

Regulation of financial services: Aims and methods

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INTRODUCTION: OBJECTIVES OF THE PAPER AND OUTLINE OF THE ISSUES

Introduction

Issues

This paper is intended to support a conversation on financial regulation between lawyers and non-lawyers, practitioners and academics, regulators and regulatees. The financial crisis prompted a re-examination and reform of regulation, leading to new rules, the restructuring of regulatory authority, and changes in international cooperation and standards. This paper is not a comprehensive review of these reforms or the research that has poured out since the financial crisis. It attempts to step back from the crisis and to start a conversation about issues that shape regulation. Why is regulation necessary, how are regulatory objectives determined, and how can they be achieved? At the same time, it is important not to divorce such discussion from a context and to consider how a particular set (or competing sets) of political, economic, historic and intellectual circumstances limits and changes the range of possibilities for regulation.

Outline of the paper

Regulation is hard to define. It might be regarded as any control system (formal or informal) that sets standards, and, typically, also monitors those standards and enforces them with the broad aim of shaping behaviour, positively or negatively. This encompasses all forms of control, whether originating in the state or an industry or a particular firm, and covers rule making, monitoring and enforcement. This broad conception of regulation can be contrasted with a narrower view that emphasises the state's monopoly over the law's coercive power and assumes, among other things, that legal rules constitute the main tool for shaping behaviour and that the articulation of public goals is principally the task of the state.

Regulation may be based on legislation or the market, and market-based regulation may involve contract law, which gives rise to legally enforceable obligations, or on non-legally enforceable principles (such as codes of practice adopted by trade bodies). Regulation may, however, involve a combination of these: an industry may be subject to both statutory and market regulation (e.g. banking is subject to statutory regulation and most banks also subscribe to the voluntary lending code) and a code of practice may be incorporated in a contract and, therefore, is enforceable by parties to that contract.

Chapter 1 uses history to analyse regulation of banking in the UK: why was it thought necessary, why were particular forms of regulation chosen and what prompted changes? The characterisation of problems and their solution are formed by, among other things, what is acceptable in a particular economy, the political colour of government, what pressure (domestic and international) is put on government to ignore, respond to or anticipate a perceived problem, and what financial resources and skills are available.

Subsequent chapters raise some of the issues touched on in this opening chapter. **Chapter 2** considers the fundamental question of why it might be thought necessary to regulate in a market economy. Regulation should, in theory, be used only in so far as it is necessary to achieve an overriding objective and only if the benefits outweigh the costs to the industry, customers and the regulator. The main issue in this chapter is the objective(s) of regulation, but regulation is rarely the simple expression of a single objective. There must, therefore, be room for negotiation between often conflicting objectives in the creation of rules and their enforcement.

Chapter 3 considers how regulation might be structured – self-regulation or third-party regulation? Even regulated industries, such as banking, are not entirely (or even mostly) state directed, and, while some activities are prohibited or restricted, the aim should be to allow the operation of the market, so that customers can choose and bear the risks involved in those choices, and firms can prosper or go out of business.

Chapter 4 looks at the use of rules or standards to prohibit activities, restrict access to market, oblige the dissemination of information in particular forms and stipulate the internal governance of firms, and **Chapter 5** looks at the choice between using detailed rules, which direct how certain activities are conducted, or principles, which may merely set out an objective and require an exercise of judgement by the regulator and the regulatees. In theory, rules make the regulatees' position clear, but they may be rather blunt instruments, allowing for no distinctions between different regulatees or situations, and they may lead to simple compliance rather than observance of the spirit of the rules, which may, in turn, encourage rule avoidance to be viewed as an entirely appropriate activity. The flexibility of principles may be both an important virtue and a significant defect. Yet, the contrast is deceptive: rules are not necessarily clear and self-enforcing, and principles are often accompanied by guidelines, which can transform them into rules. Regulatory systems are likely to involve a combination of rules and principles, so it is important to think about the different work each can do and the relationship between them.

Chapter 6 considers enforcement, raising the issues of who should enforce (customers, the regulator, a third party?), but, more importantly, the impact of enforcement on regulatory objectives. An enforcement authority must have discretion. It is unlikely to be able to monitor all regulated activities – an inspector at the elbow of every bank cashier and trader – and so there must be a decision as to how scarce resources are deployed. Even if the rules oblige prosecution of all breaches, enforcement authorities are likely to establish an informal discretion by ignoring a breach or giving some sort of warning. This changes the meaning of rules: the decision to pursue only those who drive more than 10% above the speed limit means that, in practice, the speed limit is increased by 10%. Although enforcement and punishment are, typically, treated separately, there is overlap. Enforcement authorities may have power to inflict low-level penalties because this is quick and cheap. Where enforcement officers do not have the power to impose penalties, their exercise of investigation and prosecution powers may be experienced by the subjects as a penalty because, for example, it

may involve the stopping of normal work, or the fact of an investigation may affect reputation, irrespective of the outcome.

Chapter 7 outlines the objectives of punishment. The focus is the adoption by the financial regulators of credible deterrence. This may appeal to a general desire to see people punished in the wake of a major crisis, and to a wish to shape the behaviour of others in the market. Not surprisingly, it has been combined with greater emphasis on enforcement, but there are difficulties with this strategy. Credible deterrence depends on a theatrical effect, which is achieved by the imposition of penalties that are sufficiently large to draw general attention (particularly, newspaper and television), and this may be undermined by more efficient detection of breaches which tends to render penalties more familiar and, therefore, less dramatic.

It is almost inevitable that unintended consequences will arise from regulatory intervention (**Chapter 8**). It may be that some of these can be guessed at, even if only in a rather blurred way, but concentration on an immediate problem often drives out any wish to consider collateral effects. In **Chapter 9** there is a brief look at the regulation of two non-financial areas – health and safety and food. Health and safety is unusual in that it is not focused on one industry and the breadth of its remit has meant the use of broad principles and risk-based enforcement. The food industry is, like banking, regarded as different from other parts of the economy. Problems in setting food standards and enforcement led to a risk-based approach and to the use of a hybrid form of strict liability offences in order to get around difficulties of proof.

Much of this paper concerns *ex ante* regulation, that is, regulation to prevent problems from arising by, for instance, setting out rules to govern conduct, but **Chapter 10** looks also at *ex post* provisions which address certain types of harm, such as a threat to depositors' funds or systemic collapse. This harm may arise because *ex ante* regulation has failed or because of matters outside the regulator's control, but the origin is irrelevant. What is important is to be able to identify a harmful event, and stop or mitigate its impact. It may be possible to anticipate such harm through *ex ante* regulation by, for example, requiring a firm to adopt a structure that will allow it to be more easily dismantled in the event of insolvency or establishing deposit protection insurance.

Running throughout is a tension between domestic and international concerns, such as the impact membership of the EU and adherence to international standards has on UK regulation, and the conflict between the desire to compete with other states while harmonising regulation. Other issues are omitted, including the way that the understanding of markets through economic perspectives has been challenged as regulators recognise behaviour is

driven by a more complex mixture of factors than can be envisaged simply by applying economic theory and ask questions such as, what is the implication for regulation of the recognition that people keep on failing to act as rational economic beings?¹

¹ E.g. J Black, 'Reconceiving Financial Markets: From the Economic to the Social' (2013) 13(2) *Journal of Corporate Law Studies* 401; E Avgouleas, J Cullen, 'Market Discipline and EU Corporate Governance Reform in the Banking Sector: Merits, Fallacies, and Cognitive Boundaries' (2014) 41 *Journal of Law and Society (Symposium)* 28.

1. WHY REGULATE? A HISTORY

‘Between liberty and government there is an age-long conflict.’²

This chapter uses history to think about why the state intervenes in the regulation of the finance industry in the UK, what shapes that intervention (in other words, why is a particular form of regulation chosen), and why regulation (the rules, their enforcement, the structure of the regulator) changes. This chapter is not merely a historical introduction. It raises issues discussed in the later chapters and seeks to show how those issues may be shaped by the circumstances in which they arose.

1.1 Self-regulation

Why were banks not regulated by legislation before 1979?³

1.1.1 The state (particularly, local authorities) has a long history of regulating the relationship between suppliers and customers through laws on weights and measures, the adulteration of foodstuffs, the price of bread and environmental nuisances. Traditionally, the state has taken less interest in the internal organisation of a business – although government did recognise the revenue potential involved in granting companies charters of incorporation. It was with the emergence of large-scale industrialisation and urbanisation in the nineteenth century that the central state began to intervene more systematically through, for example, the appointment of inspectors to enforce rules relating to factories, railways and mines and workers’ conditions. This intervention arose alongside – and became linked with – greater democratisation through the extension of the franchise (especially after 1867) and the growth of trade unions. Nevertheless, the capacity of the state to intervene and the belief in the legitimacy of such intervention or the need for it were limited, particularly in the finance industry.

1.1.2 The Financial Revolution, which started in the late seventeenth century, established the City as a national and international financial centre and led to the National Debt, securities trading and later the London Stock Exchange, the insurance market at Lloyd’s coffee house, the Bank of England and the merchant banks (banking associated with trading rather than goldsmiths). The connected nature of domestic and international banking was illustrated by the Ayr Bank failure in 1772, which had repercussions in London, Paris, Amsterdam, St Petersburg and the American colonies,⁴ and by the early nineteenth century, some banks had acquired significant domestic and international economic and even political influence – Barings was called ‘the Sixth Great Power’⁵ (after Austria, France, Prussia, Russia and Great Britain) and the Rothschild family had built a European-wide banking network.

1.1.3 The Bank of England was at the core of the domestic banking structure. Its involvement in monetary policy, acquired as the government’s banker, and its position as the leading domestic bank gave it a key role in the management of the banking crises in 1825, 1847,

² *Report of the Committee on Finance and Industry*, cmdn 3897 (1931), para.8 (Macmillan committee).

³ The sector was not entirely unregulated, particularly the conduct of retail banks: Sir George Blunden, ‘The Supervision of the UK Banking System’, (1975) 15(2) *Bank of England Quarterly Bulletin* 188.

⁴ H Hamilton, ‘The Failure of the Ayr Bank, 1772’ (1956) 8(3) *The Economic History Review* 405; RB Sheridan, ‘The British Credit Crisis of 1772 and the American Colonies’ (1960) 20(2) *The Journal of Economic History* 161.

⁵ P Ziegler, *The Sixth Great Power: Barings, 1762–1929*, London: Collins, 1988.

1866 and 1890. Yet, it was still a commercial bank, controlled by the City's banking and merchant elites, and in so far as it exercised authority over the banking sector it did so through persuasion and pressure, not law or adversarial confrontation: 'Regulation was pictured as an exchange between partners, not as an exercise in authority.'⁶ The key City merchant banks were located in a small geographical area and comprised partners who shared the same social, economic, educational and often family backgrounds. They formed something resembling a gentleman's club, held together by camaraderie, loyalty, professionalism and trust.⁷ The club was oligarchic, informal and secretive, protecting banks from the competitive effect of an open market and from the late nineteenth-century stirrings of democracy with its attendant requirements of openness and accountability. The club's ability to deal with problems and maintain a strong sector, as well as the access to power which money brought, meant banking was not regarded as in need of third-party regulation or public accountability. Such legislation as there was largely focused on what were characterised as fringe activities undertaken by firms that were not part of the club, such as pawnbrokers and moneylenders (e.g. Money-lenders Act 1900, s.6), although this did not preclude the prosecution of fraudulent bank directors.⁸

1.1.4 The operation of the club can be seen in the Barings crisis of 1890. It was rescued as the result of a process organised by Bank of England and funded by the banks, which were concerned at the possibility of a systemic collapse. Barings' chairman, Lord Revelstoke, was blamed for recklessness and lost both his job and most of his assets, but significantly other family members were allowed to take the lead in the new bank that rose from the ashes.⁹ But the club might also punish, as with the refusal to rescue Overend Gurney & Co, a leading discount house, in 1866 because earlier it had broken ranks by challenging the hegemony of the Bank of England.¹⁰

1.1.5 Some flavour of the view taken by Parliament and by government of their roles can be gathered from debates after the Overend Gurney and the Barings failures – or, more accurately, from the lack of such debates. Aside from mention during debates on joint-stock companies generally, the Overend crisis attracted no parliamentary attention. Similarly, there was little interest in 1890. Some months after the Barings crisis broke, Sir William Harcourt, speaking for the Liberal opposition, congratulated the banking community: 'It is a great credit to the banking institutions of the country that in two or three days they took the necessary steps to save the crisis.'¹¹ But he thought the Bank's role was not a matter for comment: 'There was, no doubt, a very dire necessity which led to very extraordinary and unexampled

⁶ M Moran, *The Politics of Banking (Studies in Policy Making)*, Basingstoke: Palgrave Macmillan, 1986, p.4.

⁷ The classic account of club government is M Moran, *The British Regulatory State: High Modernism and Hyper-Innovation*, Oxford: Oxford University Press, 2003.

⁸ There were various offences associated with banking (e.g. the statute 52 Geo II c.63 (1812) made it an offence for bankers fraudulently to appropriate negotiable instruments entrusted to them), and in 1857-61 legislation created offences in relation to all types of company. Prosecutions were rare until the convictions in Scotland following the City of Glasgow Bank failure in 1878. More prosecutions of directors followed, including Jabez Balfour who was imprisoned in 1895 for 14 years after the collapse of the Liberator Building Society, which, at the time, was the largest in the country: J Taylor, *Boardroom Scandal: The Criminalization of Company Fraud in Nineteenth-Century Britain*, Oxford: Oxford University Press, 2013. Another consequence of the Glasgow failure was the Companies Act 1879, which led most banks to take up limited liability: GG Acheson, JD Turner, 'The Death Blow to Unlimited Liability in Victorian Britain: The City of Glasgow Failure' (2008 45(3) Explorations in Economic History 236.

⁹ P Ziegler, *The Sixth Great Power: Barings, 1762-1929*, London: Collins, 1988.

¹⁰ D Kynaston, *The City of London Volume 1: A World of Its Own 1815-1890*, London: Pimlico, 1995. See the reports of the panic in *Birmingham Daily Post*, 12 May 1866.

¹¹ HC Deb 26 May 1891 vol 353 c.1128.

measures on the part of the Bank of England. I do not presume to judge that action, but there is one thing which the House of Commons is entitled to know in relation to the Barings guarantee, and that is, what part Her Majesty's Government were called upon to take, and what part they did take?'¹² His position was clear: 'The habit of the Government—it is a foreign habit—stepping into these private transactions is a most dangerous one. I object to the Chancellor of the Exchequer being so much in the market'.¹³ George Goschen, the Chancellor of the Exchequer, was quick to reassure. He admitted that the government had come under pressure to provide assistance, but declined to intervene because the City was thought (as proved) sufficiently strong to rescue the situation. And that more-or-less constituted the sum total of the debates on the subject.¹⁴

1.1.6 Club government or, at least, its key principles – secrecy, informality, flexibility and cooperation – survived into the twentieth century and continued to determine the approach of the Bank and the banking community to matters of monetary policy and regulation. The Macmillan committee (1931), which inquired into financial policy in the wake of the Wall Street Crash, regarded the maintenance of a close relationship between the Bank and the banks as essential because 'financial policy can only be carried into effect by those whose business it is'.¹⁵ Indeed, the committee expressed concern at evidence that, while the Bank continued to have its traditional connection with merchant banks, 'there is still a degree of aloofness and remoteness in the daily relations between the Bank of England and the clearing banks'.¹⁶ These banks should be 'taken into the confidence of the Bank of England... and their co-operation invited with a view to making the policy of the Bank of England fully effective'.¹⁷

1.1.7 The presence of the club can still be seen in the 1959 report of the Radcliffe Committee, which had been appointed two years earlier to inquire into the monetary system. The Bank saw itself as directing the banks through persuasion, but the banks retained a sense of autonomy:

'It is on this relationship, and on the mutual trust and confidence that are the basis of the relationship, rather than on formal power or the regular provision of statistical information that the Bank has relied in seeking to inform itself about and influence the policies of the clearing banks. One consequence of this arrangement is that the Treasury's contact with the clearing banks is at one remove, and inevitably much less intimate than the Bank's'.¹⁸

When telling the committee about the fixing of the liquidity ratio, the Governor, CF Cobbold, said, 'I have left the banks in no doubt... that they should not allow their liquidity to fall significantly below 30 per cent; and I have made it clear that I reserved the right to make observations if there were any considerable divergence'.¹⁹ The clearing banks commented: 'we listen with great care to what the Governor says to us at any time. He might give us a hint

¹² *Ibid* at c.1108.

¹³ *Ibid* at cc.1108-09.

¹⁴ Although see HC Deb 9 Feb 1892 vol 1 c.60.

¹⁵ *Report of the Committee on Finance and Industry*, cmnd 3897 (1931), para.11.

¹⁶ *Ibid*, para.371.

¹⁷ *Ibid*, para.372.

¹⁸ *Report of the Committee on the Working of the Monetary System*, cmnd 827 (1959), para.354.

¹⁹ *Ibid*, para.352.

and we should not be likely to ignore it.²⁰ Such influence and communication was, of course, rarely made public.

1.2 The Banking Act 1979: statutory self-regulation?

How did the 1979 act change regulation?

1.2.1 The club shows how regulation emerged from, and was entwined with, monetary policy, and thus its natural home was in the Bank of England and out of the public eye. The Banking Act 1979 marked a significant shift in that it put regulation on a statutory footing and asserted that it was an issue of government policy – something in which government could properly intervene. Yet, there was no clean break with the past. The act carried the clear imprint of the club, even though the power and unity of the banking club had weakened after the early twentieth century, finally collapsing by the 1970s. Non-traditional institutions were encroaching into the banking market and banks were stepping outside their familiar roles. London re-emerged as a world centre of international banking with the rise of the eurodollar markets, and the Treasury was taking greater interest in monetary policy than it had for most of the Victorian period. This brought uncertainty about the regulation of banking – indeed, uncertainty as to what banking was. These issues began to come into focus with the secondary banking crisis.

1.2.2 The secondary banking crisis of 1973-75 involved the failure of a number of small banks that had lent heavily to the commercial property sector. The Bank launched a rescue because of its fear that sterling, which had been damaged by a rapid rise in oil prices in 1973, might come under further pressure. The Bank – not the Treasury – controlled discussions about the crisis and persuaded the major clearing banks to help fund the rescue. Secrecy is still maintained about these events, so that, although the cost of the rescue has been estimated at £100 million, this has never been confirmed.²¹ The underlying regulatory issue was that the secondary banks were licensed as moneylenders by the Board of Trade under s.123 of the Companies Act 1967 (a ‘bank’ was exempt), but were not regularly supervised by the Board of Trade or the Bank of England. The Bank introduced various internal changes. Most important of these was the establishment of the Banking Supervision Division to improve collection of data and regularise meetings with banks. Nevertheless, in 1976 the government announced an intention to introduce legislation. The White Paper was unclear as to its extent, merely saying deposit-takers ‘should be subject to an adequate system of authorisation and supervision, backed by statute where necessary.’²² There were other pressures for statutory regulation, notably membership of the EEC and of the Basel Committee on Banking Supervision in which the UK took a leading role with Sir George Blunden and Peter Cooke chairing the committee from its inception in 1974 to 1988.

1.2.3 By placing regulation on a statutory basis, obliging the Bank to make an annual report to the Chancellor of the Exchequer on the exercise of its statutory functions, and granting rights of appeal against the Bank’s decisions, the act seemed finally to end the club and undercut the Bank’s authority. But the club’s influence remained, shaping the legislation and its implementation: the broad discretion given to the Bank and its continued practice of

²⁰ *Ibid*, para.350.

²¹ R Lambert, ‘A Tale of Two Banking Crises’, *Financial Times*, 2 Dec 2008. Lambert notes that although Douglas Hurd’s account of the Heath government, *An End to Promises*, deals with events of 1973-74, it omits the crisis entirely.

²² *The Licensing and Supervision of Deposit-Taking Institutions*, cmd 6584 (1976), p.3.

supervising out of the public gaze without the use of statutory powers. Moreover, the 1979 act was not concerned with the elite banks – the club. The White Paper made clear that, while they would come within the new framework, they were not its main target: ‘The arrangements for their supervision will remain unchanged’.²³ As one supporter of the act put it:

‘One of the reasons why to me the Bill makes a great deal of sense is the role that it gives to the Bank of England, which has the role of paternalistic supervision over the banking sector. That is what makes the Bill sensible and acceptable.’²⁴

The act created two tiers – the banks and the licensed deposit-takers. Banks were defined as such by the Bank: the principal criteria was that a bank had to have for ‘a reasonable period of time enjoyed, a high reputation and standing in the financial community’ (Banking Act 1979, sch.2, Pt. I, para.1(1)). The act was more prescriptive when it came to licensed deposit-takers – those that were not part of the club. They needed a licence from the Bank (s.3) and could not refer to themselves as banks (s.36(1)).

