Leviathan at Large

The new regulator for the financial markets

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The views expressed are the authors' alone.

CHAPTER 1

INTRODUCTION

LONDON IS THE WORLD'S most successful international financial market.[1] Such is the success of financial services in the United Kingdom that changes to the manner in which they are regulated demand the most rigorous scrutiny. The previous system left something to be desired, but it was well short of a disaster. In the 14 years since the Financial Services Act 1986, the City has flourished. The main beneficiary has been the consumer, who has been offered a much greater choice of products at a lower cost than ever before.

The Government is now introducing a fundamental overhaul of City regulation with the creation of the Financial Services Authority (the "FSA" or the "Authority"). The FSA will be the

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[1] The City of London is the world's largest fund management centre, with over $2170 billion of institutional equity holdings in 1998. London also houses the world's biggest foreign exchange market, accounting for 32 per cent of world turnover ($637 billion per day), more than New York and Tokyo combined. Insurance is another strong suit: London is the world's largest international insurance market with a gross premium income of £14 billion in 1997. It is the biggest market in the world for derivatives traded over the counter (with a 35 per cent market share) and the second largest after Chicago for exchange futures and options. It also plays host to the world's largest bond market: over $3 trillion is traded in London every year, leading to a market share of 54 per cent in the first three quarters of 1999. Well over 1 million people now work in this field, including over 210,000 in central London. In other areas, of course, other markets are dominant. Sources: Thomson Financial, *International Target Cities Report*, 1999; Bank for International Settlements, *Triennial Survey*, 1998; British Invisibles, *Key Facts About the City of London*; British Invisibles, *International Financial Markets in the UK* 1999

most powerful, and one of the least accountable, institutions created in the United Kingdom since the War. It will be, in many respects, legislator, investigator, prosecutor, judge, jury and executioner. Unless fundamental changes are made, the regulatory regime introduced by the Financial Services and Markets Bill, which vests the FSA with its full powers, could seriously damage the financial sector in this country. Jobs would be put at risk, business would be lost to foreign competitors and consumers would pay more for financial products.

Ultimately it will be the consumer, even more that those who work in the industry, who will lose out. Everyone who has a pension, an insurance policy, a mortgage, a bank account, or an investment could be adversely affected, directly or indirectly, by the proposals in the Bill as it stands today.

In what follows, the shortcomings of the Bill are identified together with proposals for their remedy. Chapter 1 summarises the 29 suggestions for improvement made in this paper. Chapter 2 provides a short history of regulation of financial markets in the UK, while Chapter 3 explains the need for it. Chapter 4 deals with the dangers of over-regulation which are inherent in the structure of the current Bill. It makes proposals to remedy these problems, including amendment to the FSA's statutory objectives and cost-benefit analysis of all regulation. Chapter 5 examines the inadequate accountability of the Authority. The lines of accountability to Parliament, to practitioners and to the law all need strengthening. Chapter 6 looks at the uncertainty which the Government's measures may bring to the markets. It suggests that the new market abuse provisions need tightening and that the system of guidance should be reformed. Finally, Chapter 7 deals with the risks of arbitrariness and potential oppressiveness which are created by the new legislation. There is a real danger that the new regime in its present form will breach human rights.

Many aspects of the Bill have been well designed. Much good work has indeed been done by the FSA. If this paper concentrates on the Bill's shortcomings, that is because there is still time to address them before the Bill is enacted.

There is certainly much scope for improvement. A price may well have to be paid for failure to adopt each of the amendments proposed in this paper. For some of these, the full extent of the cost may never be known, particularly where this could only be estimated by taking account of the opportunity cost of business foregone.

In other areas, the shortcomings of the legislation may become starkly apparent after a few years. This is why a fundamental review of the new regime after, say, three years is so important.[2] This mechanism would allow some of the weaknesses of the legislation to be addressed and at the same time assuage the concerns of those forced to live with it. In the absence of a commitment to undertake such a review, and the Government has so far vigorously resisted giving one, the financial services community is left without the prospect of escape from a regime which could well be deeply prejudicial to both it and its customers.

The FSA and its first Chairman have shown sensitivity to a number of the concerns expressed in this paper, particularly in recent speeches and policy documents. This, though, gives scant comfort.

The legislation is a dangerous weapon in the wrong hands. A major regulatory failure could all too easily provoke a damaging over-reaction from the FSA, particularly if parliamentarians are not restrained in their demands for action. Many such storms could well come in the years ahead.

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2 This view was recently endorsed by Don Cruickshank's *Review of Banking Services in the UK,* HM Treasury, March 2000. He recommended a review of the new regime after two years

The fact that the current stewards of the FSA have so far shown intelligence and restraint does not justify such far-reaching legislation. We should not be so dependent on enlightened implementation – better a more balanced Bill to start with. The primary objective of this paper, published while the legislation is still passing through Parliament, is to secure that balance.

CHAPTER 2

29 PROPOSALS FOR IMPROVEMENT

1 Competition and competitiveness to be statutory objectives of the FSA

As it stands, the Bill creates inducements for the FSA to over-regulate. The objectives set out for the Authority oblige it to pursue a policy of regulation with inadequate concern for competition within the UK financial services sector, and for the competitiveness of this sector in a global context. Yet these will provide the greatest long-term benefits to the consumer.

The FSA has been provided with four statutory objectives (Clause 2(2)).[3] These are:

1. market confidence;
2. public awareness;
3. the protection of consumers;
4. the reduction of financial crime.

The maintenance and promotion of competition within the UK market and competitiveness in the global market should be added to these objectives (see Chapter 4, Page 29).

