory powers.<sup>98</sup>

## Conclusion

Regulation and supervision are crucial issues in the financial markets not only at the local level but also at the international level. Supervisory agencies' activities should always be the analysis of certain issues and be improved periodically to prevent unfavorable results. First of all, consumers and stakeholders, investors and professional participants of the financial markets should be protected from the illegal activities of the financial market supervisors at least in order not to damage the trust in relation to supervisor and protection in the financial market, as trust is a crucial element in the financial market, considering that majority of participants are not lawyers and are not able to protect their rights hereof. Trust directly affects the turnover and circulation in the financial market which is a must for daily business. At the end of this article, we want to note two important suggestions regarding the above-analyzed issues and amendments to the existing legislation hereof:

- 1) Exact hard law principles governing the supervisory and regulatory activity in the financial market should be implemented; As of today, Core Principles for Effective Banking Supervision incorporated by Basel Committee on Banking Supervision is consultative documents and exact hard law principles governing the supervisory regulation activity don't exist in the Republic of Azerbaijan.

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<sup>97</sup> *Supra* note 73.

<sup>98</sup> *Id.*, [§] 14.21-14.22.

2) Advisory councils under supervisory and regulatory agencies as in the United Kingdom and France should be formed in the Republic of Azerbaijan from professional participants of the financial markets, investors in order to achieve better results in order to provide public control in case of absence of exact hard law principles governing the supervisory and regulatory activity as noted. Involving relevant participants where appropriate in defining the expectations will improve regulatory and supervisory activity and its outcomes<sup>99</sup>. The formation of the advisory council will cause the implementation of ex ante responsibility for the actions and decisions of the Supervisor.

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<sup>99</sup> See generally, OECD, Principles for the Governance of Regulation, Public Consultation Draft (2013).