1.2.4 The Bank was given discretion as to the procedures it adopted (s.5), but the minimum criteria directed it to particular issues – the fit and proper requirement for directors and senior officials, the need for at least two individuals directing the business, and solvency and liquidity provisions (sch.2, Pt.II). The detail behind these criteria was left to the Bank. Thus, in both limiting the impact on banks and leaving the Bank with a wide discretion, the legislation retained much of the self-regulatory form developed in club government. Nevertheless, the act had taken the important step of establishing that banking was no longer beyond the bounds of government or statutory intervention.

1.3 The Banking Act 1987: the death of the club?

Why and how was the 1979 act reformed?

1.3.1 The Banking Act 1979 was shaped by the identification of a particular problem – the secondary banks – and by the familiar methods of club government – secrecy, persuasion, flexibility. The underlying assumptions were that the recognised banks did not pose a problem and that the club approach was sound. The failure of Johnson Matthey, a recognised bank, challenged both of these assumptions.

1.3.2 When Johnson Matthey got into difficulties in 1984, the Bank launched a traditional rescue operation with the help of the major banks. It also instituted changes to its own structures and procedures, appointing an Executive Director with specific responsibility for supervision, establishing standing committees to coordinate the Bank’s responsibilities and advise on supervisory issues, creating a management structure within the Banking Supervision Division, increasing staff by 25%, and promoting secondments between the Bank and the financial services industry.²⁵ Nevertheless, the Bank came under fire for its failure to identify warning signs and for committing funds without reference to the Chancellor of the Exchequer, Nigel Lawson. When compared with the relatively thin response to the secondary banking crisis, Johnson Matthey indicated a key change, exposing

²³ *Ibid.*

²⁴ HC Deb 14 Feb 1979 vol 962 c.1268, Roger Moate MP.

²⁵ *Banking Supervision*, cmnd 9695 (1985), chap. 6. The issue of resources and training had also been highlighted by the Chancellor in his initial statement on the crisis: HC Deb 17 Dec 1984 vol 70 c.21.

the tension that arose from the attempt to rearticulate the club, which rested on a tight-knit relationship and confidentiality, in an age of greater public accountability. Finance had acquired a central role in politics as the economy shifted from manufacturing and mining and as governments sought to reduce welfare expenditure by, among other things, encouraging private investment. This brought more attention to financial supervision and to the work of the Bank. Governments were now willing to criticise the Bank. For its part, the Bank was rather trapped. It regarded its work as apolitical and was not expected to engage in politics, but this left it unable to defend itself. Its successes remained hidden; its failures were publicised and debated. Governments were willing to accept praise for successes in the financial industry and to ascribe blame to the Bank for perceived failures. The inquiries that began to flow in the 1980s did not examine the Bank's work holistically. Instead, they detached and placed under the microscope particular incidents.

1.3.3 This process of inquiry began with Johnson Matthey. That the Bank's decision to rescue Johnson Matthey was driven by its belief that a collapse would have an impact on the financial system made the failure to act sooner seem more worrying – if the bank had the potential to create systemic problems, why was it not more closely monitored? Lawson acknowledged the failure of the 1979 Act structure, 'Recognised bank status—as we have seen with JMB—has not always guaranteed prudence and responsibility.'²⁶ But he also remarked on what he saw as the Bank's failures:

'the supervisors cannot escape criticism for failing to respond more quickly to the danger signals...I have already made it clear that the Bank of England, despite its excellent record in general of carrying out its supervisory duties, did not on this occasion act as promptly as it should have done. It did, to some extent, fall down on the job.'²⁷

The lack of consultation with government, which seemed not to have been a problem during the secondary banking crisis, became a source of irritation and criticism. At first, Lawson brushed off the issue, saying the Governor had notified him shortly before the rescue and that with regard to the use of the Bank's funds 'my approval was neither sought nor required'.²⁸ But within six months he had changed his mind: 'The right hon. Gentleman asked if I did not feel that I should have been told at the time about the £100 million loan. Yes, I do think that I should have been told at the time; and that is accepted by the Governor of the Bank of England'²⁹

1.3.4 These themes were carried into the foreword Lawson wrote to the Government's White Paper (1985) on the matter.

'while the JMB debacle represented a wholly atypical lapse in a system of supervision that has had a good record over the years, and which compares well with the experience of financial centres overseas, there nevertheless remained serious weaknesses both in the implementation of banking supervision in the United Kingdom and in its statutory framework, the Banking Act of 1979.'³⁰

²⁶ HC Deb 20 June 1985 vol 81 c.453.

²⁷ *Ibid*, cc.454, 456.

²⁸ HC Deb 17 Dec 1984 vol 70 c.23. This mirrored the limited response of the then Chancellor to the secondary banking crisis: HC Deb 13 Oct 1976 vol 917 c.142-3.

²⁹ HC Deb 20 June 1985 vol 81 c.456.

³⁰ *Banking Supervision*, cmnd 9695 (1985), p.1.

The White Paper observed that the two-tier structure had maintained the special status of members of the old banking club, but ‘the classification did not necessarily reflect the merits of individual institutions within the two classes.’³¹ The solution was legislation that was broader in its coverage than the 1979 act and, importantly, both reduced the scope of the Bank’s discretion and rendered it more accountable. Significantly, the White Paper said, ‘The Government consider that certain aspects of supervision are important enough to warrant specific statutory backing.’³²

1.3.5 The Banking Act 1987 did not set out particular regulatory objectives – stating only that the Bank was ‘to supervise the institutions authorised by it in the exercise of [the powers conferred by the act]’ (s.1(2)). It did, however, stipulate certain rules obliging all firms that accept deposits to have adequate capital (sch.3, para. 4),³³ to report large loans (s.38: one of the principal errors made by Johnson Matthey involved large loans), to have adequate accounting and control systems, to conduct business with integrity, and to have fit and proper persons as directors, senior managers and large shareholders. The accountability and monitoring of the Bank was stepped up. The Bank was required to submit an annual report to the Chancellor, which was to be laid before Parliament, and to establish the Board of Banking Supervision, which included six independent members and was charged with giving advice to the Bank on the exercise of its regulatory functions (s.2(2)). Nevertheless, the Bank retained broad discretion. Indeed, in spite of the criticism, government was reluctant to intervene too far. The aim was ‘to create a statutory framework within which the previous, informal supervision of the traditional banks could be continued’.³⁴ On the point, Lawson endorsed the view of one of his colleagues:

‘although it is important to try to achieve the most efficient legislative and codification arrangements possible, in the last resort these matters, which often have to be handled very quickly and in a situation of some crisis, depend for their successful resolution upon having men of great judgment and experience running the central banks and that whatever we do we should be careful not to reduce the role of the Bank of England to that of the Treasury’s poodle’.³⁵

Why did government not restructure the regulatory architecture more radically? In part, it was because of the weight of tradition. Since the Bank had always been the supervisor and supervision had always followed a particular pattern, it was difficult – or not plausible – to envisage a different structure. In any event, that structure fitted in with the version of the free market to which neo-liberal governments subscribed. This opposed state regulation or, indeed, any regulation. In so far as it was necessary, the best method was assumed to be self-regulation.

³¹ *Ibid*, p.14.

³² *Ibid*, p.8.

³³ The UK and US reached an agreement on capital adequacy in 1987 and Basel published its accord in 1988 (Basel I).

³⁴ *Banking Supervision*, cmnd 9695 (1985), p.14.

³⁵ HC Deb 17 Dec 1984 c.24.

1.4 Bank of Credit and Commerce International and Barings

1.4.1 Banking regulation attracted further attention, and the Bank further criticism, as a result of the closure of BCCI and the collapse of Barings in the 1990s. BCCI's operations were closed simultaneously in seven countries in 1991. At first supervised in Luxembourg (BCCI SA) and then also in Grand Cayman (BCCI Overseas), its effective head office became London, although the plan of Mr Abedi, who founded the bank, to obtain authorisation in the UK failed because he could not meet the capitalisation requirements set by the Bank. The Bank was aware of, among other things, allegations that BCCI officers had been involved in money laundering, that accounts had been operated in the UK for terrorists, and that there had been false accounting and breaches of foreign exchange control laws, but it was concerned that precipitous action might trigger a run on the bank and was reassured that BCCI could obtain injections of funds from Abu Dhabi to supply any shortfalls. Moreover, the Bank felt it lacked sufficient evidence of a general problem at the bank. The Governor, Robin Leigh-Pemberton, later explained the dilemma: 'Our view was that even if these transactions added up to individual acts of fraud, it did not add up to systematic fraud... If we closed down a bank every time we had a fraud, we would have rather fewer banks than we have.'³⁶

1.4.2 After BCCI's closure the Bank made internal changes, including the establishment of the Special Investigations Unit within the Banking Supervision Division to inquire into warnings and suspicions, the strengthening of its legal unit and improvements to internal communications. Nevertheless, there were inquiries. Sir Thomas Bingham, at that time a Lord Justice of Appeal, produced a report littered with criticisms of the Bank:³⁷

'The Bank did not pursue the truth about BCCI with the rigour which BCCI's market reputation justified. In the later stages the Bank came to rely to an excessive extent, in my opinion, on the auditors... In these respects the Bank's supervisory approach to BCCI was in my opinion deficient.' (para. 2.67)

He also wrote, 'the Bank showed a very marked lack of curiosity' (para. 2.161), and 'I think the supervisors tended to lose sight of their primary duty to protect the bank's UK depositors. I do not think that in this instance the Bank measured up to its task.' (para. 3.8.) The influence of the club approach had played a part in the Bank's supervisory practice:

'The Bank's traditional techniques of supervision, based as they are on trust, frankness and a willingness to co-operate, seem to me on the whole to have served the community well... But one of the virtues claimed for the Bank's supervision is its flexibility. This should mean that a quite different supervisory approach is adopted where trust and frankness are lacking... [T]he degree of alertness and inquisitiveness shown by many of the Bank officials who deal with BCCI was not high.' (paras 3.8-3.9)

Yet, as this passage suggests, Bingham did not propose radical change in the method or structure of bank supervision because he could not identify 'any crucial deficiencies in the arrangements now in force and due to come into force.'³⁸ In other words, the regulatory

³⁶ N Kochan and B Whittington, *Bankrupt! The BCCI Fraud*, London: Gollancz, 1991, p.151.

³⁷ The Right Hon Lord Justice Bingham, *Inquiry into the Supervision of The Bank of Credit and Commerce International*, HC 198 (1991).

³⁸ *Ibid*, para.3.3.

architecture was right and the Bank had the necessary tools, but, in some respects, had simply failed to use them.

1.4.3 The Treasury Committee's report followed in 1992.³⁹ This claimed various warning signs had been ignored: the bank's rapid expansion, its opaque structure, the criminal allegations against bank officials, auditors' reports of concerns about the bank's management, and the Bank of England's own admissions of unease, including its refusal of full bank status under the Banking Act 1979. Like Bingham, the committee concluded that the regulatory architecture and the powers under the Banking Act 1987 were adequate, but the Bank should have acted sooner by forcing BCCI to change its structure to allow effective supervision and insisting on a single auditor for the entire bank.

1.4.4 Within four years of BCCI's closure, Barings collapsed as the result of the trading activities of an employee in Singapore and the bank's own lack of internal controls. Again, there were criticisms of the Bank in the inquiry reports. The Board of Banking Supervision concluded that there had been 'a lack of rigour'.⁴⁰

'The Bank regarded the controls in Barings as informal but effective. It had confidence in Barings' senior management, many of whom were longstanding Barings' employees. Accordingly, it placed greater reliance on statements made to it by management than it would have done had this degree of confidence not existed.'⁴¹

This trust in the competence of the managers meant that the Bank accepted what it was told about Barings' overseas subsidiaries. The subsequent report of the Treasury Committee was more forthright in its criticism:

'Given that the controls within Barings have subsequently been exposed as woefully inadequate, this must raise critical questions over the way the Bank performs its supervision and the way it evaluates the banks for which it is responsible.'⁴²

The Committee noted internal changes at the Bank had been instituted, but concerns remained about its supervisory practice.

'The Barings case illustrated considerable weaknesses in the Bank's supervisory regime, in areas such as the evaluation of internal controls at banks, the internal communication at the Bank itself, and the application of existing Bank rules. To address these issues the Bank is now committing a significant increase in the resources devoted to supervision. Yet publicly the Bank is maintaining a strident defence of the existing supervisory stance which retain a non-rules based, judgemental approach. These apparently contradictory positions highlight the dilemma facing the Bank. If it fails to act in the face of the obvious shortcomings of its supervision of Barings it would be regarded as complacent, yet it is keen... to retain the current discretionary stance of supervision. We recognise and welcome the Bank's current attempts to clarify the framework for its judgemental approach to supervision and urge the Bank to ensure that the type of laxity of management

³⁹ *Fourth Report: Banking Supervision and BCCI: International and National Regulation*, HC 177 (1992).

⁴⁰ *Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings*, HC 673 (July 1995), para.13.67

⁴¹ *Ibid*, para.13.58.

⁴² Treasury Committee, First Report: Barings Bank and International Regulation, HC 65, Sess.1996/97, para.24.

illustrated at Barings could not still go undetected under the new regime.⁴³

1.5 Financial Services Authority

How did the post-1997 reforms change regulation? What shaped regulatory practice?

1.5.1 The Bank in the 1980s and the banking industry were, of course, not like their Victorian selves. Nevertheless, regulatory practice had emerged from, and still showed the influence of, the club because it was, perhaps, difficult to envisage an alternative and it seemed to work – London was a major world financial centre and, in spite of the problems, there had been no systemic failures. Moreover, the self-regulatory approach fitted in with the neo-liberalism of the Conservative government, as exemplified by ‘Big Bang’ in 1986, which involved an assault on restrictive practices in the Stock Exchange. Opening the markets required a broader regulatory coverage,⁴⁴ but the Financial Services Act 1986 rejected detailed third-party regulation in favour of self-regulatory organisations for each sector and market.⁴⁵

1.5.2 The complex, multi-agency regulatory structure that emerged in the 1980s was abolished by the Financial Services and Markets Act 2000 (FSMA). This was not an ideological assault on the free market ideas or on the financial markets, or, really, a critique of the effectiveness of the existing regulatory structure, although various scandals had created a negative impression of its efficiency. More important was the decision by the Labour government in 1997 to make the Bank independent and give it control over monetary policy (Bank of England Act 1998) as part of what Gordon Brown, the Chancellor of the Exchequer, called ‘the monetary and fiscal settlement’.⁴⁶ At the same time the regulatory functions and powers of the Bank of England and those of the insurance, building societies and the FS Act 1986 regulators were transferred to a single third-party regulator, the Financial Services Authority (FSA).⁴⁷

1.5.3 The FSA was a company limited by guarantee and independent of government, but the Treasury appointed its members (FSMA, sch.1, pt.1, para.2(3)). It combined rule-making, supervisory and judicial powers, although this breach of the separation of powers doctrine was subject to checks and balances: for example, the FSA was obliged to consult on rule making, provide annual reports to the Treasury and hold annual public meetings (FSMA, sch.1, pt.1), and there were complaints and appeal procedures against its decisions. The Financial Services Act 1986 was required, so far as reasonably possible, to act in way that was compatible with its regulatory objectives, although it could choose how to meet them (FSMA, s.2). The objectives were market confidence, public awareness, protection of consumers, and reduction of financial crime. The FSA was also to have regard to the need to use resources in the most efficient and economic way, the responsibilities of those who manage authorised firms, the importance of ensuring that burdens on regulatees were proportionate to benefits, the desirability of facilitating innovation, the international character

⁴³ *Ibid*, para.32.

⁴⁴ HC Deb 16 Jul 1984 cc.49-50.

⁴⁵ HC Deb 16 Jul 1984 c.52; LCB Gower, *Review of Investor Protection, Report: Part 1*, cmnd 9125 (1984); M Reid, *All Change in the City: The Revolution in Britain's Financial Sector*, Basingstoke: Macmillan, 1988.

⁴⁶ ‘Gordon Brown’s Speech to the CBI’, *Financial Times*, 28 Nov 2005 at <http://www.ft.com/cms/s/2/9073a120-600d-11da-a3a6-0000779e2340.html#axzz2dFbmQzPT>. The settlement involved bank independence, an inflation target and new fiscal disciplines.

⁴⁷ Bank of England Act 1998, s.21; Financial Services and Markets Act 2000 (FSMA).

of industry, the maintenance of the UK's competitiveness, and the avoidance or mitigation of any adverse effect on competition.

1.5.4 How were these potentially contradictory objectives and considerations translated into practice? In essence, the FSA determined the style and intensity of its regulation by an assessment of the risk posed to the regulatory objectives by sectors, activities, firms and individuals. Alongside this was an evidenced-based approach to the adoption of new strategies or initiatives, which, for instance, involved considering whether a market failure was most effectively addressed by new rules. In 2007, the FSA moved away from rules to a principles-based approach with the aim of creating a cooperative relationship in which the regulatees would be 'enrolled' into a culture of self-regulation: 'Our aim is to focus more clearly on the outcomes we as regulators want to achieve, leaving more of the judgement calls on how to achieve those outcomes to the senior management of firms.'⁴⁸ The FSA explained this shift by saying that detailed rules placed an enormous burden on industry without preventing misconduct, that rules were less flexible and so unable to respond quickly to innovations, that they led to box ticking rather than adherence to regulatory standards, and that the sheer volume of rules rendered them inaccessible. But there had also been pressure from senior ministers: both Blair and Brown criticised the restrictions on the financial sector imposed by FSA, arguing, in effect, for a light touch. Blair saw the FSA's approach as indicative of a general tendency to over-regulate: 'The result is a plethora of rules, guidelines, responses to 'scandals' of one nature or another that ends up having utterly perverse consequences.' He added:

'something is seriously awry... when the Financial Services Authority that was established to provide clear guidelines and rules for the financial services sector and to protect the consumer against the fraudulent, is seen as hugely inhibiting of efficient business by perfectly respectable companies that have never defrauded anyone; when pensions protection inflates dramatically the cost of selling pensions to middle-income people'⁴⁹

In any event the result was that large parts of the FSA's rule book (FSA Handbook). This allowed the FSA to establish principles that could be applied across the financial services industry instead of having to legislate for each sector. Yet, it was a change of emphasis rather than a wholesale abandonment of rules, not least because EU law required member states to enact detailed rules. The FSA's Handbook still ran to hundreds of pages.

1.6 The Financial Crisis

How did the FSA react to the crisis and how did government react to the FSA?

1.6.1 As in the 1980s and 1990s, for many the mere fact of the crisis was sufficient evidence of the FSA's failure. The FSA responded by hiring more supervisory staff, establishing an internal structure that focused more on prudential and conduct risks, and expanding its jurisdiction by, for example, taking over regulation of retail banking conduct from the self-

⁴⁸ FSA, *Principles-based Regulation: Focusing on the Outcomes that Matter*, Apr 2007, pp.6-7.

⁴⁹ The speech by Tony Blair is reported by *Guardian*, 26 May 2005 at <http://www.theguardian.com/politics/2005/may/26/speeches.media>; the speech by Gordon Brown is in 'Gordon Brown's speech to the CBI', *Financial Times*, 28 Nov 2005 at <http://www.ft.com/cms/s/2/9073a120-600d-11da-a3a6-0000779e2340.html#axzz2dFbmQzPT>

regulatory body, the Banking Code Standards Board. At the same time there was a long period of intensive self-examination and various external inquiries.

1.6.2 The transfer of regulation from the Bank to the FSA had been a significant change in approach. The Banking Acts formally acknowledged government's legitimate interest in bank regulation and its right to hold the Bank accountable, but did not constitute a clean break with the history of club self-regulation. The establishment of the FSA in 1997 made that break. The FSA was a third-party regulator with no historic link to the banks. In contrast to the confidentiality and discretionary powers essential to the Bank's quasi-self-regulatory approach, the FSA's rules, processes and actions were designed to be public, clear and transparent, in part, to demonstrate distance between the regulator and the industry. But this created difficulties. Banking regulation arose out of the Bank's control over monetary policy, and the decision to establish the FSA involved separating these functions, which could be seen as pointing away from the focus on financial stability.