2 Stronger and clearer cost-benefit analysis

Better regulation can be achieved through comprehensive cost-benefit analysis. The Authority should be obliged to undertake cost-benefit analyses for all its rules, not just new ones (as currently required by Clause 146). Moreover, given the complexity of the issues in this area, it should make clear the

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[3] All references to clauses of the Bill relate to the Bill at 10 February 2000

methodology it will be employing in carrying out this analysis. The primary yardstick for rule-making by the FSA should be that only regulation which increases the amount of UK business activity, legitimately conducted, is appropriate; regulation which reduces business activity is generally bad regulation (see Chapter 4, Page 34).

3 Statutory obligation to deal with compliance costs in the FSA Annual Report

The FSA should be obliged to deal with compliance costs in its Annual Report, focusing particularly on whether the burdens on the industry have increased during the year, and on international comparisons (see Chapter 4, Page 36).

4 Separation of Chairman and Chief Executive roles

The Chief Executive of this immensely powerful body should be accountable to someone. Good business practice points to a splitting of the roles of Chairman and Chief Executive. While the Chief Executive takes all the major operating decisions, the Chairman can exercise some scrutiny of his performance.

The Government, however, has unified these roles in one person, in a move almost unprecedented in the public sector. Its claims that it leads to greater accountability do not stand up to scrutiny. It may do the opposite (see Chapter 5, Page 39).

5 Confirmation hearings for Chairman and Chief Executive

The lines of parliamentary accountability are unacceptably weak for a body exercising so much public power. Moreover, the powers vested in the individual with the roles of both Chairman and Chief Executive are huge. In the interests of public accountability, confirmation hearings for these appointments, probably by the Treasury Select Committee, are desirable. It may also be wise to allow the Committee, at its discretion, to hold confirmation hearings for other members of the board (see Chapter 5, Page 42).

6 Non-executive directors to have a more active role

Given the huge powers held by the executive directors of the FSA, it is imperative that their non-executive counterparts are able to scrutinise what they do in the name of the FSA. Currently, however, their formal role is heavily circumscribed – the non-executive committee is restricted to consideration of matters relating to remuneration, the efficient use of the FSA's resources and internal financial controls (Schedule 1, Para. 4).

To improve accountability, the remit of the non-executive committee should be extended to require supervision of the work of the executive directors (see Chapter 5, Page 41).

7 Removal of immunity against damages actions

The FSA enjoys almost complete immunity from actions for damages, greater than that accorded to the police (Schedule 1, Para. 19). Even if it acts in a grossly negligent or reckless fashion, the courts cannot grant the victim, whether an individual or a business, any redress in damages. In the meantime, the victim's business and livelihood could be utterly destroyed.

It is crucial that the courts should be able to award damages where the Authority has acted in an entirely improper manner. The only exception to its immunity at the moment (Schedule 1, Para 19(3)) is in cases where the FSA acts in bad faith or in breach of the Human Rights Act 1998. This should at the very least be extended to include recklessness, and probably negligence too (see Chapter 5, Page 48).

8 Better accountability for the Treasury

The Bill also hands the Treasury wide powers. These include the power to determine what is a regulated activity, what activities should be exempt, and in what circumstances the financial promotion prohibition should not apply. The FSA's rule-making powers are subject to a specific obligation to carry out a public consultation on draft rules and an obligation to prepare a cost-benefit analysis. These safeguards should also apply to the exercise of the Treasury's powers (see Chapter 5, Page 45).

9 **Stronger obligations for consultation of the Practitioner Panel**
The Bill would allow the FSA to sideline the Practitioner Panel if it chose to do so (Clause 8). The FSA is only obliged to consult the Practitioner Panel on the extent to which its general policies and practices are consistent with its general duties under Clause 2. This limited form of consultation is unacceptable. The Bill should oblige the Authority to consult the Panel on proposed rules, codes, principles and other exercises of its regulatory powers on a regular basis and to provide reasons if it rejects the Panel's advice (see Chapter 5, Page 45).

10 **Better arrangements for the independence of members and chairman of the Practitioner Panel**
The Practitioner Panel's members and Chairman are all selected by the FSA (Clause 8). Notwithstanding a recent Government concession that the Chairman's appointment and dismissal will now be subject to Treasury approval, this system of selection leaves them beholden to the body towards which they should be capable of adopting an independent and sometimes critical attitude.

The Chairman should be elected by the Panel members, who should themselves be selected only after statutory consultation with the industry (see Chapter 5, Page 47).

11 **Statutory scheme for independent complaints investigator**
In the Bill, it is left to the discretion of the FSA to set up the mechanisms for dealing with complaints against it. The terms and conditions of the investigator are to be those which in the opinion of the Authority allow him or her to conduct investigations independently (Schedule 1, Para. 7).

A comprehensive statutory scheme is required setting out exactly the basis on which the investigator will work – a scheme which must ensure his or her independence and effectiveness (see Chapter 5, Page 51).

12 Complaints to go directly to investigator

The Bill proposes that complaints go first to the FSA itself, which will decide whether to deal with them internally (Schedule 1, Para. 8). To direct them through the FSA can only serve to discourage complainants who may already be cautious in their dealings with the Authority (given that they feel forced to make a complaint). As they know that they will continue to be monitored by the regulator in the future, many will feel that they cannot afford to antagonise the FSA by making a complaint to it. Complaints made directly to an independent investigator would reduce these concerns (see Chapter 5, Page 52).

13 Complaints investigator to be able to award *ex gratia* compensation payments

Even if he finds against the FSA, the complaints investigator will not be able to award compensation to a complainant who has suffered damage. Such damage could, of course, be the loss of his entire livelihood. The loss, moreover, could result from improper action by the FSA, such as a reckless investigation of a firm or individual who has been involved in no wrongdoing.