1.6.3 The FSA sought to rebuild the confidence of government, public and industry in its competence. Inevitably, this required dramatic action, which, irrespective of the merits of pre-crisis regulation, had to demonstrate a change in direction. The FSA adopted a more rules-based approach and an aggressive enforcement strategy, summed up by Hector Sants, the FSA's CEO, when he said, 'People should be very frightened of the FSA'.⁵⁰

1.6.4 Principles-based regulation was associated with a failure to prevent the crisis. The FSA was blamed for adopting an approach before the crisis which, at the time, had been seen as positive, more flexible and less risk averse and which had been pressed by government, but which afterwards was caricatured as 'light touch'. The shift to a rules-based system reflected a global trend in which existing rules, such as those on capital adequacy and liquidity, were tightened; perceived gaps, such as those that allowed shadow banking, were closed; and new powers were established to deal with matters such as the particular difficulties posed by bank insolvency. The FSA became more interventionist. Whereas it had previously been reactive and had taken the view that firms should make their own decisions, it now became more proactive, focusing on the risks inherent in a firm's business model. Firms were judged on the likely outcome of their decisions – judged on the judgements they made. Hector Sants acknowledged that the FSA's views as to proper outcomes might not coincide with those of the firms, but the objective was clear: 'this new approach may create tensions and will certainly no longer be seen as light touch!'.⁵¹

1.6.5 Credible deterrence has played an important part in post-crisis regulation. It involves an attempt to prevent regulatory breaches both by strengthening the resources devoted to enforcement in order to increase the likelihood of detection and by imposing severe penalties on rule breakers. At its core this strategy is intended to attract media and industry attention: 'Enforcement is only one of the tools available to the FSA, but its public nature means that it plays an important role in setting the tone and reinforcing the regulator's priorities.'⁵² It relies on a dramatic display of the FSA's power by the imposition of very heavy penalties: 'It

⁵⁰ H. Sants, 'Delivering Intensive Supervision and Credible Deterrence', speech at The Reuters Newsmakers event, 12 Mar. 2009: <tinyurl.com/adzbwu>. See, HC Deb, 17 Jun 2010, cc1056, 1060.

⁵¹ H Sants, 'Intensive Supervision: Delivering the Best Outcomes', 9 Nov 2009 at http://www.fsa.gov.uk/library/communication/speeches/2009/1109_hs.shtml

⁵² T McDermott, 'Credible Deterrence: Here to Stay', speech, 2 Jul 2012 at <http://www.fsa.gov.uk/library/communication/speeches/2012/0702-tm.shtml>

means delivering results that make people sit up and pay attention.’⁵³ In 2004-5, there were 71 actions with 44% resulting in fines that totalled £22 million. The number of actions did increase to 102 in 2005-6, 203 in 2006-7 and 120 in 2007-8, but the percentages in which fines were imposed were, respectively, only 17%, 16% and 18%, yielding £17 million, £15 million and £4 million. Then, the percentages and the level of fines began to climb: in 2008-9, 185 actions, 30% and £27 million; in 2009-10, 180 actions, 26% and £34 million; in 2010-11, 197 actions, 42% and £99 million; in 2011-12, 142 actions, 42% and £76 million, and in just six months from April to December 2012 the figures were 87 actions, 36% and £286 million.⁵⁴

1.6.6 In the immediate aftermath of the crisis, various legislative reforms were introduced to address flaws, such as financial stability as a regulatory objective and establishing a special mechanism for bank insolvency. But the Labour government did not contemplate abolishing the FSA. Unsurprisingly, the FSA’s CEO, Hector Sants, vigorously defended the status quo: ‘To undo the integrated approach to risk assessment, would be to return regulation in the UK to the dark ages!’⁵⁵ But support for the FSA fell away after the 2010 election. The new Coalition government seemed keen to emphasise the responsibility of the FSA and to associate it with the previous government, perhaps as part of a strategy which placed blame for the crisis, the economic depression and the austerity measures firmly on that government’s fiscal policy and regulatory failures. The FSA was alleged to have concentrated on consumer protection and not given sufficient attention to systemic and prudential risks. A difficulty with that criticism was that financial stability was not identified in FSMA as one of the FSA’s regulatory objectives. Yet, this could be regarded as merely exposing a more fundamental flaw, which was that the removal of supervision from the Bank meant the loss of its understanding of the banking system that was vital to the work of identifying and tackling systemic risks, and that loss had not been remedied by the attempt to connect the FSA, the Bank and HM Treasury through the Tripartite System.⁵⁶

1.6.7 The Coalition government’s identification of the regulatory structure as a source of problems made the solution obvious: involve the Bank directly in regulation. Inevitably, this led to the abolition of the FSA and its replacement by two new regulators (Financial Services Act 2012) – the Prudential Regulation Authority, which operates inside the Bank of England, and the Financial Conduct Authority. This restructuring allowed a line of sorts to be drawn under the regulatory system. Blame for the regulatory failures before 2013 could be left with the FSA, giving the new regulators a clean start. It meant the government could tie the crisis to a structure that had been a significant element of the previous government’s policy and allowed it to demonstrate willingness for decisive and radical action. The new structure does create new problems, such as the precise nature of the relationships between regulators, between regulators and the Financial Policy Committee,⁵⁷ and between regulators and the Treasury. Here, the new rules-based approach is evident, and so are its limits. For example, the coordination arrangements between the PRA and the FCA are not entirely left to the new

⁵³ M Cole, ‘Delivering Credible Deterrence’, 27 Apr 2009 at

http://www.fsa.gov.uk/library/communication/speeches/2009/0427_mc.shtml

⁵⁴ Figures are at <http://www.freshfields.com/KnowledgeDetail.aspx?id=2147938671>

⁵⁵ H Sants, ‘Intensive Supervision: Delivering the Best Outcomes’, speech, 9 Nov. 2009: <http://tinyurl.com/3xl3ywg>

⁵⁶ Treasury Committee, *The Run on the Rock*, vol 1, HC 56-1 (2008), paras 269-92.

⁵⁷ Although not a regulator, the FPC is an independent committee at the Bank charged with monitoring and taking action on systemic risks

regulators, as a general framework is set out in the FSA 2012,⁵⁸ and the PRA and the FCA are expected to base their supervision on rules rather than principles. Yet, their overall approach to regulation is going to be ‘judgement-led’. Thus, while greater emphasis is placed on rules, which define the behaviour of both the regulators and the regulatees, fresh importance is placed on administrative discretion and forward-looking action.⁵⁹

1.6.8 Much about the new model seems familiar. Most obviously, the framework statute remains FSMA, subject to amendments, and most of the FSA’s Handbook survives. The explanation was that attempting to get a new statute through Parliament would have delayed reform. It could also be seen as a way of demonstrating the urgency of the situation, even though the FSA had been reorganised and refocused and might, presumably, have carried on. The strategy of characterising reform as both obvious in terms of the underlying problem (the FSA) and urgent restricted the debate. The concern is that there is a risk of repeating errors of previous regulatory statutes by resolving only those problems identified as having caused the crisis, particularly when, as the different responses of the Labour and Coalition governments show, neither the nature of the problem nor its solution is necessarily obvious.

1.6.9 Alongside these domestic issues, the government’s and the regulator’s freedom to shape the regulatory system has become increasingly constrained by international pressures since the 1970s. The EU project of establishing a single market in goods, services and labour, which allows firms to sell and customers to buy in other member state markets, has meant intervention by EU law into various aspects of regulation, particularly the protection of consumer rights, and has brought, therefore, some convergence around these standards. But the globalisation of financial services has undermined the power of nation states or the EU to regulate in isolation, increasing the importance of international agencies, such as the Basel Committee on Banking Supervision and the post-crisis G20-based initiatives on regulation.⁶⁰ Against these tendencies to convergence and cooperation, nation states also compete to attract firms by offering a regulatory regime more attractive than that of a rival nation. Even within the EU there is enormous variety in terms of regulatory architecture and methodological approach, and the harmonisation of particular rules does not necessarily translate into uniform implementation. But the post-crisis period has been marked by the vigour with which the EU has advanced its control over financial regulation, establishing a single rulebook and countering regulatory divergence, and while these EU reforms have been concerned with financial stability, they are also seeking to improve market efficiency, transparency and consumer protection. The implications of this significant shift remain unclear. In particular, it has not created tensions between the EU and Member States regarding control over financial markets.⁶¹

1.6.10 The other pressure on regulation has come from those whom it is designed to regulate. The views of depositors, investors and customers are difficult to gather or to distil into a single opinion. Generally, the banks have been more influential, arguing that regulation is

⁵⁸ A Georgosouli, ‘The FCA-PRA Coordination Scheme and the Challenge for Policy Coherence’ (2013) 8(1) *Capital Markets Law Journal* 62.

⁵⁹ A Georgosouli, ‘Judgement-led Regulation: Reflections on Data and Discretion’ (2013) 14 *Journal of Banking Regulation* 209.

⁶⁰ <http://www.bis.org/bcbs>. See E Ferran, N Moloney, JG Hill and JC Coffee, *The Regulatory Aftermath of the Global Financial Crisis*, Cambridge: Cambridge University Press, 2012.

⁶¹ Hse-Yu Chiu, *Regulatory Convergence in EU Securities Regulation*, London: Kluwer, 2008; N Moloney, ‘Resetting the Location of Regulatory and Supervisory Control over EU Financial Markets: Lessons from Five Years On’ (2013) 62(4) *International & Comparative Law Quarterly* 955.

expensive, puts the UK industry at a competitive disadvantage and restricts the ability to lend, which is a particularly well-aimed argument during a recession. There has also been the threat that banks might move away from London if they feel regulation is excessive.⁶² Many of those who became ministers in 2010 had engaged in ‘banker bashing’ during the election campaign, and, at first, the new government put pressure on banks to reduce bonuses and stripped Fred Goodwin of his knighthood. But as early as 2011 a change in emphasis seemed evident, particularly after a meeting at Davos between finance ministers and the leaders of 40 banks and insurance companies.⁶³ Those who assailed bankers were now criticised by ministers and accused of damaging the economy. When the scandals around LIBOR fixing emerged in 2012, there was a more muted response in the form of new regulations and enforcement actions rather than a general assault on the banks by ministers. While it was an opportunity to demonstrate credible deterrence through heavy fines, it did not lead ministers to fire more broadsides against the industry. Furthermore, government has attacked EU measures, such as the transaction tax and remuneration rules, that were regarded as damaging to the UK’s financial markets.

1.7 Themes

What does history tell us about regulation? One of history’s most interesting and useful functions is the way it can allow us to gain some understanding of the nature of change.

1.7.1 Law reform rarely involves a decisive break with the past, if only because it arises out of, and is defined by, the identification of a problem with the existing law. This means other problems may be marginalised or ignored because they appear insignificant, speculative or fanciful. Regulatory change is often incremental, responding to particular problems, which reveal flaws, by repairs to the existing structure. But at times there is radical reform, such as occurred with the shift from the Bank and the Financial Services Act 1986 model of regulation to the FSMA model. These changes may occur when the existing model is perceived to be unable to resolve satisfactorily problems that arise, or has been amended to deal with problems to such an extent that its ability to provide a coherent approach, and, therefore, its legitimacy are undermined.⁶⁴ Alternatively, a new model may appear not because the old model is unable to resolve the problems but because a change serves political goals. The association between the existing model and a previous government or ideology may be too close, so that a new government believes it cannot work with that model or wishes to make its mark by adopting a fresh model. Yet, even here the old model remains influential in defining what the new is not. The new is, after all, a reaction against the old – a highlighting of its failure – and must be presented as tackling problems that the old could not. This may require rearticulation of the problems in order to clear the way for new solutions.

1.7.2 Although reform is shaped by perceptions of a problem, both those perceptions and the selection of the appropriate solution are influenced by an understanding of what is possible – both practically possible, in that the resources exist which are affordable and believed capable of resolving the problem, and ideologically possible, in that the problem and the proposed solution fit within the hegemonic way of thinking. The nineteenth-century free market

⁶² *Financial Times*, 30 Sep 2010.

⁶³ *Guardian*, 29 Jan 2011 at <http://www.theguardian.com/business/2011/jan/29/davos-summit-ferguson-osborne-bankers>

⁶⁴ See TS Kuhn, *The Structure of Scientific Revolutions*, London, 1962, although suggests that serendipity plays a role in change (the gestalt switch), whereas it could be explained as a rational process.

environment did not entirely reject regulation, as can be seen in the regulation of workplaces (e.g. the Factories Acts) and even the regulation of insurance companies (e.g. the Assurance Companies Act 1870), but, broadly, the regulation of business was not regarded as one of the functions of government. Thus, while the Barings collapse of 1890 was of concern to government, its resolution was largely left to the banking community. By contrast at the end of the twentieth century the political importance of finance meant that intervention in the banking market had become a legitimate part of government policy, so that regulators had to be accountable to government. Yet, the nature of that intervention is shaped by other pressures in that regulation is not defined simply by domestic issues, but also by the international nature of finance. The EU has played an important role in defining UK financial regulation, particularly in relation to consumer rights. It has also been at the forefront in transmitting standards developed by the Basel Committee on Banking Supervision. Basel is now premised on the idea that macro-prudential regulation underpins global finance, which, in turn, is regarded as fundamental to economic growth. At the same time, government is aware of the need to maintain a competitive finance sector and may, therefore, resist or reshape international regulatory standards and priorities in order to attract business away from countries with more severe regimes.

1.7.3 The political nature of modern financial regulation has consequences for the regulator in that its performance may not be judged purely on endogenous criteria. Its performance may be assessed, not by circumstances as they existed at the time, but with the benefit of hindsight, or by the application of fresh criteria, or by a narrow political agenda perhaps not directly connected to regulation of the particular sector. The regulator is expected to ensure financial stability and consumer protection, while allowing the industry sufficient flexibility to compete in an international market. As a result, any failure can come to be seen as a failure of regulation and a failure of the regulator, almost irrespective of what the regulations say or what the regulator did or could have done.

2. WHY REGULATE?

What are the objectives of regulation and what problems are involved in setting down and applying these objectives?

2.1 Regulating a market economy

2.1.1 If competition is the best way of protecting consumers and ensuring a robust, efficient and prosperous economy, regulation is only appropriate – and to the extent necessary – to meet an overriding public interest objective which is not achieved by the operation of the market, and only if the benefit of intervention is proportionate when compared with the costs involved. But how are costs and benefits identified and quantified? It may be that the law can only define the objectives, leaving whether, when and how it is appropriate to intervene to enforcement authorities.

2.1.2 Regulations control the quality of a product or service (e.g. safety features on cars), or the nature of the market (e.g. whether such a market should be permitted – the sale of certain types of drugs is prohibited: Misuse of Drugs Act 1971, s.4), or require that those dealing in the market (usually, as suppliers, intermediaries or advisers) are licensed and/or comply with certain standards (e.g. fit and proper, internal controls), or stipulate certain aspects of the relationship between the parties (e.g. imposing extra-contractual obligations, such as cooling-off periods, and excluding unfair contractual terms or practices).

2.2 Determining the objectives of regulation

2.2.1 Regulation is rarely the simple expression of a single idea or objective. Normally, it involves negotiation and compromise. It is not obvious how protecting investors can be balanced against ensuring choice and that suppliers and buyers take responsibility for their choices. This seems easy to get wrong, or, at least, easy to characterise as having done so if, for example, a large number of investors suffer loss. The assessment of each investor's ability to understand and take responsibility for the risk involved will vary with such things as the product, information concerning that product, the skill of the investor or their access to advice. It may be possible for the regulator to draw broad distinctions. For example, COBS (FCA Handbook) defines a 'retail client' as not a 'professional client', and a professional client as broadly any financial institution or professional investor (COBS 3), and prohibits the sale of certain investments to retail clients, or permits sales subject to information and warnings. But it cannot be assumed that professional investors, such as banks, require little or no protection because there may be systemic dangers – one of the causes of the crisis was poor investment decision making by large financial institutions.

2.2.2 Under the Financial Services and Markets Act 2000 (FSMA as amended), the Financial Services Authority (FSA) was required to discharge its functions, so far as reasonably possible, in a way that was compatible with the regulatory objectives set out in the act (s.2):

- (a) market confidence (s.3);
- (b) public awareness: promoting public understanding of the financial system including the benefits and risks involved (s.4);
- (c) 'securing the appropriate degree of protection for consumers', having regard to the different risks involved in different investments and transactions, the differences in expertise between consumers, the need for advice and accurate information, and 'the general principle that consumers should take responsibility for their decisions' (s.5);

(d) the reduction of financial crime: that is, reducing the extent to which it is possible for a business carried on by a regulated person (or a person who should be authorised) to be used for a purpose connected with financial crime (s.6).

The financial crisis led to changes in the objectives. The Financial Services Act 2010 added 'financial stability' (revised FSMA, s.3(2)(ab)) and removed public awareness (2010 act, s.2(2)(b)). The FSA was required to have regard to the need to use resources in the most efficient and economic way, to the responsibilities of those who manage authorised firms, to the importance of ensuring that burdens on regulatees were proportionate to benefits, to the desirability of facilitating innovation, to the international character of industry, to the maintenance of the UK's competitiveness, and to the avoidance or mitigation of any adverse effect on competition.

2.2.3 These objectives changed again when the Financial Services Act 2012 abolished the FSA and established the new authorities. The Prudential Regulation Authority (PRA) 'must, so far as is reasonably possible, act in a way which advances its general objective', which is 'promoting the safety and soundness of PRA-authorised persons', and this is to be advanced 'primarily' by seeking to ensure that the business of such persons does not adversely affect the stability of the UK financial system (FSMA, s.2B).⁶⁵ The PRA's general objective has been further amended by the Financial Services (Banking Reform) Act 2013 (FS(BR)A), which seeks to protect retail banking services through ring fencing to prevent cross-pollution from other activities. The PRA is required to ensure that ring-fenced bodies carry on their businesses in ways that avoid adverse affects on the continuity of 'core services' (primarily, those associated with deposit taking) and minimise the risk of failure of such bodies. The PRA must 'determine its strategy in relation to its objectives' (FSMA, s.2E). Finally, FS(BR)A requires the PRA to promote competition, although this will be subordinate to the general objective (FSMA s.2H).

2.2.4 The Financial Conduct Authority (FCA) must discharge its functions, so far as reasonably possible, in a way that is 'compatible with its strategic objective, and advances one or more of its operational objectives' (FSMA, s.1B(1)). The strategic objective is to ensure that the relevant markets function well (FSMA, s.1B(2)).⁶⁶ Its operational objectives are in FSMA, s.1B(3).

(a) To secure an appropriate degree of protection for consumers. In determining this, the FCA must consider:

- the risks involved in different investments or transactions
- the different expertise of consumers
- the needs of consumers for timely information and advice 'that is accurate and fit for purpose'
- 'the general principle that consumers should take responsibility for their decisions'
- 'the general principle that those providing regulated financial services should be expected to provide consumers with a level of care that is appropriate having regard to the degree of risk involved in relation to the investment or other transaction and the capabilities of the consumers in question'

⁶⁵ The new provisions were introduced by the Financial Services Act 2012, s.6 (replacing FSMA, ss.1-18).

⁶⁶ 'Relevant markets': FSMA, s.1F. There are further amendments to the FCA's objectives in FS(BR)A, s.2, which require it also to consider ring-fencing issues.

- the differing expectations consumers may have in relation to different investments
 - information supplied to the FCA by the consumer financial education body or by the ombudsman (FSMA, s.1C).
- (b) To protect and enhance the integrity of the UK financial system, which includes its soundness, stability and resilience, that it should not be used for crime or affected by market abuse, its orderly operation and transparency of price formation (s.1D).
- (c) To promote effective competition in the interests of consumers. This involves consideration of matters such as the needs of different consumers, which includes information ‘that enables them to make informed choices’, the ease with which consumers can obtain services and change suppliers, access for new entrants to the market, and encouraging innovation (s.1E).

The contrast between the original and revised versions of FSMA reveals much about the intervening period and reactions to the crisis. The more detailed objectives disclose the wish to confine and direct the regulators to issues that it was felt had been neglected by the FSA. In particular, there is the emphasis on the stability of the market, which was not part of the FSA’s original objectives (a financial stability objective was only introduced by the Financial Services Act 2010, s.1), and the emphasis on competition.⁶⁷

2.2.5 This range of objectives and the complex nature of the relationship between them are confusing. The history of bank regulation in Chapter 1 showed how the regulator can be criticised for focusing on the wrong objective – even though such criticism is often able to benefit from hindsight. It could be argued that allowing Johnson Matthey to slip into insolvency would have been appropriate in a market system, but at the time the regulator believed this would have adversely affected the gold market which was potentially systemically important, and perhaps also the reputation and, therefore, the integrity of the UK financial system. The Bank of England might have closed BCCI before 1991 in order to protect depositors and end criminality, but its view was that acting sooner would not have protected depositors and that the mere fact of criminality was not necessarily sufficient reason for closing a bank.