Furthermore, if no action is subsequently brought by the FSA, no costs will be obtainable against the regulator; yet the damage is often done from the moment rumours start circulating that the FSA is investigating a company or individual. The investigator should be given the discretion to award *ex gratia* compensation (see Chapter 5, Page 52).

14 Independent investigator to make recommendations to the FSA on remedying well-founded complaints

The investigator's only power in relation to a complaint is to make a report to the FSA, and to place the report and the Authority's response in the public domain if the investigator so wishes (Schedule 1, Para. 8). This needs to be strengthened to ensure that appropriate action in response to reports of the investigator is taken where the Authority has been found wanting (see Chapter 5, Page 53).

15 FSA's budget to be reviewed by the Comptroller and Auditor General

The budgets of bodies exercising public power are generally subject to review by the Comptroller and Auditor General. Even though the FSA is in principle a private company, the nature and extent of the powers it exercises suggest that it be subject to the same scrutiny. The Comptroller and Auditor General has expressed a willingness to perform this role (see Chapter 5, Page 44).

16 Widening the scope for judicial review

In many places the Bill limits severely the scope for judicial review of the regulator's actions. For example, the FSA is required only to act in such a way as it considers most appropriate for meeting its objectives (Clause 2). This subjective criterion limits the scope for judicial scrutiny. Other provisions do likewise.

A provision should be included stating that nothing in the Bill should be taken to limit the scope of judicial review of the Authority's actions (see Chapter 5, Page 51).

17 FSA to act in a way which is fair, reasonable and proportionate

The Bill contains no general obligation on the FSA to act in a reasonable or fair manner. Nor is there a requirement of proportionality (although the Authority must "have regard" to it as a principle when discharging its general functions). The FSA should be obliged by statute to use its powers in a fashion which meets these standards. A statutory obligation would act as a day-to-day reminder of the need to observe proper levels of fairness. It would also assist judicial review (see Chapter 5, Page 51).

18 Review of the system after three years

At least one fundamental review of the new system of regulation should be undertaken after, say, three years. The current Bill leaves the possibility of review at the discretion of the Treasury, and limits the areas which it can cover (Clause 10). The review should be independent of the Treasury and of the FSA, and should be seen to be so. Extraordinarily, the "independence" of any review undertaken is left to the Treasury to define. The review should cover all aspects of the FSA's work and the regulatory regime (see Chapter 5, Page 44).

19 Reform of the market abuse system

The market abuse system is a novel component of the new financial services regulatory arrangements (Clause 109). It is targeted at those whose standards of conduct on the market fall below acceptable behaviour. The clause is extremely widely phrased. Furthermore, it does not require intent: a firm does not have to intend to abuse its market position, or even know that it is doing so to contravene the prohibition. This casts the net unacceptably wide.

The breadth of the prohibition has generated considerable concern amongst practitioners. Even the addition of a Code, giving guidance on the prohibition, does not alleviate matters much: behaviour which the Code does not cover will still be judged according to the main provision. In a fast-moving market, this could inhibit legitimate business activity.

Intent should be made a requirement and the clause should be more tightly drafted (see Chapter 6, Page 56).

20 Strengthen the status of guidance

The Bill allows the Authority to give guidance to practitioners on matters relating to financial services regulation (Clause 148).

However, even if a practitioner obtains and then follows FSA guidance, he may still subsequently be sued in damages for breaching the relevant rule. Worse still, if the Enforcement Committee and the Tribunal take a different view from the guidance followed, their word is final and the practitioner may be fined.

Guidance from the FSA ought to be given enhanced legal status to provide at least some security for practitioners. Even if it is decided that making it a full "safe harbour" is not appropriate, its status should certainly be strengthened in the interests of both justice and market efficiency. (see Chapter 6, Page 60).

21 Obligation on Authority to provide guidance on request

The Bill as currently drafted does not oblige the FSA to give guidance on request. Moreover, it allows the Authority to charge for such guidance as it gives (Clause 148). In the interests of maximising certainty in the markets, the FSA should be required to give guidance when asked, unless the request is clearly frivolous (see Chapter 6, Page 60).

22 Statutory mechanism for enforcement action

The original draft Bill left it to the FSA to decide how it arranged its internal investigative and enforcement functions. This provoked considerable demands for a total separation of these functions.

The Government has responded by adding a provision stating that the person taking the enforcement decision should be someone "not directly involved in establishing the evidence" on which the decision is based. Nothing else is said in the Bill about the mechanisms to be employed. This level of generality is not adequate.

A detailed scheme is required, which ensures the independence of the enforcement function from the investigation function and which provides reassurance to practitioners that this has taken place (see Chapter 7, Page 69).

23 Reform of costs mechanism

The Financial Services and Markets Tribunal may only award costs against a party which has acted "vexatiously, frivolously or unreasonably". Therefore, even if the FSA loses the case, costs may not be obtainable by the other party. The Enforcement Panel has no power to award costs at all. The Bill should be amended to allow the other party to choose to have costs awarded at the relevant body's discretion. It should also be made explicit that the FSA has no power to include its costs in the amount of any fine (see Chapter 7, Page 73).

24 Greater procedural safeguards for disciplinary offences

Considerable confusion remains regarding the classification of "offences" in the Bill as civil or criminal. While the Government has insisted that they are all civil in nature, it was forced to concede that the European Court of Human Rights might well decide that the market abuse provisions were in substance criminal. As a consequence, extra safeguards appropriate in criminal cases were added.