2.2.6 The confusion of objectives is much worse for modern regulators because they are stipulated in legislation without a clear indication as to how they can be balanced against one another. Each objective poses problems of interpretation, arising partly from trying to define each on its own terms and partly from the need to interpret each objective against the other objectives. For example, in addition, to promoting its strategic objective (although only ‘so far as reasonably possible’), the FCA must promote one of the operational objectives, ‘so far as is compatible with acting in a way which advances the consumer protection objective or the integrity objective, discharge its general functions in a way which promotes effective competition in the interests of consumers.’ (s.1B(4).) The complexity is increased by the requirement that the FCA also applies the ‘regulatory principles’ – the need to use resources efficiently and economically; burdens placed on persons should be proportionate to benefits arising; the desirability of sustainable economic growth; the principle that consumers should take responsibility for their decisions; the responsibilities of senior management in relation to compliance with regulations; the desirability of regulators recognising the differences

⁶⁷ The FSA had merely been directed to have regard to ‘the desirability of facilitating competition’ (FSMA, s.2(3)(g)).

between businesses, and of publishing information regarding regulations; and regulatory transparency (s.3B).

2.3 Competition

2.3.1 An understandable reaction to a crisis is to regulate, but this has an impact on competition. Competition may be about allowing free access of suppliers and buyers to the market, but there may also be regulatory competition by which one jurisdiction adjusts regulatory oversight in order to attract business away from other jurisdictions: e.g. it has been suggested that London sought to attract business from New York by operating light-touch regulation, and the concern that London's regulatory regime might be undercut by non-EU jurisdictions is implicit in opposition to some changes in EU financial regulation. These different types of competition (between firms and between regulatory systems) may create confusion for the regulator and undesirable effects, such as regulatory arbitrage, that undermine attempts to establish uniform international standards and cross-border trading.

2.3.2 The importance of competition explains why it has been flagged up as an issue for all regulators, but this may lead to an overlap with the competition authorities. The Competition and Markets Authority (CMA) has been established out of the Office of Fair Trading and the Competition Commission (Enterprise and Regulatory Reform Act 2013 (ERRA), Parts 3 and 4). Like the amended FSMA, the regulatory objective is 'to promote competition, both within and outside the United Kingdom, for the benefit of consumers' (s.25(3)). The CMA's statutory functions are:

- (a) to investigate mergers that could undermine competition;
- (b) to conduct investigations into particular markets where competition and consumer problems are suspected;
- (c) to investigate individual businesses to determine whether they have breached UK or EU prohibitions against anti-competitive agreements and abuse of a dominant position under the Competition Act 1998;
- (d) to bring criminal proceedings against individuals who commit cartel offences;
- (e) to enforce a range of consumer protection laws and bring criminal proceedings under the Consumer Protection from Unfair Trading Regulations 2008;
- (f) to conduct regulatory appeals and references in relation to price controls, terms of licences or other regulatory arrangements under sector specific legislation.

2.3.3 Curiously, in its original form FSMA did not include competition among the regulatory objectives (ss.3-6). The FSA was only required 'to minimise the adverse effects on competition' in discharging its functions (s.2(2)(f)) and have regard to 'the desirability of facilitating competition' (s.2(3)(g)). But now, as has been seen, the FCA must promote effective competition, which suggests a more active role.⁶⁸

2.3.4 What is the relationship between, on the one hand, the CMA and, on the other, the FCA and the PRA?⁶⁹ Under FS(BR)A, in addition to its competition objective, the FCA will have, concurrently with the CMA, powers to investigate competition law breaches under the

⁶⁸ The same proactive obligation arises from the amendment to the PRA objectives under FS(BR)A: HM Treasury, *Financial Services (Banking Reform) Bill Government Amendments: PRA Competition Objective*, Oct 2013 at <http://tinyurl.com/pzfnfjh>.

⁶⁹ See ABI, *FCA and Competition: A New Direction for Financial Regulation* (2014) at <http://tinyurl.com/p817tzc>.

Competition Act 1998 (enforcement regarding cartels, anti-competitive agreements and abuse of dominant position), and the Enterprise Act 2002 (powers to conduct market studies and make references to the CMA) (FS(BR)A, s.129, sch.8). The FCA will be required to consider taking action under these competition powers before using regulatory powers under FSMA (FS(BR)A, sch.8, inserting s.234K into FSMA). The reason for giving these powers to the FCA is the belief that they will reinforce its efforts to ensure that financial markets are competitive in the interests of customers. Moreover, it is thought that the FCA's ability to refer matters to the CMA will lead firms to change their behaviour voluntarily. The FCA will also join the European Competition Network and thus influence EU competition law.⁷⁰ As has been mentioned, the PRA will have a competition objective, which will be subordinate to its general objective, and, it is hoped, will ensure that the PRA takes a proactive view of competition issues when exercising its powers (FS(BR)A s.130, inserting s.2H into FSMA).

2.3.5 FS(BR)A also provides for ring fencing certain activities and services. In exercising its powers to achieve this, the Treasury must have regard to the adverse effect of ring fencing on competition in respect of 'core activities' (in essence, deposit taking) (s.4 inserting a new s.142A into FSMA). The Act requires the FCA to create the Payment Systems Regulator (Part 5). That regulator must have regard to the need to promote effective competition in the payment systems market, and to that end is given a long list of matters to which it 'may have regard in considering the effectiveness of competition in the market' (s.50(3)) and a range of powers, which in some circumstances may require it to involve other authorities, including the CMA.

2.3.6 The CMA's latest consultation paper, *Vision, Values and Strategy for the CMA* (Oct 2013), does not explicitly refer to the financial sector, and there is the possibility of conflict over the best course of action for preserving competition in the interests of consumers of financial services. A particular concern must be institutional overlaps and underlaps (situations where neither regulator supervises) as a result of developments in the market. There may also be problems arising from the adoption of different regulatory philosophies and methodologies.

⁷⁰ HM Treasury, *Financial Services (Banking Reform) Bill Government Amendments: FCA Concurrent Powers*, Oct 2013 at <http://tinyurl.com/pggk7zu>.

3. FREE MARKET, SELF-REGULATION AND THIRD-PARTY REGULATION

3.1 Free market

3.1.1 In a free market transactions are subject to rules determined by the parties in their contract. The law does not intervene because it is assumed that the parties have equal bargaining power and can choose whether or not to enter into the contract and the terms upon which they will contract. The role of the state (through the courts) is to enforce the contract at the request, and according to the intention of, the parties, and not to write the contract on the basis of some concept of fairness.

3.1.2 The room for negotiation over terms may be restricted. Where there is a perceived imbalance between different broad categories of contracting party (e.g. consumer and business person), the state may intervene to prevent one party (typically, the business party, such as a trader, broker or advisor) from relying on unfair terms or excluding its liability for breach, or terms may be implied into the contract giving the other party (usually, a consumer) additional rights (e.g. the Sale of Goods Act 1979, ss.12-14, implies terms as to title, description and quality; or statutory rights to cancel a contract within a stipulated period). Aside from such state regulation of the contract, model contracts are commonly used to minimise time and transaction costs and to provide industry-wide benchmarks, such as the JCT in the construction industry, the Institute of London Underwriters clauses in marine insurance, and the Loan Market Association model contracts in large-scale lending. Typically some of the terms in such contracts are negotiated (e.g. price). These contracts may in effect become almost mandatory because parties engaged in that trade expect to do business using them. On a smaller scale, a supplier or buyer may develop a standard form contract, which also contemplates no (or limited) negotiation over terms. Indeed, the standard form contract, which is not open to negotiation – the buyer has only a choice to enter into the contract or not – is dominant in the broad field of consumer sales from railways to internet shopping to financial services. The contract may supplement statutory regulation: for example, a motorist is subject to various laws relating to driving and is required to have third-party liability insurance, but the insurer may also insist on the installation of a black box to set driving standards above those required by the law, such as a curfew and restricting hard accelerating or braking, which are enforced by higher premiums or a refusal of cover.

3.2 Self-regulation and third-party regulation

3.2.1 Regulation may be self-regulation by a firm or industry, or third-party regulation by either a statutory body, such as the FCA, or a non-statutory body, such as the Advertising Standards Authority, or, most likely, a combination of some or all of these. Industry or statutory bodies may also set standards which affect the marketability of products or services without directly regulating them, such as the British Standards Institute or credit rating agencies. Where regulation is thought necessary, governments may still favour self-regulation because it is cheaper than third-party regulation and/or because of ideological objections to government intervention in the market.⁷¹ The industry may be motivated to self-regulate by the threat of government intervention: insurance was excluded from the Unfair Contract Terms Act 1977⁷² on the understanding that the industry would produce the Statements of Practice to regulate consumer insurance policies.

⁷¹ For an example of that form of objection that arose in the funeral industry, see *The Telegraph*, 6 Nov 2002 at <http://tinyurl.com/mebmgwf>.

⁷² This regulates terms purporting to limit or exclude liability for, among other things, contractual breach.

3.2.2 Industry expertise and awareness of the market should make self-regulation more effective and efficient in identifying and resolving issues. But there is a danger that issues will be seen from the industry's perspective rather than that of the consumer, or, what is just as bad, be perceived as having this tendency. Self-regulation may also lack clear accountability. In some industries, there are different trade associations and different self-regulatory systems, which might encourage the belief that they would compete. The funeral industry has two main industry associations – the National Association of Funeral Directors and the National Society of Allied & Independent Funeral Directors – each with its own code of practice and complaints mechanism. But the level of competition this generates is unclear because the schemes are very similar and it is impossible for customers to compare their performance, and once the customer has entered into a contract with a particular firm he or she must use the dispute mechanism of the trade association to which that firm belongs.

3.2.3 Industry self-regulation schemes often arise out of a trade association and may involve a code of practice devised by members. A code can be suited to a particular sector rather than having to be drafted in general terms for a whole industry, as may be necessary if legislation is used, and it may be easier to amend as circumstances change. The industry may adopt such schemes because they see them as good for business in that they improve customer confidence, but this is likely to require full commitment to the code otherwise customers may see it as merely a public relations exercise without substance, undermining rather than improving their view of the industry. The code will be voluntary or may not cover the entire industry. It may, however, become mandatory in practice for the entire industry because it is a condition of membership of a trade association or customers refuse to deal with those who do not subscribe to the code; but, of course, this depends on customers being aware of the trade association or the code's existence. If the code is incorporated by a firm into its contracts, it becomes enforceable through the courts as part of the contractual terms. A code may acquire the force of regulatory law where approved by a statutory body, or legislation authorises a self-regulatory body to regulate (e.g. Lloyd's of London insurance market). Legislation may also prompt the adoption of codes. The Office of Fair Trading (OFT) has a duty under the Fair Trading Act 1973, s.124(3), to encourage trade associations to draw up codes of practice. In 2001, the OFT began the Consumer Codes Approval Scheme (CCAS) and identified seven industries in which codes were needed. But progress proved slow, and the OFT faced serious problems in enforcing its views in a climate which favoured leaving such decisions entirely to industry.⁷³ In 2013, the Trading Standards Institute (TSI), a non-statutory association of trading standards professionals, took over the CCAS on a self-funding basis. The scheme requires a code to meet certain general criteria and enforcement to be monitored on the basis of indicators of performance agreed with the industry.⁷⁴

3.2.4 A code of practice will normally have some complaint mechanism that offers consumers a cheap or free means of pursuing a claim. These are likely to have elements of independence, such as the appointment of laypersons to the complaints authority. The Advertising Standards Authority is independent, but is funded by the industry and its rules are written by the industry. There may be problems where that mechanism is perceived as being too closely connected to the industry – something that has dogged the Press Complaints Commission. Some can be spectacularly successful, such as the Insurance Ombudsman Bureau in 1981, which demonstrated a high degree of independence and led to other schemes

⁷³ *The Telegraph*, 6 Nov 2002 at <http://tinyurl.com/mebmgwf>.

⁷⁴ <http://www.tradingstandards.gov.uk/advice/ConsumerCodes.cfm>.

and eventually to the statutory Financial Ombudsman Service. Some codes do not have a consumer complaints mechanism. The Lending Code (2009) is a voluntary code of practice issued by the British Bankers' Association, the Building Societies Association and the UK Cards Association to protect consumers and small businesses.⁷⁵ The Lending Standards Board (LSB) consists of three public interest directors, an independent chair, the executive directors of the three sponsoring trade bodies and the chief executive of the LSB.⁷⁶ The LSB monitors compliance with the Code through reviews and investigations, but it does not normally investigate individual complaints, which means complainants must go either to the courts or to the Financial Ombudsman Service.

⁷⁵ The five main banks also subscribe to Lending Principles for Larger Businesses.

⁷⁶ <http://www.lendingstandardsboard.org.uk>.

4. HOW ARE RULES DRAFTED?

Statutory regulation involves rules or standards with which market participants (and regulators) are meant to comply. These rules or standards should be determined by, and seek to achieve, the regulatory objectives.

4.1 Sources of rules

4.1.1 Parliament may lay down rules for the regulation of a sector in primary legislation, or provide a broad framework which is filled in by a minister through secondary legislation (statutory instrument), or by a regulatory agency, such as a third-party (as with the PRA and FCA) or an industry appointed body (as under the Financial Services Act 1986). Rule making by a regulator will involve a procedure set out in the framework act. Under FSMA 2000, Part 9A (inserted by Financial Services Act 2012, s.24), the FCA may make such rules ‘as appear... to be necessary or expedient for the purpose of advancing one or more of its operational objectives’ (s.137A(1)), and a similar power is granted to the PRA (s.137G(1)), but these powers can only be exercised after consultation (ss.138I(1) and 138J).

4.1.2 Delegation of rule making to a specialist agency has a number of advantages. It allows use of the skills acquired by those whose everyday job is to regulate a particular sector of economy. It should reduce the possibility of political intervention, and the regulator will acquire practical experience of the rule which can be fed back into the rule making. But there are disadvantages. Delegating rule making power may mean it is less effectively subject to democratic accountability in that any consultation process is narrowly defined. While law making through Parliament is certainly expensive and slow, the requirement of consultation by a regulator is not cheap and may involve delays that prevent rapid response to a new problem, which may encourage obstruction by those who oppose a new rule and deter the regulator from using its rule making power, leading it to adopt other, less transparent, strategies, such as compromise with regulated firms.

4.1.3 Some statutory regulation originates in industry self-regulation. Health warnings on cigarette packets started as the result of informal agreement between industry and government in 1971, becoming formal as the result of an EC directive in 1989.⁷⁷ In the 1980s the financial services industry was a mix of third-party regulation (e.g. deposit-taking was regulated by the Bank of England and insurance business by the Department of Trade and Industry) and self-regulation (Financial Services Act 1986), but FSMA adopted third-party regulation. Nevertheless, certain aspects of banking were not within the new regime, such as LIBOR (the London Interbank Offered Rate) and most of the bank-customer relationship, which was subject to the voluntary Banking Codes of Practice. Some of these issues were drawn into third-party regulation after the financial crisis. Allegations about the manipulation of LIBOR led to the mechanism being redesigned and brought under regulatory control by the FCA with the calculations, which used to be undertaken by BBA LIBOR Ltd, an industry body, now the responsibility of IntercontinentalExchange (ICE) Benchmark Administration Ltd.⁷⁸ Similarly, in the wake of the financial crisis and complaints about the way banks treated customers the Banking Codes were replaced in 2009 by the FSA’s *Banking: Conduct*

⁷⁷ Now, The Tobacco Products... Regulations 2007 (SI 2007/2473).

⁷⁸ M Wheatley, *The Wheatley Review of LIBOR: Final Report*, HM Treasury, 2012 at http://www.hm-treasury.gov.uk/wheatley_review.htm; Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2013 (SI 2013/655). On ICE LIBOR: <https://www.theice.com/iba.jhtml>.

of Business Sourcebook (BCOBS) together with the Payment Services Regulations 2009 (SI 2009/209), although the Lending Code remains outside this statutory system.

4.2 Designing rules

4.2.1 In financial regulation the regulatory objectives guide the approach taken by the regulator in drafting rules, monitoring their compliance and imposing sanctions for breach. The primary legislation (FSMA as amended) contains some fundamental standards that authorised persons must observe, such as the threshold conditions (Sch. 6), but it is principally the task of the regulators to make rules regarded as necessary to meet the regulatory objectives. As has been seen, this is difficult because the objectives may conflict, the way they are translated may be contested, and legislation may constrain rule making by, for example, the considerations to which the regulator must have regard in discharging its functions and the procedures that must be observed.

4.3 Uses of rules

4.3.1 Market restrictions

4.3.1.1 Rules may prohibit or restrict the entry of certain parties into a market. There may be a restriction on who can enter the market as a seller or advisor or intermediary: under FSMA, s.19(1), ‘No person may carry on a regulated activity in the United Kingdom, or purport to do so, unless he is (a) an authorised person; or (b) an exempt person.’ Sellers and intermediaries may be restricted in the transactions they can conduct or advisors in the advice they can provide: it is an offence to sell tobacco to someone under the age of 18 years (Children and Young Persons Act 1933, s.7(1)(a)), and there are controls under FSMA on the sale of investment products to retail clients. In rare cases buyers may need authorisation: the Firearms Act 1968 requires both parties to have licences for the sale and possession of guns.

4.3.1.2 Rules may restrict the products that can be sold.

(a) Absolute prohibitions are rare (e.g. Misuse of Drugs Act 1971, s.7).

(b) Some products require licensing before sale: the approval of National Institute for Health and Care Excellence (NICE) must be obtained before medicines can be marketed (Medicines Act 1968, Health and Social Care Act 2012, Part 8).

(c) More often, products must have particular qualities: ‘Every motor vehicle shall be so designed and constructed that the driver thereof while controlling the vehicle can at all times have a full view of the road and traffic ahead of the motor vehicle’ (The Road Vehicles (Construction and Use) Regulations 1986 (1986/1078), art 30(1)); ‘Toys... must not jeopardise the safety or health of users or third parties when they are used as intended or in a foreseeable way, bearing in mind the behaviour of children’ (Toy (Safety) Regulations 2011 (SI 2011/1881), art 5(2)).

(d) Product regulation may seek to prevent third party or environmental harm, such as Regulation (EC) No 715/2007 on type approval of motor vehicles with respect to emissions (Euro 5 and Euro 6)).

Regulation of the terms upon which a transaction is conducted is a separate issue from these sorts of product regulation and from the regulation of the parties: the FCA Handbook does regulate some transactions by intervening in the terms and by providing non-contractual

rights; but the Firearms Act does not, and, if a car meets the standards set down, the manufacturer can charge whatever price they wish (see 4.3.3).

4.3.2 Information and advertising

4.3.2.1 There may be rules about information:

‘A firm must ensure that the distance marketing information, the commercial purpose of which must be made clear, is provided in a clear and comprehensible manner in a way appropriate to the means of distance communication used with due regard, in particular, to the principles of good faith in commercial transactions and the legal principles governing the protection of those who are unable to give their consent, such as minors.’ (FCA Handbook, BCOBS 3.1).

A market can be distorted by a lack of information creating an imbalance between seller and buyer, and regulation may require information to be provided. When should information be provided? What sort of information is required? To whom must information be supplied? Should all customers receive the same information or just retail customers? The aim is to address information asymmetry by requiring appropriate information prior to sale, leaving the customer to decide whether or not to buy or invest. The rules should make rights to information clear, predictable and easy to enforce.

4.3.2.2 Rules may oblige the seller to provide information about the firm and/or the product to the market generally (e.g. the listing of securities under FSMA, Part VI and FCA Handbook DTR), or to an individual customer (e.g. FCA Handbook BCOBS 4.1), or to give a customer advice (e.g. FCA Handbook COBS 9). Information may be necessary during the life of the product or service and rules may place the supplier under a continuing obligation, such as the duty to provide statements of account in a durable medium to banking customers (BCOBS 4.2.1R), or to inform customers of a material change in an interest rate (BCOBS 4.1.2R). The misuse of information may be prohibited: under the Criminal Justice Act 1993, s.52(1) ‘An individual who has information as an insider is guilty of insider dealing if... he deals in securities [on a regulated market or as a professional intermediary] that are price-affected securities in relation to the information.’

4.3.2.3 There may be restrictions on advertising: the Consumer Credit Act 1974 prohibits advertising goods on credit that cannot be bought for cash (s.45), or sending a minor an invitation to obtain credit (s.50); there are also prohibitions on misleading information in the Trade Descriptions Act 1968 and in the Advertising Standards Authority’s Code of Advertising Practice, which states, ‘Marketing communications must not materially mislead or be likely to do so’ (r.3.1).