However, disciplinary offences have not been treated in the same way, in spite of widespread concern that a large number of them could be classified as criminal. Even if the European Court of Human Rights were not to do so, it is clear that they are close to the line. The safeguards applied to the market abuse offences should be extended to the disciplinary offences (see Chapter 7, Page 72).

25 Legal aid for those under investigation

Legal assistance for those charged with market abuse is provided by the Bill (Clauses 125-127). There are, however, three flaws in the proposed system. First, it is to be funded from an additional levy on the regulated community. This is harsh on firms who do not transgress. Secondly, "legal aid" is only obtainable once the FSA has decided to take enforcement action and the defendant has decided to take the matter to the Tribunal. Much of the legal expense will be incurred long before this point has been reached (i.e. when the FSA starts investigating). Thirdly, the Bill provides that assistance is only available in cases of market abuse. There is a case for providing legal aid should for all those under investigation, not just for those alleged to have been engaged in market abuse (see Chapter 7, Page 74).

26 Tribunal members to have adequate legal experience

The status of the members of the Tribunal is not made clear in the legislation. Given the very substantial powers set out in the legislation for the Tribunal, and the impact of its decisions, members should have adequate legal experience. The

President and Deputy President should be High Court judges (see Chapter 7, Page 71).

27 A fair Ombudsman scheme

The Bill amalgamates the several Ombudsman schemes operating under the old multi-regulator system. Registered firms are now obliged to be members of this scheme (Clauses 219-221). The Bill, however, sets up an unbalanced mechanism for the Ombudsman: his decisions will be binding only on the practitioner, not on the complainant. The latter will be able to go to the courts if he does not like the Ombudsman's adjudication. This may encourage an over-cautious and pro-complainant approach from the Ombudsman. The Ombudsman scheme should be reformed so that the interests of complainants and practitioners are balanced (see Chapter 7, Page 68).

28 A consistent approach to mortgage regulation

The Government has, at the last minute, added the regulation of the mortgage industry into the FSA's ambit. The proposals, however, are incoherent. Only mortgage provision – the act of lending – will be regulated under the new system; advice from brokers will generally have to be dealt with under the old system. The Government's approach to this area is ill-thought-out and needs a comprehensive review (see Chapter 7, Page 66).

29 Restrict territorial ambit of regulation of financial promotion

The Bill purports to regulate all financial promotion originating outside the UK which is "capable of having an effect in the UK" (Clause 19). In the internet age, this will catch promotional activities which are entirely undirected at the UK consumer. The Bill should be amended to regulate promotional activity which is "intended to be acted upon" by the UK consumer. The globalisation of financial markets may well render otiose even this proposal. (See Chapter 7, Page 65).

CHAPTER 3

NEW REGULATOR FOR OLD

THE FINANCIAL SERVICES AND MARKETS BILL will replace the Financial Services Act 1986. Under the 1986 Act, regulatory functions were conferred on the new Securities and Investments Board (SIB), which in turn recognised and supervised a number of Self-Regulating Organisations (SROs) and a number of Recognised Professional Bodies (RPBs), which conducted the substance of regulation. The SIB's role was primarily to oversee the SROs, only directly intervening in exceptionally serious cases.

There were originally five SROs:

- the Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA);
- the Association of Futures Brokers and Dealers (AFBD);
- the Investment Management Regulatory Organisation (IMRO);
- the Life Assurance and Unit Trust Regulatory Organisation (LAUTRO);
- The Securities Association (TSA).

Each SRO had its own body of rules, modelled on the rulebook of the SIB itself. To these sets of rules was added the SIB Statement of Principles – issued a few years later in an attempt to simplify what had already become a confusing and complex web of regulation.

Even when mergers created just three SROs, the system remained confusing for practitioners and consumers alike. Practitioners – who were dealing in an increasingly multi-disciplinary financial world with widespread diversification –

found themselves accountable to several different bodies and several different sets of rules. The approaches taken, for example, by regulatory bodies in the banking sector and in the pensions industry had little in common. Consumers, meanwhile, faced too many doors when they wished to make a complaint.

A report by the Treasury Select Committee in 1995 had found that the system was unnecessarily complicated, involving a duplication of rule-making and confusion amongst consumers.[4] City law firm Clifford Chance commented in 1997 on the effect on the City's global position:

> The existing structure is thought to be too complex and likely to drive off foreign investment.[5]

A number of regulatory failures, such as pensions mis-selling and the collapse of Barings Bank, lent strength to calls for an overhaul of the system. The Chancellor of the Exchequer, Gordon Brown MP, outlined his views on the problems in a speech to the House of Commons just after the last election:

> It has long been apparent that the regulatory structure introduced by the Financial Services Act is not delivering the standard of supervision and investor protection that the industry and the public have a right to expect.
>
> The current two-tier system splits responsibility between the SIB and the SROs… This division is inefficient and confusing for investors, and lacks accountability and a clear allocation of responsibilities.
>
> It is clear that the distinctions between different types of financial institutions – banks, securities firms and insurance companies – are increasingly blurred. Many of today's financial institutions are regulated by a plethora of different supervisors. This increases the cost and decreases the effectiveness of the supervision.[6]

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4 Treasury and Civil Service Select Committee, *The Regulation of Financial Services in the UK*, 1995

5 Clifford Chance, *The Changing Direction of UK Regulation*, 1997

6 Hansard, 20 May 1997, col 509

A single regulator seemed the obvious solution, though not one without problems. It was hoped that a new system would bring greater co-ordination and consistency across different areas of regulation, simplified access to the regulator for consumers, clearer accountability, and greater efficiencies through economies of scale.