4.3.2.4 Rules on transparency may produce too much information and, by swamping the customer, make it difficult to understand a product or to compare different products. Is there an obligation to enable consumers to acquire the skills to understand the information? On whom is this obligation placed? Since the objective is customer protection without removing choice or risk taking, what obligation should be placed on customers to acquire the skills that enable them to understand the information provided? Is it possible to explain some complex products? Like medicines, investments such as pensions may come with risk warnings, but what use can the investor make of them if the only choice is between investing and not investing? Furthermore, there is the problem of enforcement. Should information rights

entitle the consumer to avoid the transaction, or receive compensation, or allow the regulator to impose a penalty, or all of these?

4.3.3 Additional rights

Rules may set out procedures or give rights additional to those arising under the contract. The FCA's Handbook (e.g. COBS, BCOBS and ICOBS) has stipulations on the way firms must act with regard to their customers, such as communications and complaints procedures; it also gives customers the right to cooling-off periods in respect of certain products, such as life assurance, during which the customer can revoke the contract. The supplier may be restricted as to the terms that can be included in a contract, or forbidden from relying on terms that purport to restrict liability for breach or impose obligations on the customer (e.g. Unfair Contract Terms Act 1977; Unfair Terms in Consumer Contracts Regulations 1999). These additional rights may be confined to certain types of customers who are regarded as less able to protect themselves, such as 'retail clients' in COBS (FCA Handbook).

4.3.4 Rules on corporate structure

Rules may not be concerned with the product or the relationship with the customer, but only with the corporate structure of firms operating in a particular market. The rules under FSMA may require certain firms, such as banks and insurance companies, to have a particular type of governance and financial structure, such as management systems and controls, capital adequacy, liquidity, and fit and proper persons in senior positions. These requirements will differ according to the nature of the particular firm. The reasoning is that if these elements are present the firm will be strong, it will pose less threat to the financial system, the way it treats customers will be improved and investors' funds will be safer. Yet, too much intervention may inhibit innovation and flexibility and distort the operation of the market by focusing on preventing firms from failing or protecting investors. From the outset the policy of the FSA was not to operate a zero-fail regime: as the first chair of the FSA put it, 'a corporate failure is not necessarily a failure of regulation. It may simply be a sign that market forces are working'.⁷⁹ But, as he also acknowledged, the issue is 'just how safe one wishes to make the industry'.⁸⁰ The financial crisis signalled a wave of bank rescues that exposed the fragility of the no-zero fail regime. This led to various proposals for ensuring that firms could fail without affecting the financial system, such as the special resolution regime introduced by the Banking Act 2009 (see Chapter 10). But this does not guarantee a no zero-fail policy because, while it is relatively easy to implement with regard to the smaller firms, it is less simple when it comes to the largest banks and insurance companies, which have proved difficult or impossible to break into smaller units, and may, therefore, continue to pose substantial risks to the global financial system.

⁷⁹ H Davies, 'Rational expectations': What Should the Market and Policyholders Expect from Insurance Regulation?' FSA, 29 Jan 2002 at <http://tinyurl.com/c9fx82>.

⁸⁰ *Ibid.*

5. RULES OR PRINCIPLES?

What is the difference between rules and principles? Is it more useful and efficient to use rules or principles to achieve regulatory objectives?

5.1 Introduction

5.1.1 The discussion so far has been in terms of rules, but regulation may take the form of rules or principles. The distinction is not straightforward, but, in essence, principles require the exercise of judgement for their application and rules prescribe a specific conduct which requires no judgement and of which the regulatees are aware in advance. Principles are seen as lacking certainty and predictability, but promoting flexibility and adaptability, while the opposite is regarded as true of rules.

5.1.2 The history of bank regulation (Chapter 1) suggests that a crisis prompts a drift towards rules, which obliges the regulator to act in particular ways and is, therefore, implicitly critical of previous practice. On the other hand, principles may be adopted during a boom period when the emphasis is on allowing greater flexibility in the market, although principles might also be useful when broad discretion is needed to deal with a volatile and unpredictable market in allowing the regulator and, or the regulatee to exercise judgement in responding to changing market conditions, new products and different ways of conducting business.

5.2 Rules

5.2.1 An example of a rule is: ‘No person may carry on a regulated activity in the United Kingdom, or purport to do so, unless he is (a) an authorised person; or (b) an exempt person’ (FSMA, s.19(1)). A rule appears to offer clarity, precision and ease of application, but this is not necessarily the case: what is meant by ‘a person’, ‘a regulated activity’, ‘carry on’, ‘purport to do so’, ‘an authorised person’ and ‘an exempt person’? Meaning may be obfuscated: ‘Where this Act has become applicable to any dwelling-house or any mortgage thereon, it shall continue to apply thereto whether or not the dwelling-house continues to be one to which this Act applies.’ (Increase of Rent and Mortgage Interest (Restrictions) Act 1920, s12(6).) The Dangerous Dogs Act 1991, s.1(1)(a), prohibits, among other things, the breeding or sale of ‘any dog of the type known as... [pit bull terrier, or Japanese toast]’, but gives no indication as to how to determine what constitutes a dog of this type or whether it includes crossbreeds, and, as a result, the measure has been roundly criticised almost from the time it was enacted.

5.2.2 The attempt to improve clarity and, therefore, certainty can lead to greater detail in a rule, which may reduce flexibility and stifle innovation, but gaps may remain because the rule-maker does not contemplate a particular activity. Certain Citigroup trades in 2004 were seen to exploit a weakness in the Italian-based MTS electronic bond market, breaching the spirit but not the letter of the trading rules.⁸¹ An attempt to draw a rule more broadly can also render its meaning obscure or its potential application too wide. The Bribery Act 2010 creates an offence where someone ‘offers, promises or gives a financial or other advantage to another person’ to induce the other to act in particular ways (s.1(2)), the wording of which, while it would cover the offer to a business client of a brown envelope stuffed with cash, might also include buying that client a coffee. A rule can operate harshly where it takes no account of

⁸¹ *Financial Times*, 22 Aug 2006 at <http://tinyurl.com/p4863nv>.

context, and may prevent firms from approaching problems in different and, perhaps, more effective ways. A speed limit allows no exceptions for police, ambulance or fire brigade. Writing in exceptions might make the rule very long and more open to dispute as to its meaning and application, but the alternative is to leave the matter to the discretion of the enforcement agency, which might choose not to enforce, or the sanctioning agency, which might not punish.

5.2.3 Rules may lead to box ticking so that compliance is merely about observing the letter of the rules without looking at their purpose. This approach may empty the rules of meaning and encourage the view that they are simply a nuisance and a firm can, therefore, legitimately seek to avoid their impact: for example, shadow banking developed partly as a means of removing transactions from balance sheets and, therefore, from regulatory oversight. Rules can become obsolete, which may inhibit the market and open the law to ridicule: a fine may still be imposed on ‘Every person who flies any kite’ or ‘beats or shakes any carpet, rug, or mat (except door mats, beaten or shaken before the hour of eight in the morning)’ (Town Police Clauses Act 1847, s.28). The need to adjust rules to deal with such issues is time consuming and expensive.

The eighteenth-century statutory law on theft illustrates how detailed rules may not bring clarity, may create complexity and may still leave gaps. Legislation defined stealing according to a mixture of all or some or one of the following factors: the nature of the thing stolen, its value, the place in which the offence occurred, the use of violence (against person or property), whether the offence was committed during the day or night, and the status of the defendant. For example, there were separate capital statutes for each of following (sometimes more than one statute): stealing a horse; stealing a sheep, cow, ox, steer, bullock, heifer, calf, or lamb; stealing cloth from a rack or tenter at night; stealing linen, fustian, calico or cotton goods from their place of manufacture in daytime; stealing linen, yarn or implements used in their manufacture; stealing goods valued at 40/- from a ship or wreck on a navigable river or in a port; stealing the pump of a ship in distress; stealing goods from a ship wrecked; stealing mail conveyed by post; stealing military or naval stores; burglary (breaking and entering dwelling house at night); entering without breaking and breaking out at night; breaking into a house, shop, or other building with intent to steal linen, yarn or cloth or implements used in their manufacture; stealing in a church or chapel; housebreaking in the daytime when the premises are occupied; breaking into a booth or tent in a market or fair by day or night when the owner or family is present; robbery in a dwelling in the day or night without breaking where anyone is present and put in fear; breaking into a dwelling and stealing goods worth 5/-; privately stealing goods worth 5/- in a shop, warehouse, coach-house, or stable without breaking; stealing goods valued at 40/- from a house without breaking. In addition, there were various statutes covering larceny from the person, larceny by ‘thieves and spoil-takers’ in Northumberland and Cumberland, larceny by servants, larceny and embezzlement by post office employees, and embezzlement by other servants.

Aside from the gaps left by such legislation, other issues left unresolved included whether or not the capital offence included accessories before and after the fact and the meaning of key descriptive terms.

Compare this with the Theft Act 1968, which reduces the law of theft to 36 sections and 3 schedules. Its main provision is s.1(1): ‘A person is guilty of theft if he dishonestly appropriates property belonging to another with the intention of permanently depriving the other of it.’ This is much more comprehensive than any of the eighteenth-century statutes. The terms used in s.1(1) are explained in ss.2-6; s.8 defines robbery, ss.9-10 burglary, s.11 stealing from a place open to the public, ss.12-12A car theft, s.13 abstracting electricity, s.14 mail theft outside England and Wales, and that is pretty much it.

Yet, this does not mean the Theft Act has simplified the law in all respects. Whole books have been written on its meaning: what is ‘dishonesty’, ‘appropriation’, when does property belong to another, what amounts to an intention permanently to deprive, etc?

5.3 Principles

5.3.1 Principles are a guide to action or set out an objective, such as treat the customer fairly, or act with due care. They require the use of judgment, and appear to offer greater flexibility than rules. In financial regulation, the Principles for Business (PRIN) in the PRA and the FCA Handbooks are broadly drafted: ‘A firm must conduct its business with integrity’ and ‘A firm must conduct its business with due skill, care and diligence’ (PRIN 2.1.1R). Firms are obliged to observe these principles as ‘a general statement of the fundamental obligations of firms under the regulatory system’ (PRIN 1.1.2G) and breach can lead to a penalty (PRIN 1.1.7G). At the same time, they are meant to be a foundation upon which more detailed rules are built, if appropriate. Principle 6 requires each firm to ‘pay due regard to the interests of its customers and treat them fairly’ and was the basis for the Treating Customers Fairly initiative, which set out a number of goals, such as ensuring that products and services marketed in the retail market are designed for the needs of identified consumer groups and targeted accordingly, that customers are provided with clear information, given advice that takes account of their circumstances, supplied with products that perform as firms have led them to expect, and have no unreasonable post-sale barriers to changing products or providers or making a complaint or claim.

5.3.2 Principles appear to offer a number of advantages and disadvantages.⁸² They seem to allow the flexibility needed to keep pace with innovation, whether to control or to permit them. The FSA was able to punish Citigroup over the MTS trades for breach of the principles relating to the exercise of due care, skill and diligence and failing to take reasonable care to organise and control its affairs and risk management systems.⁸³ The regulator may also innovate in its approach to regulation, which can promote the competitiveness of the regulatory environment. In addition, the hope is that instead of box ticking and attempts at avoidance firms will focus on embedding the spirit of the principles within their internal culture. As part of this, principles may encourage negotiation between the regulator and the firm, which might mean that instead of, for instance, setting detailed capital adequacy rules each firm can negotiate the appropriate level of capital for its business, although this may carry the danger of the regulator becoming too sympathetic to the regulated firms and losing

⁸² J Black, ‘Forms and Paradoxes of Principles Based Regulation’ [2008] 3(4) *Capital Markets Law Journal* 425 at 447-57; SL Schwarz, ‘The ‘Principles’ Paradox’ (2009) 10 *Euro Bus Org L Rev* 175.

⁸³ Principles 2 and 3: PRIN 2.1.1R.

sight of other interests, such as the protection of investors. The interpretation and enforcement of principles should involve the regulator in a more careful consideration of the circumstances to determine if a breach has occurred than might appear to be the case with a rules-based model, and that should allow for greater openness by the regulator in its reasoning, although there is the risk that a regulator will fail to explain itself – perhaps, not wishing to lose flexibility or open itself to challenge.

5.3.3 Principles may be very broad, or given some direction through guidance or illustrations of good and bad practice, but regulators may be reluctant to do these things because of a fear that they turn principles into rules. There may also be confusion where guidance is trickled out through a range of platforms, such as a handbook, speeches and notices, creating contradictions or leaving firms to root around in a mass of material to uncover the likely approach a regulator will take to the application of a principle.

5.3.4 The virtues of the principles are also weaknesses. The flexibility may mean the principles lack certainty and predictability, and the regulator may appear to act retrospectively. If firms are unclear as to how principles are going to be interpreted and applied, they may be overly cautious, stifling innovation. The lack of certainty may encourage challenges by regulatees seeking to anchor meaning in the law rather than in a more fluid understanding that allows the regulator to shift interpretation and application according to changing circumstances. Here the courts may play an important role in resisting such attempts to solidify meaning.⁸⁴ On the other hand, compliance officers within firms may struggle to convince senior managers, who see their main interest as running the business and not regulation, of the importance of compliance with principles that might seem to them vague and not applicable. Compliance officers have to determine how the regulator will interpret and apply the principles and will, therefore, be forced to make a judgment, which may turn out to be wrong. Thus decisions about compliance involve risk management, potentially reducing compliance to fairly well defined processes so that, in effect, principles become rules.

5.3.5 The advantages and disadvantages of principles-based regulation depend on one's viewpoint and the approach taken by the regulator, the regulated firm and other interested parties, such as compliance officers. A principles-based system needs to be one in which there is a general engagement in the process – as opposed to the control and command model of a classic rules-based system. The regulator must be clear as to its objectives and the firms must embed the regulatory culture into their organisations and not merely pursue minimum compliance and avoidance. At root this requires trust and confidence, which, in Professor Black's words, gives rise to 'the ultimate paradox', namely, that principles-based regulation 'can help create trust, but it itself has to be founded on trust if it is ever to operate effectively, if indeed at all.'⁸⁵

5.4 Relationship between rules and principles

5.4.1 Contrasting rules with principles may be misleading because, for example, rules are not necessarily clear and, therefore, will often require interpretation, and principles-based systems can have guidelines or even rules to indicate how they are to be construed or

⁸⁴ *R (on the application of the British Bankers Association) v Financial Services Authority and Financial Ombudsman Service* [2011] EWHC 999, discussed in 5.4.2 below.

⁸⁵ J Black, 'Forms and Paradoxes of Principles Based Regulation' [2008] 3(4) *Capital Markets Law Journal* 425 at 457.

applied.⁸⁶ There is no simple model of what a principles- or a rules-based system looks like, and, indeed, a hybrid approach is much more likely. For example, even the 2007 FSA system, which appeared to be principles-based and was promoted as such, was really a mix of rules and principles: principles elaborated by rules in certain areas (e.g. treating customers fairly) and rules supported by principles to cover gaps or inconsistencies. Moreover, a rules-based system may have a principles-based enforcement or sanctioning regime – mandatory penalties are rare.

5.4.2 The relationship between principles and rules was at issue in *R (on the application of British Bankers Association) v Financial Services Authority and Financial Ombudsman Service* [2011] EWHC 999. It was argued that because specific rules in the FSA Handbook (ICOB) governed the sale of payment protection insurance policies, the regulator could not apply the Principles for Business in such a way as to contradict or supplement those rules. Thus, as long as a firm complied with the rules it could not be held in breach. Quseley J rejected this argument:

‘The Principles are best understood as the ever present substrata to which the specific rules are added. The Principles always have to be complied with. The specific rules do not supplant them and cannot be used to contradict them. They are but specific applications of them to the particular requirements they cover. The general notion that the specific rules can exhaust the application of the Principles is inappropriate. It cannot be an error of law for the Principles to augment specific rules.’⁸⁷

5.4.3 The other element in this discussion is the government’s wish to reduce and simplify regulation. Before the crisis this translated into a shift towards principles-based regulation. More recently, the government has been trying to negotiate between a more rules-based system and a system in which the regulatory burden is reduced.

‘Some regulations are ineffective and unnecessary. Complying with them costs businesses time and money, and can restrict growth. Red tape can also make running charities and community groups more difficult than it needs to be. The government wants to ensure all regulations are fair and effective. We want to strike the right balance between protecting people’s rights, health and safety and freeing them from unnecessary bureaucracy.’⁸⁸

To achieve this the Department for Business, Innovation & Skills (BIS) has put forward an action plan, including a one in, two out rule that requires two regulations to be removed for each new business regulation,⁸⁹ an assessment of the impact of new regulations, a review of the effectiveness of regulations, an assumption that rules should be abolished unless there is strong justification for them, a reduction in the burden of regulations, and the adoption of

⁸⁶ PRIN 3.

⁸⁷ At [162]. He added that, even if the FSA could not punish where the Principles contradicted or augmented the rules, the Financial Ombudsman’s role is to determine cases on the basis of what is ‘fair and reasonable’ (FSMA, s.228(2)), which allowed an award where the Ombudsman believed one of the conflicting provisions was dominant or the Principles had not been adequately represented in the rules so that strict application of those rules was not fair and reasonable.

⁸⁸ Reducing the Impact of Regulation on Business programme. See also Regulators’ Code at <http://tinyurl.com/9wbmbq>. Also Regulators’ Code at <http://tinyurl.com/ovblqdq>.

⁸⁹ There are exceptions, such as rules implementing EU regulations, decisions or directives, or international agreements, and any fiscal measures designed to address systemic risk: HM Government, *One-in, One-out: Statement of New Regulation* (2011), Annex A at <http://tinyurl.com/62rrtp6>; *The Seventh Statement of New Regulation* (Dec 2013) at <http://tinyurl.com/qae8zqm>.

alternatives to regulation, such as better information, self-regulation through the adoption of codes of practice, tax, quotas, subsidies and competition.

5.4.4 The choice between rules and principles should be guided by which achieves the objective most efficiently in a particular context with least intervention in the operation of the market and least cost (in resources, but also cost to other objectives). History indicates, however, that the choice can depend on prevailing political views. The slow accretion of rules in the regulation of banking during the 1980s and 1990s was the response to greater politicisation of these issues and perceptions about the regulator's effectiveness, and similar political pressures were factors in the shifts between principles and rules in 2007 and after the financial crisis.

6. HOW DOES SUPERVISION SHAPE REGULATION?

How can the way rules are interpreted and applied by the regulator affect the regulatory objectives?

6.1 The nature of supervision

6.1.1 Supervision may involve authorisation, monitoring compliance, enforcement and imposing penalties. Often, there will be a distinction between the agency responsible for monitoring compliance and identifying suspected rule breaking (the ‘policing role’), and the agency (tribunal, court, arbitrator, ombudsman) which determines whether there has been a breach and imposes any penalty, compensation, or settlement (the ‘judicial’ role); although this is not the case in financial regulation where these functions have been assigned to separate parts of the regulators.

6.1.2 The style and intensity of monitoring depends on the likelihood of the firm/individual breaching the rules, the likely consequences of a breach and the resources available to the supervisor. Enforcement may result from the supervisor’s own monitoring, or a complaint by a customer or another regulator or market participant, or notification by the regulatee of a breach.⁹⁰ It will, typically, involve an inquiry to determine issues such as whether there has been a breach, its causes, and whether further action is required.

6.1.3 The supervisor may operate through enforcement officers with powers to gather information. Indeed, the power to conduct an inquiry into a breach may be experienced by the firm as punishment if it involves suspension of work or damage to reputation, and such powers may be used simply for these purposes, which, although an abuse, would be difficult to challenge.

6.1.4 The actions of enforcement officers may lead to prosecution before a court or quasi-judicial authority, which has the power to impose a penalty, such as a fine, suspension or withdrawal of authorisation. The aim may be to achieve compliance of the firm/individual or across the industry, or punish for the breach, or compensate loss suffered by a customer as a result of the breach.

6.1.5 They may also have powers to impose sanctions, such as cautions, compliance notices, or temporary suspensions of authorisation. The need to take immediate action to protect a vulnerable third party (such as bank depositors or employers) may be regarded as sufficiently important as to override the due process rights of the party allegedly in breach (the bank or employer). The authority to impose sanctions, such as a fixed penalty notice,⁹¹ may save scarce resources, but not serve the public interest in punishment (see Chapter 7). The supervisor may be guided by the need for a co-operative relationship with regulatees in order to make their work easier – confrontational supervision is likely to be more expensive. On the other hand, the supervisor can come under pressure from public opinion to take a more aggressive approach. The regulatory objectives in FSMA may work against enforcement. For example, s.3(1), states that one objective is ‘maintaining confidence in the UK financial system’, which might encourage non-enforcement because exposing non-compliance might

⁹⁰ E.g. *FCA Handbook*, SUP15.3.1R.