The speech by the Chancellor quoted above continued:

> There is a strong case in principle for bringing the regulation of banking securities and insurance together under one roof. Firms now organise and manage their business on a group-wide basis. Regulators need to look at them in a consistent way. That would bring the regulatory structure closer into line with today's increasingly integrated financial markets. It will deliver more effective and efficient supervision, giving both firms and customers better value for money, and would improve the competitiveness of the sector and create a regulatory regime to genuinely meet the challenges of the 21st century.[7]

The new structure looks much simpler than the old one. The two-tier system is replaced by a single "super-regulator", the Financial Services Authority. The FSA will supervise all sectors of the financial services industry, including mortgages, pensions, banking, insurance, building societies, the financial markets, investment business et al. Unlike most regulators, who deal with only a few firms, the number under the FSA's jurisdiction is immense. It will be directly responsible for about 10,000 financial services firms and partially responsible for the financial services activity of at least another 16,000 firms currently authorised by Recognised Professional Bodies. To do this, it will employ over 2,000 staff.[8] It combines the regulatory and registration functions of no less than nine bodies:

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7 Hansard, 20 May 1997, col 509

8 There are, however, considerable concerns about FSA staffing. The calibre of staff it employs will play a crucial role in its effectiveness. It is likely, however, that the Authority's best people will be attracted to the rather higher rewards available in

- the Building Societies Commission;
- the Friendly Societies Commission;
- the Insurance Directorate of the DTI;
- the Investment Management Regulatory Organisation;
- the Personal Investment Authority;
- the Registry of Friendly Societies;
- the Securities and Futures Authority;
- the Securities and Investments Board;
- the Supervision and Surveillance Division of the Bank of England.

Elements of self-regulation are swept away in favour of a wholly statutory structure. The FSA will be supported by two major pieces of legislation. The first, the Bank of England Act 1998, is already in place. This transferred banking supervision to the FSA from the Bank of England. The second is the Bill currently passing through Parliament: the Financial Services and Markets Bill.

Under the new Bill, all practitioners in the relevant fields will need to apply for authorisation; the Authority has substantial powers to refuse, vary, cancel or attach conditions to the permissions which give such authorisation. Their activities will then be supervised by the Authority, which has the power to levy unlimited fines for breach of its rules. The Authority, for example, has extensive discretionary power to issue "statements of principle" relating to the conduct of approved persons.[9] If it then decides that an approved person has been involved in misconduct through breach of these principles, it can "impose a penalty on him of such amount as it considers appropriate" or "publish a

the private sector, particularly since firms may well be prepared to pay almost any price to secure the best protection from "regulatory risk". It was well known that the quality of staffing and staff turnover was a major problem for one of the FSA's regulatory predecessors, IMRO

9 i.e. persons who have been approved to perform "controlled functions" for an authorised person

statement of his misconduct", which could be ruinous.[10] New powers to punish "market abuse" and give guidance on what constitutes it are also included. These were not part of the powers of any of the predecessor bodies, and are both very widely drawn and subject to unlimited fines for breach.[11]

The Authority is given huge discretionary powers by the Bill. Particularly notable is the power to make and alter rules affecting both the regulated activities of all authorised persons[12] and also the non-regulated activities of authorised persons.[13] The Board of the FSA exercises an immense amount of public power over a major sector of the British economy. The FSA will be able to make or break any City firm or individual, almost in the blink of an eye. As the Chairman of a major City institution put it recently:

> Regulatory risk is many times greater than other traditional banking risks, such as credit default risk, interest or exchange rate risk or even systemic risk. A firm can make adequate provision for bad loans, but a serious compliance failure could lead to wipe-out.[14]

The Bill itself has been subject to an unusual degree of Parliamentary scrutiny, though the large Labour majority has impeded many desirable changes. The Bill has been considered by the Treasury Select Committee and by a Joint Committee of the Lords and Commons chaired by Lord Burns (the Burns Committee). The timetable for both, however, was too brief, meaning that both had to limit their scrutiny to certain key areas. The Bill is also the first to be carried over from one session of Parliament to the next.

It was crucial in creating the new regulator that the Government would put in place adequate checks on its vast powers, that it should not become an over-mighty leviathan.

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10 Clause 65

11 Clauses 109-122

12 Clause 129

13 Clause 130

14 In conversation with one of the authors

Unfortunately, as shown below, the Government has failed to offer that reassurance in the Bill it has brought forward. Rather, it is in the process of creating a huge, largely unaccountable and under-scrutinised body whose mistakes could do great harm to consumers and practitioners alike.

CHAPTER 4

THE NEED FOR A SYSTEM OF REGULATION

THOSE OF A CONSERVATIVE DISPOSITION tend to be wary of regulation. Generally, they believe that it adds to costs, impedes efficiency and discourages risk-taking and innovation.

Competition is usually the best regulator. A firm which acquires a bad reputation will simply lose its business to its competitors. Those firms with a strong reputation for integrity will attract more custom and become models for success. As Ford and Kay put it:

> Most people will only make a handful of major financial services purchases in their lifetime. This means that there is little scope for learning from experience. As a result, a firm's reputation will play a large part in their decisions. In the long run, reputation can only be built up by consistently delivering high quality. It is therefore a powerful form of investor protection.[15]

But competition has its limitations in this field. Such is the complexity of the financial service industry that individuals are forced to place trust in those advising them on, and dealing with, their money. The principle of *caveat emptor* remains an important one, but it must be modified to give those who deal in the financial sector a reasonable degree of confidence that the product or advice they are getting is legitimate. As the FSA put it in explaining its role to the Treasury Select Committee:

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[15] C. Ford & J. Kay, "Why Regulate Financial Services?", in *The Future for the Global Securities* Market, F. Oditah (ed.), 1996

> [We] believe that the role of regulation is to protect consumers – especially retail consumers – against risks which they are not in a position to assess and cannot reasonably be expected to assume.[16]

Failure to take action on those risks will shake confidence, leading to serious long-term damage to the market.

Confidence in the market is essential to win global business. If there is a fear that a lack of integrity could prejudice an investment, that investment will not be made in the first place. The losses from fraud are not only to those directly defrauded. The whole market can suffer if confidence is eroded. As the FSA's recent publication, *A New Regulator for a New Millennium*, puts it:

> Market confidence is fundamental to any successful financial system; only if it is maintained will participants and users be willing to trade in financial markets and use the services of financial institutions.[17]

Commentator James Cheek agrees, and stresses the crucial importance of confidence in the system:

> Without investor confidence, an economy cannot raise capital, sustain economic growth or give individuals a means to provide for their long-term financial needs.[18]

London has a sound reputation for probity and integrity, which it will be the task of the FSA to maintain. In doing, so it must strike the right balance, and not be seduced into the trap of believing that the more regulation the better. The right level of regulation is a huge asset to a market. The wrong level can lead to its demise.

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16 Evidence to Treasury Select Committee p 50

17 FSA, *A New Regulator for a New Millennium,* 2000

18 J. Cheek, "Approaches to Market Regulation", in *The Future for the Global Securities Market*, F. Oditah (ed.), 1996

THE NEED FOR A SYSTEM OF REGULATION

CHAPTER 5

THE RISK OF OVER-REGULATION

Summary
The Bill will place pressure on the FSA to over-regulate. Countervailing forces are weak. Competition and competitiveness should be added to the statutory objectives of the Authority. The FSA should be obliged to set out the full costs and benefits of existing and new regulation. Compliance costs should be carefully monitored.

An unbalanced Bill

There will always be calls for more regulation. Every time something goes wrong, and particularly when it reaches the popular press, the cry goes out: "Something must be done!" This Bill is, at least in part, a response to recent well-publicised regulatory failures such as the Maxwell affair and pensions mis-selling.

It is all too easy for governments to encourage regulators to over-react. Governments cover their backs, but it is industry, the consumer and society as a whole who ultimately suffer. In financial regulation, as in so many fields, there is a tension between what is politically expedient and what is economically or morally appropriate.

The wider purpose of regulation needs always to be borne in mind. Part of the regulator's task is to protect the consumer (as well as other financial institutions) against fraud. But that is only part of the task. The wider purpose of regulation is to maximise welfare for the consumer and hence for the economy as a whole.

A financial package that is essentially fraudulent is certainly "a bad deal". Regulation therefore tries to prevent it. But a package that is legitimate but which comes at an exorbitantly high cost is also a bad deal. The FSA's most important task is to balance the prevention of bad deals due to fraud (through regulation) and the minimising of bad deals due to excessive cost (through efficiency).

The same phenomenon could be observed in other areas of the law and of life. We know, for example, that burglary is a bad thing; so we seek to prevent it through the criminal law and the criminal justice system. We could stamp it out almost completely by stationing a policeman in every home. But we don't. The costs, in economics terms as well as in terms of civil liberties, are judged to be too high; so a balance is struck.

The need for this balance is too often ignored by lawyers and legislators. Lawyer-economist Cento Veljanovski explains that:

> All too often, lawyers (politicians, pressure groups and civil servants) discuss the law as if it were costless. Economics informs us that nothing is free from the viewpoint of society as a whole.[19]

The great American lawyer, Oliver Wendell Holmes, makes a similar point as he suggests that lawyers cannot ignore the lessons of other disciplines such as economics:

> Every lawyer ought to seek an understanding of economics. There we are called on to consider and weigh the ends of legislation, the means of attaining them, and the cost. We learn that for everything we have to give up something else, and we are taught to set the advantage we gain against the other advantage that we lose and to know what we are doing when we elect.[20]

The economists Ford and Kay develop this idea that the lawyer's mechanistic view should be tempered by the outcome-based viewpoint of the economist: legislation should not seek to deal with

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19 C. Veljanovski, *The Economics of Law*, IEA, 1990

20 Quoted by C. Veljanovski, *The Economics of Law*, IEA, 1990

every individual problem unless the ultimate effect of that legislation has been investigated thoroughly. An "outcome-based approach" should be used in addition to the more "process-based approach" of most lawyers and legislators. Ford and Kay even end up suggesting that "financial services regulation would benefit from the involvement of fewer lawyers and more economists."[21]

The consequences of regulation are also time-sensitive: the longer-term costs of trying, through regulation, to prevent short-term problems must be taken into account. The legislation should seek to optimise the benefits to the consumer through the *dual mechanisms* of efficiency and regulation.

Balanced regulation is in the interests of the consumer

The objection has come from certain quarters that the good of the City is far from synonymous with the good of consumers. What of all those stories of City fat cats, of traders and their huge bonuses?