⁹¹ E.g. Environmental Protection Act 1988, s.88(1), (2)(b).

affect confidence – although equally that objective might be achieved by the supervisor being tough on breaches of the rules.

6.1.6 Enforcement affects how rules are experienced. The supervisor will have discretion whether or not to enforce, which may lead to *de facto* rules: if the speed limit is 30 mph (*de jure* rule), but the police only take action where a motorist is driving at 35 mph, 35 mph becomes the *de facto* rule. Regulations may, in effect, emerge in the form of guidelines developed by an enforcement agency: e.g. the Metropolitan Police's guidelines on firearms licensing.⁹² This can be seen as a way of ensuring consistency or as an unauthorised acquisition of legislative power (rule makers should make rules, enforcement agencies should enforce them).

6.1.7 How is the effectiveness of supervision assessed? A rise in enforcement actions may reflect a rise in offences, but other explanations are possible and offending may have stayed the same or even dropped: (a) the supervisor has become more efficient in detecting breaches, or (b) the public has greater confidence in the supervisor and this led to more reports, or (c) the public has become less tolerant and reports breaches that might not previously have been reported.

6.2 Methods of enforcement

6.2.1 Is enforcement primarily concerned with prevention or detection of offences? Is it proactive or reactive? This problem can be seen in the division between the uniformed and detective police. When the Fieldings organised a group of thieftakers at Bow Street in 1751 their plan was to reduce crime through more efficient detection. Peel, in establishing the Metropolitan Police in 1829, rejected this and instead based his approach on preventing crime by the use of uniformed patrols. A small detective branch was eventually set up in the 1840s, but there remains a separation between the two branches and between the ideas of crime reduction through prevention and through detection, which they embody. Although uniformed officers are the most familiar on the street and engage in more crime detection, the detective branch is regarded as the more glamorous and high profile activity because rule-breaking and its detection are more interesting and more dramatic than prevention, and detection is associated with the detectives.⁹³ This dichotomy over enforcement can also be seen in financial regulation.

6.2.2 Typically, where there has been a regulatory breach it is the supervisor that brings an enforcement action or prosecutes for an offence. But this may not preclude action by the customer where there has been a breach of contract, or a breach of statutory duty. Whether or not a customer who has suffered loss as the result of a breach of statutory duty can bring an action is rather obscure (*Lonrho Ltd v Shell Petroleum Co Ltd* [1982] AC 173). Fortunately, unlike most statutes, FSMA makes provision for this possibility in section 138D (inserted by Financial Services Act 2012), although this contemplates action only by a private person who suffers loss as a result of the breach and only where the regulator provides in the rules for such action (s.138D(1), (3)),⁹⁴ and 'In prescribed cases' if a private person could have brought an action, those who are not 'private persons' may do so, 'subject to the defences and

⁹² <http://content.met.police.uk/Site/firearmslicensing>.

⁹³ PJ Rawlings, *Policing: A Short History*, Cullompton: Willan Publishing, 2002; 'A Force Divided' [2006] 65 *Criminal Justice Matters* 22.

⁹⁴ E.g. *FCA Handbook*, ICOBS sch. 5; but *R (on the application of the British Bankers Association) v Financial Services Authority and Financial Ombudsman Service* [2011] EWHC 999.

other incidents applying to actions for breach of statutory duty” (s.138D(4)). The Financial Ombudsman may take the breach into account when determining whether it is ‘fair and reasonable’ to award damages to a customer. Where the action arises as a result of a breach of EU law, the European Court of Justice has held that those suffering loss can obtain compensation if the law conferred rights on individuals, the breach was serious and the breach caused the loss (*ex parte Factortame Ltd (No. 4)* [1996] 2 WLR 506). It may be that, even if no action for breach of statutory duty arises, there is a breach of a common law duty of care. But the mere existence of a regulatory duty does not mean there is also a common law duty of care; this depends on the nature of the relationship between the parties. If a duty arises, such as where a bank undertakes an advisory role and, thus, is under a duty to exercise skill and care, the content of that duty will be determined, in part, by any regulations.⁹⁵

6.2.3 Formal enforcement requires solid evidence, and market volatility and the complexity and volume of financial transactions make it difficult and potentially expensive for regulators to collect and process data. Indeed, the generation, management and meaningful use of an ever-growing volume of information pose challenges for supervisors, as they must be in a position to have timely access to significant amounts of data and then translate it into action. Important data may never be picked up, or may have gaps, or may not be subject to appropriate analysis because of a lack of resources or confidentiality rules. The US has tried to address this issue by the creation of the Financial Research Office, but this may merely add complexity and engage more resources.

6.3 Strict liability for senior managers

6.3.1 Generally, regulatory offences impose strict liability – that is, they require proof of the act but not of an intention to commit the act. This is not only because it makes enforcement cheaper and quicker, but also because a company cannot form an intention. Of course, the same reasoning would suggest that it is pointless to punish a company since it cannot learn a lesson, but the assumption is that inflicting a penalty on the company will lead to its managers and/or shareholders improving internal controls and disciplining staff. This, however, also assumes that managers will recognise their regulatory responsibilities and take a firmer grip on the actions of more junior staff and that shareholders are able to exercise this level of influence. All these assumptions are open to challenge. Nevertheless, as part of the enforcement-led approach, which was introduced in the wake of the financial crisis, the attempt has been made to hold senior company officers accountable. This suffered a setback when the fine imposed on former UBS wealth-management CEO, John Pottage, was overturned on appeal because the regulator had not proved that he had failed to take reasonable steps to ensure the firm was compliant.⁹⁶ The case called into question the FSA’s view that senior managers had quasi-strict liability in respect of systems and controls within the firm.

6.3.2 Strict liability in financial regulation is probably not acceptable where the breach carries with it some quasi-criminal allegation, such as fraud or bribery. There is also the concern that strict liability might discourage people from taking senior roles, particularly in view of the fact that the complexity of many financial institutions and sophistication of risk management systems and controls mean that, in practice, senior managers must rely on the expertise of

⁹⁵ *Green and Rowley v Royal Bank of Scotland plc* [2013] EWCA Civ 1197.

⁹⁶ *John Pottage v FSA* (FS/2010/0033), Upper Tribunal. The FSA had to show Pottage failed to take the reasonable steps set out in Statement of Principle 7 in *FSA Handbook* APER (now rewritten, but the burden of proof still rests on the regulator: APER 2.1A.3P).

compliance officers, risk managers and other professionals. These objections might be met by extending the fit and proper test to a greater range of people within firms. The other possibility is to shift the burden of proof, making certain senior officials liable for the systems and controls in a firm without the need to prove knowledge or negligence, but allowing the defendant to show that he or she had taken all reasonable precautions. The Food Safety Act 1990 has various strict liability offences: e.g. ‘Any person who sells to the purchaser’s prejudice any food which is not of the nature or substance or quality demanded by the purchaser shall be guilty of an offence’ (s.14(1)). Thus, a retailer is guilty where tinned goods are sold that are discovered on opening not to be fit for human consumption, irrespective of the fact that the goods could not have been examined before sale. But under s.21(1) it is ‘a defence for the person charged to prove that he took all reasonable precautions and exercised all due diligence to avoid the commission of the offence’, although if the defence relies on an allegation that commission of the offence is due to the act of another person, the retailer must assist in identifying that person (s.21(5)).

6.3.3 The Financial Services (Banking Reform) Act 2013 has revisited the existing Approved Persons regime, which regulates senior managers, following the recommendations of the report of the Parliamentary Commission on Banking Services. The PRA and the FCA will designate ‘senior management functions’. The regulator must approve appointments to these roles, which will require the firm to present a statement of the issues managed by the individual – this puts into statutory form the existing practice (introduced in recent years) of requiring firms to provide signed declarations from senior persons. The Act (s.36) introduces a criminal offence, punishable with up to seven years in prison, where a senior manager takes, or agrees to, a decision by the firm or ‘fails to take steps that [s/he] could take to prevent such a decision being taken’, when aware of the risk that the decision may cause the failure of the firm, and this conduct ‘falls far below what could reasonably be expected of a person’ in that position, and the implementation of the decision causes the firm’s failure – firm here is not just the company for which the person works, but any company within the group. All of this is extremely vague and likely to be difficult to prove, but its objective is clearly to scare such individuals from engaging in risky decisions. While the courts will assess behaviour on the basis of the individual’s knowledge and not with the benefit of hindsight, the creation of the offence still may achieve its effect of making senior individuals pause before taking actions.

6.3.4 The burden of proof in this offence is on the prosecution and the difficulties involved in discharging that burden mean the regulators are much more likely to use another new provision, which reverses the burden of proof. A senior manager will be presumed guilty of misconduct if the firm fails to observe regulations and that manager was at the time responsible for compliance (FSMA, s.66A(5) inserted by FS(BR)A, s. 32(2)). The defence is that the manager took reasonable steps to prevent breach (FSMA, s.66A(6)). There remains concern about its impact on the willingness of well qualified candidates to act, but this argument struggles against the desire of government to have the means of effecting a strong response to misconduct, which, it is hoped, will help in shaping a culture of compliance, and it also, perhaps, fails to acknowledge the misguided nature of past hiring practices at banks.

6.3.5 The regulators’ powers under the 2013 act are drawn more widely so that they can construct rules governing the conduct of employees below the senior level. This is likely to involve adapting existing rules related to approved persons, and the regulators will require firms to take on the bulk of the responsibility for employees’ conduct – backed up by powers

to punish the firm and senior managers where these responsibilities are not met. Greater focus will be placed on the roles of compliance officers and non-executives within firms.

6.4 Compliance

6.4.1 Regulators expect firms to have effective internal compliance mechanisms. The financial crisis has seen the FSA and now the PRA and the FCA place even more emphasis on this issue (e.g. FCA Handbook SYSC). A firm must have clear compliance and internal controls, which are properly recorded and subject to continuous review, and senior officers of the firm must be accountable for ensuring robust compliance procedures.

6.4.2 Firms have turned to technology to assess risks and ensure compliance. This means that compliance has become much less a matter of judgement. But two points need to be made in this regard. The first is that technology is not neutral. The reduction of regulatory commands to code is informed by the personal beliefs, choices and world-views of computer programmers about what these commands entail in practice. How a computer programmer interprets rulebook provisions may be worlds apart from the normative framework that informs the priorities and collective goals of the financial regulator. Since technology is not merely a tool for implementing regulatory objectives but also shapes the meaning of those goals, it must be asked whether such software should be regulated. The second point is that there can be a tendency to place excessive reliance on software and to disregard contrary information.

7. WHAT ARE THE AIMS OF PUNISHMENT?

What are the aims of punishment? How do they relate to the regulatory objectives? What is the relationship between enforcement and punishment? Might credible deterrence offer a practical and cheap method of changing behaviour?

Various factors come into play when determining the punishment for regulatory breach, such as the seriousness of the offence, the benefit enjoyed by the offender, the losses inflicted, the costs to the regulator and the regulatees involved in imposing the penalty, the likelihood of detection, the likelihood of further offences by this offender and by others, and the reassertion of the power balance (rule breaking as a denial of authority, punishment as its reassertion).

7.1 Objectives of punishment

7.1.1 The objectives of punishment are, variously, deterrence, retribution, rehabilitation and incapacitation. Rehabilitation involves punishment that addresses the offending behaviour. Deterrence is where the decision not to commit an offence arises out of a fear of the punishment that may be inflicted. This can be contrasted with retribution: deterrence determines the level of punishment by its effect on behaviour, so that it would be sufficient to fine someone for murder if this deterred; but retribution requires the punishment to fit the gravity of the offence – the murderer is punished heavily because of the nature of the crime, irrespective of the impact such punishment has on behaviour. Deterrence may also be distinguished from incapacitation because in the latter the aim is simply to put the offender into a position where they cannot commit the offence.

7.1.2 There are two main types of deterrence. Specific deterrence is aimed at changing the behaviour of the particular offender, while general deterrence, although inflicted on the particular offender, is aimed at changing the behaviour of the broader community. Both may be further refined by marginal deterrence where the level of punishment is adjusted so that serious crimes are punished more than minor crimes and recidivists more than first offenders.

7.1.3 The assumption underpinning deterrence is that people act rationally – weighing up the potential punishment and the risk of being punished (will they be detected and, if detected, will they be punished?). But this does not take account of other factors that may lead them to commit the offence, such as drugs, drink, peer pressure, or workplace culture. Being punished for one offence may affect how the offender behaves in other ways. If A is punished for insider trading, but has also committed money-laundering offences without being punished, the experience of the punishment for insider trading may have an effect on whether or not A continues to launder money. X may not want to risk further punishment and so stops all offending, or may continue to offend because of the belief that he or she was unlucky to get caught and punished for insider trading. Similarly, X's observation of other people may influence behaviour: seeing others punished may deter X from offending; seeing others breach the law without being punished may encourage X to offend.

7.1.4 In the end, it may be difficult or impossible to determine the effectiveness of a particular punishment in achieving its objective: is a decline in crime the result of penalties or a reduction in unemployment? The choice of punishment may be reduced to a matter of belief or political pragmatism, and even if an effective strategy can be identified, it may not fit in with contemporary beliefs and so not be implemented.

7.2 Credible deterrence

7.2.1 Looked at rationally, in order to achieve deterrence it is enough to impose a penalty that exceeds the benefit to be obtained from the offence. But, aside from the possibility that people are influenced to offend by other factors, prospective offenders will also take into account the risks of being caught and convicted. Thus, deterrence depends on some certainty of detection. Alternatively, credible deterrence involves the use of higher levels of punishment than might normally be expected for the particular offence in order to catch the attention of the public and the industry and tilt the balance against offending without engaging in the additional expense and uncertainty involved in detection. The decision to adopt such a strategy may, however, be driven as much by the wish to counter criticism following a crisis as by the aim of deterring offenders. It is important to choose carefully those who are punished in this way otherwise there is a risk that the penalty will appear unjust, creating sympathy for the victim and criticism of the regulator. Moreover, the elements of theatre and spectacle are essential and the effect may be undermined if used too frequently. On the other hand, caution or inconsistency in its use may create uncertainty as to the circumstances in which it will be imposed, making it appear that the supervisor is acting unfairly and arbitrarily. Credible deterrence may also lead to problems in seeking to build mutual trust and cooperation between the industry and the regulator because it could easily appear to be an attack on industry.

7.2.2 How effective is such a strategy? Empirical studies indicate that the severity of punishment has little impact on levels of crime, and that much more effective is better detection.⁹⁷ The recent history of financial crime would seem to support this view, or, at least, it suggests that any impact is short-lived. Heavy fines and long prison sentences are familiar in the US and have been used in many high profile cases, such as the junk bond scandal in the 1980s and Enron in 2001, but these did not prevent Ponzi schemes, rate rigging, etc. It may be that the time lag was too great, or the asset boom of the early 2000s made those earlier events too distant to overwhelm a culture of short-term gain (improved profits, bonus payments, etc).

7.3 The FSA and credible deterrence

7.3.1 Before the crisis, the FSA strategy placed most emphasis on prevention through formal and informal communications with the industry and individual firms. This stressed the importance of encouraging self-reflection and the development by firms of strategies for complying with FSA requirements. Culture change was seen as the key.⁹⁸ This works only if there is mutual trust and confidence between the regulator and the firms, and both the public and politicians believe the system is working. All of this vanished after the financial crisis. The reaction was to shift from a persuasion-based regime to an enforcement-led regime which entailed not only tougher enforcement and a more intrusive approach to supervision, but also more focus on punishment.⁹⁹ The aim was still, 'to improve the way people

⁹⁷ A von Hirsch *et al*, *Criminal Deterrence and Sentence Severity: An Analysis of Recent Research*, Oxford: Hart, 1999; P Gendreau, *et al*, *The Effects of Prison Sentences on Recidivism*, Ottawa, Ontario: Public Works and Government Services, 1999.

⁹⁸ J Black, 'Enrolling Actors in Regulatory Systems: Examples from the UK Financial Services Regulation' [2003] *Public Law* 63.

⁹⁹ FSA, *Annual Report 2007/8*, p.6. Continued by the PRA and FCA: <http://tinyurl.com/nqc5xke>.

behave’,¹⁰⁰ but the method was different in its emphasis on threat rather than persuasion: ‘It means delivering results that make people sit up and pay attention.’¹⁰¹

‘Effective, visible enforcement is good for consumers who need to have confidence that the regulator is looking after their interests where things do go wrong; it is good for other market participants who can see that it pays to do the right, rather than the wrong, thing; and ultimately it is good for the industry and society as a whole as we begin to rebuild the reputation of UK financial services and ensure those who need financial products and advice can have confidence in those who provide them.’¹⁰²

This toughening of action led to a dramatic increase in fines,¹⁰³ greater use of the public censure power in FSMA, s.205, more effort to obtain redress for customers, and attempts to punish senior managers as well as firms.¹⁰⁴

7.3.2 The treatment of the mis-selling of payment protection insurance (PPI) illustrates this shift.¹⁰⁵ Following concerns about treatment of complaints, the Financial Ombudsman Service made a formal reference to the FSA in 2008 requesting consideration of whether regulatory action was appropriate. With support from the FSA, the trade associations inquired into the possibility of an industry-led solution, but the failure to achieve consensus or to satisfy the FSA that consumers would be fairly treated led it to stipulate in 2009 actions firms would be required to take in dealing with complaints.¹⁰⁶ In particular, these sought to address concerns over poor training and failures to maintain adequate systems and controls or to carry out suitability checks before selling products to customers. There was dissatisfaction at the delays in resolving cases and a sense that banks focused too much on resisting claims and too little on pushing forward with internal changes. Indeed, the British Bankers Association brought an action for judicial review to challenge both a package of measures introduced in 2010 by the FSA,¹⁰⁷ which included amended rules and guidance on handling claims, and the use of this package by the ombudsman in dealing with claims.¹⁰⁸ The banks failed at first instance and decided not to seek an appeal, but the impression had been given – rightly or wrongly – that the industry was reluctant to adopt the Treat Customers Fairly initiative.¹⁰⁹ It may also have reinforced the regulator’s resolve on credible deterrence as well as on the shift from principles to rules.

7.3.3 The transfer of the Enforcement and Financial Crime Division from the FSA to the new Financial Conduct Authority shows that the reshaping of the regulatory architecture has not affected the emphasis placed on enforcement: ‘The job of enforcement is to help the FCA change behaviour by making it clear that there are real and meaningful consequences for

¹⁰⁰T McDermott, *The Telegraph*, 27 Dec 2011 <http://tinyurl.com/o5fkbf>.

¹⁰¹M Cole, FSA Annual Financial Crime Conference, 27 Apr 2009 at <http://tinyurl.com/oc9t7a9>.

¹⁰²T McDermott, ‘Credible Deterrence: Here To Stay’, 2 Jul 2012 at <http://tinyurl.com/nhdx537>.

¹⁰³See above Chapter 1.

¹⁰⁴FSA, *Enforcement Penalties*, PS10/04.

¹⁰⁵For a full account: E Ferran, ‘Regulatory Lessons from the Payment Protection Insurance Mis-selling Scandal in the UK’ (2012) 13(2) *European Business Organization Law Review*

¹⁰⁶FSA, *The Assessment and Redress of Payment Protection Insurance Complaints*, CP09/23.

¹⁰⁷FSA, *The Assessment and Redress of Payment Protection Insurance Complaints*, PS10/12.

¹⁰⁸*R (on the application of the British Bankers Association) v Financial Services Authority and Financial Ombudsman Service* [2011] EWHC 999.