The fact is, however, that the right level of regulation should usually render the interests of the consumer and those of the marketplace synonymous in the long run. If the costs on City firms go up, these costs will sooner or later be passed on to consumers. The interests of consumers are intricately bound up in the interests of the City. If firms are driven out of business by the costs of regulation, it is the consumer who will be hurt by the loss of competition in the financial services marketplace. If firms find themselves having to put up their fees due to new regulatory burdens, it is consumers who pay. If firms are prevented from entering the market in the first place by an excessive regulatory threshold, competition is prevented and it is the consumer who suffers. Falling profits may to an extent be compensated for by falling bonuses and salary freezes, but eventually, it is the consumer who pays. As Ford and Kay put it:

[21] C. Ford & J. Kay, "Why Regulate Financial Services?", in *The Future for the Global Securities* Market, F. Oditah (ed.), 1996

> Whilst [a high level of regulation] may produce a *process* which gives investors an admirable degree of protection, the danger is that the *outcome* is to exclude products which investors would wish to buy or to impose costs which discourage the purchase.[22]

The mobility of financial institutions

It is to be expected that major financial firms will be tempted to avoid the impact of an over-burdensome regulatory regime. If compliance costs become too high, large financial institutions can move, relatively easily, to a friendlier jurisdiction. Today, they are increasingly likely to succeed, as the communications revolution has led to an unprecedented degree of mobility.

It is no longer necessary to have a physical presence in a specific location. As Kit Farrow of the London Investment Bankers Association (LIBA) put it in his evidence to the Burns Committee:

> The more IT improves, the easier it is to have the people who represent the British, the French, the Japanese, and the German subsidiaries all actually sitting in the same office and deciding, as circumstances permit, which of those national companies is actually to be designated as the person who is conducting the business… [T]he competition between exchanges is becoming much more real. The cost of doing a transaction on one exchange is extremely easily compared to the cost of doing the same transaction on another exchange. I believe cost competitiveness in international competition between exchanges is something that we need to be quite alert to.[23]

Academic Alistair Alcock agrees:

> With the growth of computers and telecommunications and the free movement of capital, the danger of over-regulated markets moving offshore increases year by year. Even in the 1970s, the SEC's regulation of the domestic debt market produced the offshore Euromarkets in dollar-denominated bonds. More recently the light

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22 C. Ford & J. Kay, "Why Regulate Financial Services?", in *The Future for the Global Securities* Market, F. Oditah (ed.), 1996

23 Minutes of Evidence to Joint Committee, p 113

regulation of SEAQ International has led to the United Kingdom importing trading in overseas equities.[24]

This sort of regulatory arbitrage is now quite simple, and, as Alcock notes, it has been practised before: the imposition of a withholding tax on the American bond market led to its ruin. The City was then the beneficiary of another country's over-regulation.

The impact on the City of high compliance costs could be huge. David Challen of the Practitioners Forum pointed out to the Joint Committee that the markets were "extremely sensitive" to hikes in compliance costs.[25] Switzerland, Japan and, to a lesser extent, Dublin, are already actively competing for the business conducted in London, using light regulation as an inducement.

The incentive to over-regulate

The Government's Bill fails to strike the right balance. In spite of Alan Milburn's claim (when he was Chief Secretary to the Treasury) that it operates according to "a philosophy based on light touch regulation,"[26] it is biased in the direction of over-regulation.

The powers of the Authority are immense, and it has significant discretionary power to make new rules (and principles) binding the markets. Its instincts will be to use them. The regulator and its senior staff are likely to be slated if a even a minor scandal occurs. Such a scandal will no doubt lead to public opprobrium being heaped on the Authority: it will take the blame in the most public way, as the newspapers are always likely to take the side of the victims. There will always be a gap between public expectations of such a regulatory regime, and what it can achieve.[27]

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24 *Journal of Business Law*, July 1998, p 375

25 Ibid., p 112

26 Hansard, 28 June 1999, col 35

27 In practice, a high proportion of irregularities which do come to light are reported by firms themselves which, discovering an internal breach, attempt to minimise the impact by co-operating with the regulator

This gap creates the pressure for over-regulation or "regulatory creep":

> A regulator is faced with a very real problem – there is very little incentive to relax a rule if you know that as soon as something goes wrong in that area (whether or not it has anything to do with the rule change) everyone who has lost money will blame the regulator.[28]

A paper by City law firm, Clifford Chance, made the same point in relation to the reaction of MPs:

> Parliament's concern when there is a financial sector failure is typically that any insolvency indicates a regulatory failure, whereas in general regulators do not seek to prevent all insolvencies. If [the FSA's] officials feel that they will be criticised in Parliament for any financial sector collapse, this may engender an unduly cautious attitude which may be frustrating for regulated firms.[29]

It is understandable that the FSA's staff will err on the side of avoiding such failure, even at the risk of imposing excessive regulatory burdens. Giving evidence to the Burns Committee, Alastair Ross Goobey, the Chief Executive of Hermes Pensions Management, expressed fears that the instinct of the Authority would be to cover its back at all costs:

> I am concerned that there will inevitably be a tendency to err on the side of reducing the risk to the regulator at the expense of the regulated.
>
> The FSA and its Chairman will probably be judged harshly if there is even modest wrongdoing that escapes their gaze.[30]

The penalties for the staff of the FSA if they *over*-regulate, by contrast, are likely to be much less severe, even if the consequences are worse for the markets and for consumers as a

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28 C. Ford & J. Kay, "Why Regulate Financial Services?", in *The Future of the Global Securities Market*, F. Oditah (ed.), 1996

29 Clifford Chance, *The Reform of the UK Financial Regulatory System*, 1997

30 Minutes of Evidence to the Joint Committee, p 49

whole. Even if business seeps away from the City, even if compliance costs mean a much worse deal for consumers, headlines are unlikely to make the front pages of the tabloids. But the damage to Britain and to consumers, through higher costs, will be done.

Thus the instinct to go with the flow of the Bill, to protect their own backs, will be a strong one. The hand of the regulator will be heavy and could easily damage the City's global competitiveness. The instinct to regulate should have a counterbalance in the Bill.