¹⁰⁹A Georgosouli, ‘The FSA “Treating Customers Fairly” (TCF) Initiative: What Is So Good About It and Why It May Not Work’ (2011) 38(3) *Journal of Law and Society* 405.

those firms or individuals who don't play by the rules.'¹¹⁰ The FCA has continued the use of credible deterrence:

'We have been clear with industry that we have the resources and commitment to follow through with meaningful sanctions and that we are committed to achieving better outcomes for consumers and ensuring markets are clean and free from abuse.'¹¹¹

This will be achieved by bringing more enforcement cases and pressing for tough penalties 'to reset conduct standards'; 'pursuing more cases against individuals and holding members of senior management accountable for their actions'; bringing criminal prosecutions; taking action against unauthorised business; and prioritising compensation for consumers.¹¹² The FCA is not simply concerned with the probity of senior officials, but also their competence and control and their duty to take responsibility for the firm. Thus, alongside tougher enforcement there is a tighter authorisation regime for those working in banking, which seeks to tackle a perceived lack of individual responsibility and accountability.¹¹³ But the most notable feature of this strategy is the imposition of penalties that are sufficiently spectacular to attract media attention. In 2012-13, UBS was fined £160 million, Rabobank £105 million, Royal Bank of Scotland £87.5 million and Barclays £59.5 million for allegations related to LIBOR; JP Morgan Chase was fined £137.6 million and UBS £29.7 million in connection with trading; and Prudential was fined £30 million for failing to inform the FSA of its acquisition plans. Similarly, in 2014 a fine of £30.6 million was imposed on HomeService for mis-selling policies and £22.8 million on State Street Bank over its trading practices.¹¹⁴

7.3.4 There are problems in combining more effective enforcement, which aims to punish people and firms, and credible deterrence, which seeks to draw attention to particular offences (and offenders) through punishments rendered spectacular by their severity. Detecting more breaches may render heavy penalties routine and thus remove the element of drama. Heavy penalties may also prompt firms to contest decisions, which, if nothing else, may drag out the process and reduce its effect. The regulator is obliged to watch its costs and may seek a negotiated settlement – indeed, discounts for early settlements are part of the regulatory process (e.g. FCA Handbook DEPP 5). Credible deterrence should also be balanced against other factors which the regulators are meant to consider, such as proportionality and the effect of the penalty on the viability of the firm: can the regulator suspend the licence of a too-big-to-fail firm? This touches on a more general point. Credible deterrence relies on exemplary and spectacular punishments which are given maximum publicity, but these things necessarily have a deleterious effect on the firm and also the industry – this, after all, is their point. How does this fit with the need to maintain and promote the UK's financial system and its international reputation? Furthermore, is there a danger that the focus on strong punishment becomes a goal in itself so that the regulators lose sight of the main objective, which is to ensure compliance?

¹¹⁰ <http://www.fca.org.uk/about/what/enforcement>. G Wilson and S Wilson, 'The FSA, "Credible Deterrence, and Criminal Enforcement' (2014) 21(1) *Journal of Financial Crime* 4.

¹¹¹ Speech by Martin Wheatley, then CEO designate of the FCA, 2012 at <http://tinyurl.com/o8yjspr>.

¹¹² <http://www.fca.org.uk/about/what/enforcement>.

¹¹³ These proposals are part of the recommendations of the Independent Commission on Banking report 2010. See the Financial Services (Banking Reform) Act 2013.

¹¹⁴ www.fca.org/firms/being-regulated/enforcement/

7.4 Case study on credible deterrence: the ‘Bloody Code’¹¹⁵

7.4.1 The most extreme manifestation of credible deterrence was the ‘Bloody Code’, which was developed during the eighteenth-century. Criminal justice relied on the individual victim, who was largely responsible for bringing an offender before a court. Parishes appointed constables, and, in some areas, there were watchmen, but, in general, such officials were unpaid or poorly paid and their function was to guard property or maintain low-level public order (drunks, prostitutes), not detect crime. The offer of rewards for the conviction of certain offenders, such as highway robbers, led to the emergence of thieftakers, who often were themselves engaged in crime and were certainly not shy of perjury or extortion. The idea of a centrally organised police force was occasionally raised, but never seriously contemplated because it was seen as equivalent to a standing army, which would make government too powerful and, therefore, threaten English liberty.¹¹⁶

7.4.2 This did not mean the English were unconcerned about crime. Indeed, as the country prospered and developed new forms of wealth, concern grew; but the response was to use what might now be called credible deterrence. By 1800, there were, perhaps, as many as 300 capital offences – from cutting down a tree and shoplifting goods worth 5/- to murder and high treason. The most common types of such offences (robbery, burglary, housebreaking, shoplifting) were already capital by 1700 and many of the new offences dealt with things such as the protection of government revenues, new technology (e.g. machines) and commercial documents (banknotes, share certificates, etc). The death penalty was carried out in public – in London, a long procession took several hours to travel from Newgate prison on the site of the present Old Bailey in the City to Tyburn, which was at what is now Marble Arch. The idea was to create a dramatic representation of the state’s power.

7.4.3 Too many executions could have had the effect of inuring spectators to the penalty, or making government appear callous, or creating too much sympathy for the offenders. There was, however, a good deal of discretion throughout the justice system, which meant most were not executed. There was the difficulty of identifying the offender, and, even if identified, victims often chose not to prosecute, perhaps, because they did not want to see someone hanged or because it was too much trouble, so the offender was forgiven, or thrown into the village pond by neighbours, or the threat of prosecution was used to extract something from the offender, such as a payment or the return of stolen goods. If the case reached court, the jury might acquit or commit what was known as ‘pious perjury’ by finding the defendant guilty of a non-capital offence. This was possible because capital crimes often stipulated that goods had to be of a particular value or the offence had to occur in a particular location. The jury might convict of stealing from a house goods worth 39 shillings instead of the capital amount of 40 shillings, or convict the person of stealing but not from a dwelling house so that the offence was not housebreaking. At the Surrey Assizes between 1660 and 1800 there were 1,795 jury verdicts in property cases involving capital offences, 606 (34%) ended in acquittals, 694 (39%) in convictions for capital offences and 495 (27%) were partial verdicts (guilty of a non-capital offence).¹¹⁷ It seems likely that the judges urged juries towards partial verdicts or acquittals in some cases, and in others they construed capital

¹¹⁵ The label ‘Bloody Code’ was coined later by those keen to emphasise their reform agenda by characterising the criminal justice system as nakedly brutal and primitive, while pressing for the brutal alternative of punishment in penitentiaries.

¹¹⁶ PJ Rawlings, *Policing: A Short History*, Cullompton: Willan Publishing, 2002.

¹¹⁷ JM Beattie, *Crime and the Courts in England 1660-1800*, Oxford: Oxford University Press, 1986, p.425.

statutes narrowly – for example, although stealing goods worth 5/- privately in a shop was capital, such theft was not privately done if the shopkeeper saw the offence.¹¹⁸

Old Bailey, 10 December 1735

‘Sarah Batley, alias Sarchel, was indicted for stealing a pair of Breeches, thirty-four Guineas two half Guineas and five Shillings, the Goods and Money of John Watson in the House of Thomas Jordan, Nov. 17th.

John Watson. This Thomas Jordan keeps a Lodging House in Rag-Fair . We went to drink together at Mr Smith's, and there I told Jordan, that I did not like my Bed. He said I should have a better, and so I went home with him again, and there I saw the Prisoner whom I had never seen before. I drank a Mug of Beer, there and then was for going to Bed. Jordan bid the Prisoner, take the Candle and make the Bed; and while she was doing that I undrest. I put my Breeches under the Pillow and got into Bed. My Money was sew'd up in my Fob. The Prisoner came pretending to take the Candle, but took hold of my Breeches. I got a grip of them. But she cryed, Let go ye Old Dog, or I'll cut your Neck, and so pulled them away from me, and run down Stairs and out of the House, tho' I got out of Bed and called to Jordan to stop her. I put on my Coat and went down to follow her, but he stood at the bottom of the stairs, and would not let me go out, for he said if I did, the Mob would kill me. He gave me a pair of his Breeches to put on. I would have gone out the next Day but he would not let me. At last I took him up, then he found out the Woman. It was I that made her a Woman, for she was a ragged ars'd Beast before she laid hold of my Breeches.

Su Smith. I keep an Alehouse in Rag Fair. On Friday in the Afternoon, the Prosecutor and Jordan and four more, were five Hours, at my House, and got drunk, and squabbled about the Reckoning - Next Day I was told that the Prosecutor had lost his Breeches - Jordan was sent to New Prison, where he lay for a Week. The Prisoner came drunk to my House, and said to me, Jordan is taken up, but poor Man he is innocent, and knows nothing of the matter, for I took the Breeches myself.

Prisoner. The Prosecutor came to me in Newgate, and said. Do not be dead hearted, poor thing! For when you come to the Bar, I won't hurt ye.

The Jury found her guilty to the value of thirty-nine Shillings.’

(*Old Bailey Sessions Paper*, 10 Dec 1735. See also *Read's Weekly Journal*, 20 Dec 1735.)

7.4.4 A defendant who was convicted of a capital offence was sentenced to death, but the judge could grant a reprieve and recommend the offender to the king for mercy, which would result in a pardon, or the prisoner could petition the Crown directly, or the Crown could pardon on its own initiative (with advice). In Surrey between 1660 and 1800, 59.5% of those capitally convicted were not executed.¹¹⁹

7.4.5 As has been said, the system had two principal objectives – to punish crime and to demonstrate the state's power. In terms of the crime objective there is little evidence that it

¹¹⁸ *Ibid*, pp.425-26, 430.

¹¹⁹ *Ibid*, p.433. After 1718, those reprieved were usually transported to North America and, later, Australia.

worked. It is impossible accurately to determine the number of offences committed, as opposed to the number prosecuted, but there was a perception that crime was increasing from the mid-eighteenth century as a result of a rapidly rising population, an increase in the poor in agricultural areas in the south alongside the rapid growth of prosperous trading and moneyed classes, and periodic panics about the demobilisation of large numbers of soldiers and sailors at the end of the various wars. This concern about crime led to criticism of the effectiveness of the criminal justice system. One reaction was to increase the number of executions: the crime panic at the end of the American War of Independence led to more convictions and to the government policy of denying pardons to all convicted of robbery, burglary and housebreaking – 173 were sentenced to death at the Old Bailey in 1783, a rise of 60% on 1782 and more than double the figure during a previous panic in 1751; the percentage of those executed increased from around 29% to 65% and reached 80% in 1787.¹²⁰ The effectiveness of this policy was challenged, and, indeed, a campaign began to reduce the number of capital offences.¹²¹ At the same prisons were developed as a means of rehabilitating offenders, and a detective police force and a London-wide patrol administered were established at Bow Street to improve the efficiency of crime detection and with it the certainty of punishment.

7.4.6 Credible deterrence in the form of the Bloody Code arose as part of a means of domestic governance – maintaining an image of government, which had relatively limited resources and was controlled by a tiny elite, as strong and as exercising legitimate authority (through the ability to kill and to reprieve). But it also sought to deal with crime. A high degree of discretion was essential to prevent the justice system appearing too harsh and too bloody, but this also allowed participants to fit the system to their own interests rather than those of the broader public, and, at the time, some argued that the lack of certainty meant offenders were not deterred. By the 1830s the vast bulk of the capital offences had been swept away in the search for a more efficient solution to crime. The theatrical spectacle could only ever have a limited and short-term effect. In a sense, such a system is either an admission that effective enforcement is impossible or an attempt to achieve goals other than crime reduction.

¹²⁰ PJ Rawlings, *Crime and Power: Criminal Justice 1688-1998*, London: Longman, 1998, p.39.

¹²¹ This campaign linked to others, such as the anti-slavery and the factory reform movements.

8. WHAT UNINTENDED CONSEQUENCES CAN ARISE FROM REGULATORY INTERVENTIONS?

8.1.1 The criticisms of Donald Rumsfeld, while he was US Secretary of Defense in the government of George W. Bush, that misfire completely are those that ridicule him for talking about known and unknown knowns because here, at least, he was engaging with some tough philosophical issues. It was during a press call in 2002 that he said:

‘Reports that say something hasn’t happened are always interesting to me because as we know, there are known knowns: there are things we know we know. We also know there are known unknowns: that is to say we know there are some things [we know] we do not know. But there are also unknown unknowns—the ones we don’t know we don’t know. And if one looks throughout the history of our country and other free countries, it is the latter category that tends to be the difficult one.’¹²²

In another form this sums up difficulties facing regulators. A danger of regulation is that it fails to address future problems, perhaps because they are unforeseen or because, although foreseen, they were discounted or their consequences underestimated. It may be that a crisis leads to such intense focus on a particular issue that the collateral damage caused by intervention is unnoticed or ignored. An action intended to have one effect may also misfire entirely, or it may have unintended consequences that would not have occurred without the action. These ‘unanticipated consequences of purposive social action’ may be positive or negative.¹²³ Public executions in the eighteenth century were meant to bring crowds to impress on them the consequence of crime and the power of the state, but they also provided opportunities for pickpockets.

8.1.2 Unintended consequences arise from a variety of things, such as the failure to anticipate all outcomes or to look beyond the short-term or immediate implications. It may be difficult to identify an action as having led to a particular consequence and it may be tempting after the event to work backwards, ignoring alternative explanations. Nevertheless, certain examples can be given of unintended consequences. A law requiring motorcyclists in West Germany to wear crash helmets, which was enacted to reduce head injuries, seems to have been responsible for a dramatic fall in motorcycle thefts (down by two-thirds). This drop was not matched by a rise in other thefts (cars, bicycles),¹²⁴ which was unusual because a consequence of action taken to reduce one type of crime or crime is often an increase in other types of crime – flooding an area with police tends to shift crime to neighbouring areas. That this did not occur suggests the theft of motorcycles had been largely opportunist. When Victoria in Australia made it mandatory for cyclists to wear helmets, the number of head injuries was reduced, which was the intended consequence, but the number of young cyclists declined because they regarded the helmets as unfashionable and so stopped riding. Indeed, in general, people cycled less, which meant they did not get the associated benefit of exercise, and the result was said to be worse health overall.¹²⁵ Similar effects may arise if controls are

¹²² <http://papers.rumsfeld.com/about/page/authors-note>.

¹²³ RK Merton, ‘The Unanticipated Consequences of Purposive Social Action’ (1936) 1(6) *American Sociological Review* 894.

¹²⁴ PM Mayhew, RV Clarke & D Elliott, ‘Motorcycle Theft, Helmet Legislation and Displacement: (1989) 28 *The Howard Journal* 1.

¹²⁵ MH Cameron, AP Vulcan, CF Finch, SV Newstead, ‘Mandatory Bicycle Helmet Use Following a Decade of Helmet Promotion in Victoria, Australia – An Evaluation’ (1994) 26(3) *Accident Analysis & Prevention* 325; P de Jong, ‘The Health Impact of Mandatory Bicycle Helmet Laws’ (2012) 32(5) *Risk Analysis* 782; L Turner, ‘Australia’s Helmet Law Disaster’ (2012) *Institute of Public Affairs Review* 28.

placed on enforcement agencies. It was discovered in 2013 that to improve clear up rates, which is a statistic used to measure performance, Kent police focused on crimes that could be solved relatively easily, and this sometimes led resources to be diverted from dealing with crimes that had a greater impact on communities.¹²⁶ Any intervention in financial markets is likely to have unintended and unforeseen consequences, although making a causal connection is difficult when dealing with complex markets. The tightening of capital adequacy rules from the 1980s led banks to create structured finance vehicles to remove assets from their books. These became increasingly complex and obscure, leading to the creation of new, unregulated devices, such as credit default swaps, and, ultimately, they played a key role in the financial crisis.

8.1.3 The crisis has led to various initiatives with a range of collateral consequences. Most may have been foreseen, but were not necessarily intended or their severity may have been misjudged, or they were regarded as a price worth paying. Limits on bonus payments in financial services firms are likely to be met by firms increasing basic pay or moving to other jurisdictions not covered by the new rules, or they may lead talented people to go into other businesses or move to other countries. These concerns led the UK to criticise EU proposals on bonus caps. Breaking up large firms to render them easier to supervise and less problematic in the event of failure may reduce the ability of a firm to engage in activities seen as fundamental to the economy and may even lead to the firm's collapse. Similar considerations may limit the ability of the supervisor to impose penalties or restrictions on firms – can a supervisor fine a company so heavily that its existence is threatened, and, if it cannot, does this undermine the power of the supervisor? Under EMIR (European Market Infrastructure Regulation) certain types of derivatives trading are to be cleared through central counterparties to improve market transparency, but this carries the danger of central counterparties carrying a high concentration of potentially systemic risks.

¹²⁶ HM Inspectorate of Constabulary, *Crime Recording in Kent*, 2013 <http://www.hmic.gov.uk/media/crime-recording-in-kent-130617.pdf>

9. DO OTHER SECTORS HAVE LESSONS FOR THE REGULATION OF FINANCIAL SERVICES?

Most of the examples used in previous chapters have been drawn from the regulation of risk in economic activity where the main objective has been to facilitate competition. Are there any lessons to be drawn from other sectors in regulating financial services? The case studies in this chapter involve risk in relation to health – health and safety and food safety. How are the risks in these areas monitored and regulated?

9.1 Occupational health and safety

9.1.1 The history of health and safety law illustrates two contrasting regimes as detailed rules on safe environments gave way to broad principles stipulating outcomes supplemented by rules to deal with specialised problems. This area of law arose piecemeal, which meant it became very complex with seven regulators and nine separate regulatory regimes. Many of the rules were over elaborate and detailed.

‘The general illumination over those parts of the factory where persons are regularly employed shall be not less than 6 foot candles measured in the horizontal position at a level of 3 feet above the floor’¹²⁷

This level of detail can result in high costs for firms and regulators. It tends to box ticking and assumes all workplaces are the same: in other words, the employer is directed to look at whether or not the lighting system complies with these precise measurements rather than at whether or not the workplace is adequately lit for the nature of work and the design of the premises. Not surprisingly, employers may focus on compliance and regard what constitutes a safe environment as the responsibility of the body that drafts the rules; indeed, that is, presumably, the regulator’s intention.

9.1.2 This system was reformed by the Health and Safety at Work Act 1974, which established the Health and Safety Commission (HSC) with members nominated by industry, unions, government and local authorities. The act obliged the employer to think about how best to create a safe environment: ‘It shall be the duty of every employer to ensure, so far as is reasonably practicable, the health, safety and welfare at work of all his employees’ (s.2(1)). This new regime was built around simpler standards. The lighting regulations now read: ‘Every workplace shall have suitable and sufficient lighting.’¹²⁸ Employers are expected to adjust practice to each workplace.

9.1.3 Employers are given general guidance by the Health and Safety Executive,¹²⁹ although some principles are supported by very detailed statutory rules, for example, The Control of Substances Hazardous to Health Regulations 2002 (SI 2002/2677) contains general duties, such as:

‘An employer shall not carry out work which is liable to expose any employees to any substance hazardous to health unless he has— (a) made a suitable and sufficient assessment of the risk created by that work to the health of those employees and of the

¹²⁷ The Factories (Standard of Lighting) Regulations 1941 (SI 1941/94, reg.2(a)).

¹²⁸ Workplace (Health, Safety and Welfare) Regulations 1992 (SI 1992/3004), reg.8(1).

¹²⁹ <http://www.hse.gov.uk/managing/index.htm>.

steps that need to be taken to meet the requirements of these Regulations; and (b) implemented the steps referred to in sub-paragraph (a).' (Reg. 6(1).)

But this is followed by 12 factors to be considered in the risk assessment and an obligation to review the assessment (reg. 6(2), (3)).

9.1.4 Health and safety law is enforced by inspectors, who have various powers, such as the right to enter premises. If they discover a breach, their discretion is guided by the Health and Safety Executive's Enforcement Policy Statement.¹³⁰ This states that the purpose of enforcement is to ensure the dutyholders (e.g. employers, contractors) deal immediately with serious risks, to promote compliance and to hold to account those who fail to meet their responsibilities. These broad objectives are refined by a number of principles and for each the statement provides explanations, including: proportionality, whereby enforcement is related to the risks; targeting, which means focusing on those whose activities create the most serious risks; consistency, which 'does not mean uniformity. It means taking a similar approach in similar circumstances to achieve similar ends.' (p.4); transparency to help dutyholders understand their responsibilities and what they can expect from enforcement agencies; accountability to the public, which involves measuring the enforcement activities against the principles; and the use of discretion to determine whether or not to investigate. Thus, the inspector's action will depend on the nature of the breach and the risk to health involved. In the case of a minor breach, the inspector may informally notify the employer of the action needed for compliance. A more serious breach may lead to an improvement notice, which requires action by the employer within a stipulated period and allows an appeal to an industrial tribunal. If the breach involves risk of serious injury, a prohibition notice may be served stopping the particular activity until remedial action is taken; but, again, an appeal is available. Finally, a decision may be made to prosecute before a court where a fine and, or a period of imprisonment can be imposed.

9.2 Food standards

9.2.1 The Food Standards Agency (FSA) is a non-ministerial government department, established under the Food Standards Act 1999 as a result of a decision to split the promotion of food businesses from the enforcement of food safety in the wake of concerns arising from cases of food poisoning and Bovine Spongiform Encephalopathy (BSE). The FSA is part of a complex regulatory structure. Local authorities, Department for Environment, Food and Rural Affairs, Environment Agency, Rural Payments Agency, the Health and Safety Executive and the Veterinary Medicines Directorate have statutory duties in relation to food, labelling, public health, medicinal products for animals, health and safety, pollution and feed hygiene. The potential for duplication and overlap is tackled by, for example, the use of joint inspections and data sharing, and Codes of Practice for local authority officials promote consistency.

9.2.2 The main objective of the FSA is to protect public health from risks arising out of the consumption of food and drink (s.1(2)), and it is required to develop policies in relation to these issues and provide advice, information or assistance to other public authorities (s.6(1)). The FSA's approach is to 'deliver risk-based, targeted regulatory interventions that promote a reduced level of intervention for businesses where there is evidence of compliance.'¹³¹ This

¹³⁰ <http://www.hse.gov.uk/pubns/hse41.pdf>.

¹³¹ www.food.gov.uk/multimedia/pdfs/compliancestate.pdf.

requires an impact assessment that balances the risk to public health, including the risk involved in not intervening, with the costs and benefits, although the FSA adopts a precautionary approach where there is a serious risk to public health. The FSA has programmes to deal with emerging risks and food fraud, which use intelligence to target enforcement. In 2009, the FSA adopted ‘a cause for concern process’¹³² for meat businesses which focuses on those producers and retailers posing the greatest risk to consumers. The assessment of that risk is based on factors which the producers and retailers can control and not those beyond their control. Four years later, in 2013, this strategy and the emergency response capability of the FSA were tested following the discovery of beef products contaminated with horse and pork meat and DNA. A subsequent review was critical of the FSA in ways reminiscent of the criticisms of the Financial Services Authority after the financial crisis. The report by Professor Troop recommended better information gathering, improvements to the major incident plan, greater clarity in the role of government departments in relation to large incidents, and a review of the FSA’s powers.¹³³

9.2.3 At the same time and in line with the government’s policy of reducing regulation and making it easier to understand and observe,¹³⁴ the FSA acknowledged that ‘excessive or unclear regulations can place a burden on business, the public sector and civil society groups [e.g. charities]... and so hinder effective delivery of the intended benefits.’¹³⁵ It has, therefore, adopted the one in, two out approach to regulation, the objective of reducing national food safety regulations by two-thirds by 2015, post-implementation reviews of regulation, and sunseting legislation, which means rules automatically expire on a stipulated date. The FSA has also sought to focus more on alternatives to regulation, such as food hygiene rating and information: for example, the Safer Food, Better Business initiative, which provides tailored guidance in various languages to different types of small catering businesses.¹³⁶

9.2.4 Inspection is related to the degree of risk posed by a particular activity, but the FSA has reduced the number of inspections by more than 70% as the result of ‘earned recognition through third party accreditation’. For example, the Red Tractor Farm Assurance Dairy scheme (previously National Dairy Farm Assurance Scheme and Assured Dairy Farms) has been established – and paid for – by the food industry (farmers and food companies) with representatives on its board from farmers and retailers.¹³⁷ It certifies, among others, milk, beef and lamb producers on the basis of standards of husbandry and welfare, which cover production, storage, traceability, integrity, animal health and welfare, feed, water, housing, shelter and handling facilities, animal medicines, bio-security, calf rearing, casualty and fallen stock, livestock transport, environmental protection, contamination control, staff and contractors, documents, procedures, and vermin control.¹³⁸

9.3 Comment

¹³² *Ibid.*

¹³³ P Troop, *Review of Food Standards Agency Response to the Incident of Contamination of Beef Products with Horse and Pork Meat and DNA: An Independent Report*, 28 Jun 2013 at <http://tinyurl.com/pjcazc4>.

¹³⁴ See <http://tinyurl.com/ohhamvb>. For the Department for Business, Innovation and Skill programme to reduce the impact of regulation on business: <http://tinyurl.com/9wbmbq>.

¹³⁵ <http://tinyurl.com/o4q3pc6>.

¹³⁶ <http://www.sfbtraining.co.uk>.

¹³⁷ <http://www.redtractor.org.uk>.

¹³⁸ <http://tinyurl.com/nda4csa>.

9.3.1 These case studies reveal that regulation of other sectors has posed problems similar to those encountered in finance – the mix between rules and principles, the structure of the regulator, the relationships between regulatory authorities, and the appropriate enforcement strategies (enforcement that depends on external authorities or the industry). Detailed rules offer the prospect of clarity for both regulator and regulatees, but – leaving aside the issue of whether rules can ever be drafted in a way that renders their meaning clear –lack of flexibility, which is their chief advantage, is also their chief failing in that the regulatees may see rules narrowly, as something to be slavish followed or a business cost to be limited or avoided rather than an expression of a broader objective. The use of principles seems to offer a more flexible approach in which the regulatees are not directed to a particular way of working (e.g. lighting is specified), but only to a particular objective (e.g. lighting must be adequate for the work). This not only makes regulation more flexible and, therefore, not in need of frequent changes in order to keep up with changes in an industry, but also places on the regulatees the onus of ensuring that the precautions taken are adequate: in lighting this might, for example, mean increasing expectations as lighting technology improves; in food safety it might mean abandoning old methods of food preservation or preparation and adopting new ones in response to scientific advances. But principles leave the uncertainty of regulatory discretion because ultimately it is the regulator – not the regulatees – that determines whether or not there has been a breach.

9.3.2 The case studies also illustrate different enforcement strategies. The use of strict liability offences may shift the burden of proof away from the prosecution, on whom it normally lies, but it may make senior officials liable even though they are not directly involved in an activity. Their offence is not the activity itself, but failing to take reasonable steps to stop it occurring. The public interest in ensuring people are not treated unfairly is balanced against the public interest in preventing some greater disaster. But the former can easily swept aside: the protection of the individual cannot compete with what is seen as the protection of a section of the public (employees, consumers, the UK's food security or financial system). Health and safety and food safety both involve the extensive use of inspectors with summary powers to, for example, close a site or shop, if only while further inquiries or changes are made. Procedural fairness is balanced against public health, so that the powers can be used rapidly and subjected to later inquiry. This contrasts with the financial sector where there is no professional body of inspectors similar to those working in health and safety and food safety, and enforcement is likely to be slower and the procedural fairness tends to come before the enforcement action (although emergency powers exist). Health and safety and food safety mix prevention with reaction: inspecting premises to prevent problems from arising and reacting to accidents or complaints from consumers. This mix is also important in financial regulation, but it may be that the role of consumers is somewhat different in that major systemic threats may not be revealed by consumer complaints. Indeed, it was alleged that the Financial Services Authority was distracted from macro-prudential issues by its concentration on such complaints.

10. PREVENTING HARM OR MITIGATING HARMFUL EFFECTS?

10.1 Distinguishing between *ex ante* and *ex post* regulation

10.1.1 Regulation should prevent market failure or promote welfare goals that may not be achieved by the market.¹³⁹ It usually involves *ex ante* provisions: that is, regulation that aims to prevent harmful conduct from arising. In contrast *ex post* measures are concerned with halting or reducing the harm caused to counterparties, customers, third parties (through, e.g., a drop in asset values) and the broader financial system (e.g., systemic collapse), irrespective of whether this harm arises from a regulatory breach or not.¹⁴⁰

10.1.2 Historically, financial regulation has taken an *ex ante* approach. Beyond the establishment of a deposit protection scheme, there has been surprisingly little interest in the possibility that, in spite of regulations, a bank failure or market collapse might occur. In part, this may be because of the view that planning for such an event might remove some of the risk and encourage banks and customers to take less care. But the failure to plan meant that when a bank collapse occurred it was dealt with by *ad hoc* measures organised in a rush, as, for example, happened with Barings in 1890 and Johnson Matthey in 1984. The financial crisis demonstrated that waiting for the harm to occur before reacting was dangerous. It was not only that this was an unprecedented event, but it also brought home the reality that the old club method of leading banks getting together to rescue one of their number was no longer a viable option, particularly since those banks were themselves facing uncertain futures. This led to the adoption of a framework designed to respond to and manage a crisis, and, while such interventions disturb the balance of the market and upset market discipline, that is their objective.

10.1.3 Determining when to intervene is a problem. Ideally, intervention should come before any harmful effects. For example, in bank regulation, the regulator needs to take into account depositor protection, public confidence, financial stability, the preservation of critical banking functions, competition, the minimisation of resolution costs (particularly, where these are borne by public funds) and the avoidance of moral hazard. The trigger mechanism needs to be set so as not to activate either too soon or too late, but that is extremely difficult to judge. Setting the trigger to react when capital levels fall would probably miss a liquidity problem, and an overly sensitive trigger might discourage risk taking and make the market less efficient. Moreover, there are political pressures not to act too soon and, perhaps, hold back what appears to be a booming economy. Powerful interests within the market might also resist early intervention, preferring to trade out of difficulty.

10.2 Responding to bank insolvency

10.2.1 The problems that can arise when a retail bank gets into difficulties were vividly illustrated by the run on Northern Rock in 2007¹⁴¹. This seemed to demonstrate the

¹³⁹ As has been seen, governments may regulate for other, narrower, political objectives, and, of course, regulation may not be designed to address market failure because the circumstances do not allow it (e.g., there is a demand for some action, but government does not have the resources to deal with the problem and so merely symbolic regulation is established).

¹⁴⁰ I Anabtawi & SL Schwarcz, "Regulating *Ex Post*: How Law Address the Inevitability of Financial Failure" (2013) 92 Texas LR 75.

¹⁴¹ C Russo, 'La Crisi della Northern Rock: un Recente Esempio di Regulatory Failure', Banca, Impresa, Società, 2/2009, 241; 'Northern Rock: The Right Decision at the Right Time?' (2008) 7 Bulletin of International Legal Developments, Issue 75.

importance of a deposit protection scheme, which privileges depositors above other creditors and reassures them that their money is safe. It acknowledges that depositors cannot assess the risk involved in depositing funds with a particular bank, and, although other creditors might make the same argument, the need to privilege depositors arises from their unique position and the damage that might be inflicted by a large-scale withdrawal of funds. One difficulty is that this argument would apply irrespective of the size of the deposit. Depositors might look only to the rate of return and not the security of their funds, driving banks to compete by offering high rates, and a disparity between deposit protection schemes in different jurisdictions may cause funds to be moved between banks as depositors seek the best protection.

10.2.2 Depositors must have sufficient confidence in the scheme that they will not rush to withdraw their money: it must be sufficient in terms of coverage, it must return funds rapidly, it must be adequately funded and it must be sufficiently publicised and understood. Northern Rock's collapse perhaps revealed that depositors did not understand the scheme or believe it provided sufficient coverage, but they may have taken the entirely rational view that – irrespective of the efficiency and coverage of the scheme – they preferred not to wait for their funds to be reimbursed, which seems a likely explanation since the scheme covered those with relatively low deposits who may not have had access to alternative funds while waiting for reimbursement. There were other problems with the scheme. It did not have sufficient funds to deal with the failure of a large bank without Treasury support. It was limited by jurisdictional borders in that it covered only UK banks, but when non-UK banks failed concern that this might generate a broader panic prompted the Treasury to fund return of deposits to affected UK customers. The crisis demonstrated that limits on such schemes might be overridden – and their purpose lost – in the face of fear about the effects of a widespread run on banks.

10.2.3 Other measures relating to bank insolvency law were introduced after the crisis. These comprise *ex ante* and *ex post* provisions. *Ex ante* provisions relate to all those remedial actions taken by bank regulators to correct problems at an early stage with the aim of helping banks avoid harmful conduct and return to normal business without the need for resolution actions. Such action may reduce the risk of a bank becoming insolvent, minimise the cost of failure for the depositors, other creditors and taxpayers, and maintain or even enhance confidence in the financial system and the effectiveness of the regulator. The difficulty is determining when action should be triggered – under-capitalisation, liquidity shortfall? The remedial provisions might include obliging the bank to hold own funds in excess of the minimum level or to use net profits to strengthen its capital base; implementing one or more of the arrangements and measures set out in a recovery plan; restricting or limiting the business, operation or network of the bank; requiring a reduction in the risk inherent in activities, products and systems; imposing a limit on variable remuneration and enabling remuneration clawback; requiring creditors to take losses; and removing directors and senior employees.

10.2.4 To deal with a failing bank, the Banking Act 2009 established a special resolution regime (SRR).¹⁴² This comprises three stabilisation options, and special insolvency and administration procedures.¹⁴³ All or part of the bank's business may be transferred to a

¹⁴² D Singh, 'The UK Banking Act 2009, Pre-insolvency and Early Intervention: Policy and Practice' (2011) *Journal of Business Law* 20; C Russo, 'The UK Banking Act 2009 – New Law, Old Problems (2009) 4 *Bulletin of International Legal Development* 41.

¹⁴³ There is a separate administration regime for investment banks (Banking Act 2009, ss.232-236): HM Treasury, *Special Administration for Investment Firms*, (2010); The Investment Bank Special Administration

private sector purchaser, or to a bridge bank (a subsidiary of the Bank of England) pending a proposed future sale, or the bank may be placed into temporary public ownership¹⁴⁴, or it may enter the Bank Insolvency Procedure (BIP) to allow rapid payments to depositors from the Financial Services Compensation Scheme or the transfer of accounts to another bank. The Bank Administration Procedure (BAP) may be used to deal with part of a bank that is not transferred and is instead placed in administration.¹⁴⁵ The SRR operates within a framework meant to determine the various roles of the different authorities - the Prudential Regulation Authority, the Financial Conduct Authority, the Treasury, the Financial Services Compensation Scheme and the Bank – and a code of practice guides these authorities in the use of the various tools and powers.¹⁴⁶

10.2.5 The SRR will almost certainly have an effect on other parties, if only by limiting the rights of creditors. Some *ex post* provisions directly address such rights. For example, the Financial Services (Banking Reform) Act 2013, Sch.2, provides for bail-in, which gives rise to a range of powers, such as cancelling or modifying a liability owed by the bank, or converting an instrument (e.g. debt into equity).¹⁴⁷

10.2.6 These *ex post* measures, which were designed to stop or mitigate the impact of a bank failure, have been supplemented by *ex ante* measures to mitigate or prevent harm arising by providing for an orderly resolution of any failing bank. Living will provisions¹⁴⁸ require banks to maintain recovery plans, which must include action to be taken to ensure that the bank is able to continue business.¹⁴⁹ In addition, the Financial Services (Banking Reform) Act 2013, Pt 1 and Sch.1 (inserting new provisions into the Financial Services and Markets Act 2000) implemented some of the proposals of the Vickers report on ring-fencing.¹⁵⁰ The objective is to separate retail banking from proprietary trading (defined as dealing in investments as a principal) to limit the possibility that difficulties in those activities will affect retail banking operations. The Treasury may prohibit ring-fenced parts from entering transactions of certain types or with persons in a specified class, or establishing or maintaining a branch in specified countries, or holding shares in specified types of company. In exercising these powers the Treasury must have regard to the risks to which the ring-fenced entity would be exposed if there were no prohibition, and consider whether allowing it to undertake the particular activity would make it more likely that its failure would have an adverse effect on the continuity of provision of core services (such as deposit taking) in the UK.

Regulations 2011. One major concern was the problems encountered in the Lehman failure over the distribution of available funds to clients. These issues were largely managed in the UK under the Claims Resolution Agreement, but the regulations seek a permanent framework. Under the Financial Services Act 2012, ss.101-102 the SSR will extend to investment firms, banking group companies and clearing houses.

¹⁴⁴ For an example of the unintended consequences of temporary public ownership, see C Russo, 'Bank Nationalizations of the 1930s in Italy: the IRI Formula', (2012) 13(2) Theoretical Inquiries in Law 417.

¹⁴⁵ See Bank Administration (England and Wales) Rules 2009 (SI 2009/357).

¹⁴⁶ Banking Act 2009, Pt.2 as amended by the Financial Services Act 2012; HM Treasury, *Special Resolution Regime: Code of Practice* (2010).

¹⁴⁷ Government is conducting a consultation on the use of bail-in: <http://tinyurl.com/qbqbcmg>.

¹⁴⁸ See C Russo, 'Cosa Sono e a Cosa Servono le Living Wills? Luci e Ombre della Futura Regolamentazione' Banca Impresa Società 3/2011, 423.

¹⁴⁹ See FCA Handbook at http://www.fca.org.uk/static/pubs/cp/cp11_16_draft_handbook.pdf. For the broader possibilities of living wills: E Avgouleas, C Goodhart, D Schoenmaker, 'Bank Resolution Plans as a Catalyst for Global Financial Reform' (2013) 9 Journal of Financial Stability 210.

¹⁵⁰ Independent Commission on Banking, *Final Report: Recommendations*, (2011), ch.3., Not as yet in force.

10.2.7 As has been mentioned, this mix of *ex ante* and *ex post* measures directed at banks involves provisions concerning the behaviour of the authorities (the regulators, the Bank and the Treasury). As well as a framework within which the SRR operates, there are crisis management and state aid provisions. The Treasury, the Bank of England and the PRA are required by the Financial Services Act 2010 to co-ordinate the discharge of their functions in relation to the stability of the UK financial system and the impact on the public interest (s.64), and to prepare a memorandum of understanding (MoU) on how this will work in circumstances where the Bank is considering giving a public funds notification – that is, a notification of a ‘material risk’ of specified circumstances arising that may require the use of public funds (ss.58, 64(2), 65). This MoU must, among other things, define how the Treasury and Bank determine what constitutes a material risk, the steps to be taken, the roles of the authorities and how they will co-operate.

10.2.8 One problem facing the UK measures is how they will work in relation to international banks – both those UK banks with operations abroad and foreign banks operating in the UK – and how to deal with those banks that are defined as systemically important in that their failure may have consequences for domestic or international financial stability.¹⁵¹ Tackling these sorts of problems might involve improving international co-operation or establishing an international mechanism. Those banks in countries that are part of the Eurozone come within the Single Supervisory Mechanism (SSM) and will be subject to the (as yet, only provisional¹⁵²) agreement on the Single Resolution Mechanism (SRM). The SRM covers banks regarded as ‘significant’ by the European Central Bank (ECB) – the resolution of other banks will be handled by national authorities. Decision-making for significant banks will be centralised under the Single Resolution Board (SRB), which should make it easier to plan for orderly resolution across all Eurozone states within which the bank operates. There will also be a Single Resolution Fund comprising funds from banks, which is intended to reach a target of 1% of covered deposits, or around €55 billion. Decisions on expenditure are taken by the SRB. The resolution mechanism will normally be triggered by the ECB, which notifies the SRB, the European Commission and relevant Member State authorities. The SRB will determine whether the failing bank poses a systemic threat, in which case it will see if a remedy can be negotiated through the private sector, but if that is not possible it will use the resolution mechanism, subject to intervention by the European Commission (which, in turn, may be subject to objection by the Council of Ministers). This does not resolve problems in countries or banks outside the Eurozone, and the attempt to provide some cross-border framework may run up against national wishes to defend particular banks and the desire to compete with other countries for business.

10.3 Issues

The difficulties of judging what *ex ante* regulations are best suited to preventing harmful events without intervening too much in the market means that such regulations will never be completely successful – indeed, avoidance of any harmful events might indicate that the regulations are strangling the market. It is inevitable, therefore, that a regulator will need to respond to these events at some points. In the past, the UK has largely relied on reacting as and when they arise. This should have the advantage of allowing the response to be precisely

¹⁵¹ R Lastra, ‘Systemic Risks, SIFIs and Financial Stability’ (2011) 6(2) Capital Markets LJ 197; R Olivares-Caminal, ‘The European Stability Mechanism: Some Notes on a New EU Institution Designed to Avert Financial Crises’ in J LaBrosse, R Olivares-Caminal and D Singh (eds), *Financial Crisis Containment and Government Guarantees*, Cheltenham: Edward Elgar, 2013, 212.

¹⁵² The regulation is due to be voted on by the European Parliament in April 2014. See CA Russo, ‘The UK and Proposed EU Bank Resolution and Recovery Regimes: Clash of the Titans?’ (2012) 5(3) CR & I 87.

judged, but, in practice, this may not be the case because of the pressure of time – the need to resolve issues before markets open again means decisions are rushed. Moreover, it is clear that the tradition of the Bank inviting leading bankers to fund a rescue has gone. One of the consequences of the various financial instruments developed in the 1980s has been that the extent of the funding required for a rescue is no longer clear. That lesson was first learned with the Barings failure in 1995, but the financial crisis rammed home the point. Moreover, in 2008 the leading banks were uncertain as to their own position. The adoption of a crisis management framework that defines the roles of the various interested parties – the regulators, the Bank, the Treasury and the Financial Services Compensation Scheme – and can be deployed rapidly seems uncontroversial. More difficult is the attempt to render banks easy to resolve since this means, in part, unwinding banks when they are not in any difficulty, and designing a mechanism that triggers early intervention – if this is to be before a bank becomes insolvent, one is left to define what the trigger should be and how it can be activated in the moments before a crisis without removing risk taking or stagnating innovation.