A competition and competitiveness objective

The Government, however, has failed entirely to provide such a counterbalance. The tenor of the Bill serves to encourage regulation. The regulatory objectives of the FSA, as set out in Clause 2(2) of the Bill, are:

a) market confidence;
b) public awareness;
c) the protection of consumers;
d) the reduction of financial crime.

These objectives will be at the core of everything the FSA does. The Authority is obliged to act in a way "which is compatible with the regulatory objectives" and which is "most appropriate for the purpose of meeting those objectives".

There can be no doubt that objectives (c) and (d), and arguably the others as well, can all easily lead to the promotion of a heavy-handed regulatory atmosphere. While they are all worthy in themselves, they are without the necessary counterbalance of maintaining the competitive position of the market.[31]

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[31] *The Interim Report into Competition and Regulation in the Banking Sector* by Don Cruickshank (HM Treasury) notes that other UK regulators "have, in effect, an additional regulatory objective to *promote* competition", stemming from their role as competition authority in their particular field.

The only counterbalance in the Bill is tucked away in the "principles" in Clause 2(3), which enjoy less weight than the objectives. The Authority is required to do no more than "have regard" to the maintenance of competitiveness and competition. A good example of the relative status of the objectives and the principles comes in the FSA's new document, *A New Regulator for the New Millennium*. Explaining its new operating framework, it explains how the first key stage, on which all the others depend, is to "identify the risks to the statutory objectives". No mention is made of the principles. The exclusion of explicit consideration of the principles and the high profile given to the objectives is a cause for concern.

The *Interim Report* by Don Cruickshank on the banking sector expressed its concern that the downgrading of competition could have a very serious effect:

> Getting the regulator's primary statutory duties right is essential. These drive the way the regulatory body recruits, organises and rewards its staff. A competition objective that is weak relative to the regulator's other objectives is unlikely to be delivered effectively.[32]

Many financial institutions have expressed alarm that these considerations enjoy such a relatively lowly status. A survey of practitioners by the FSA's Practitioner Forum found that a large majority believed "enabling the UK to remain competitive" was an essential criterion for a regulator.[33] A large number have insisted that it is imperative that these dual considerations of competition and competitiveness be elevated to objectives to make the Bill more balanced. The British Bankers Association and the Association of British Insurers both made clear to the Burns Committee that an objective relating to competitiveness and competition was urgently required. Significantly, the National Consumer Council put forward the same argument.

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32 Op. cit.

33 *FSA Practitioner Forum/BRMB Survey of Financial Services Firms*, August 1999

A Government pledge to reconsider the matter if Don Cruickshank took a position on this issue seems to have been ignored.[34] The Treasury Select Committee also agreed that there was a good case for its inclusion and called on the Government to consider it.[35] It should be noted that the Security and Exchange Commission (SEC) in the United States – the only body with comparably large powers – is now under a duty to consider "whether the action will promote efficiency, competition and capital formation."

Nothing, however, has been done. The Economic Secretary to the Treasury suggested that, although competition and competitiveness figure in the FSA's principles but not in its objectives, this did not represent a downgrading of the importance of these issues.[36] She was, however, unable to support this assertion.

Arguments from the Chairman of the FSA and from responsible Ministers that such an objective would tread on the toes of the Office of Fair Trading (OFT) are less than convincing: the contention is not that the FSA should take on new powers to supervise competition. It is that in the exercise of its existing powers it should not damage competition in the marketplace or the United Kingdom's competitive position in the world. The inclusion of a balancing objective would not turn the FSA into another competition regulator; it would merely mean that, in carrying out its distinct remit, it should seek to facilitate competition and competitiveness.

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34 Hansard, 8 July 1999, col 73. Mr Cruickshank, anxious to make at least some improvement in this area but recognising Government intransigence on his original proposal to add a fifth objective, has now come forwards in his final report with a more modest scheme to improve the Government's flawed system. He states that "the OFT's role in overseeing the financial services sector should be strengthened" and that "the Competition Commission, not ministers, should be the final arbiter" in these matters. These proposals, however, leave the root problem untouched

35 Treasury Select Committee Third Report of Session 1998-99, *Financial Services Regulation*

36 See Hansard, 8 July 1999, Standing Committee A

The Government's objection ignores the fact that the competition regulators have no role in relation to the competitive position of the UK. They regulate competition *within* the UK market. Making sure that the FSA acted in a way which did not damage the UK's competitive position in the global economy would not infringe on the territory of the Competition Commission and the Office of Fair Trading. This objection, furthermore, has not troubled the Government in other areas of regulatory reform: competition is at the heart of the mandates of several other regulators in the UK.

After considerable pressure, the Government has finally come up with a response; but the result is a bizarre mishmash which manages to miss the substantive point altogether.

The Government has proposed a scheme whereby "regulating principles" (i.e. rules, general guidance and certain statements of principle and codes) applied by the FSA can be scrutinised by the Director General of Fair Trading and the Competition Commission. This amendment apparently seeks to do by a bureaucratic backdoor what could be done by the much simpler means of adding a fifth balancing objective of competition and competitiveness. Moreover, this strange *post hoc* arrangement means that the FSA will be subject to the competition regulators' scrutiny on matters which are not within its objectives in the first place. As Howard Flight MP said in the Commons debate on the issue:

> It is ludicrous to set up all this complicated machinery involving the OFT, the Commission and the Treasury without giving the FSA the right brief in the first place. While I hope that the machinery will lead to some useful analysis, it will undermine itself unless the FSA is given the right brief.[37]

In any case, the Treasury retains the right under the new scheme to override the views of the Competition Commission, and subject them to any countervailing political considerations.

[37] Hansard, 27 Jan 2000

The FSA itself is aware of the problem. Its recent announcement of a "radical new risk-based approach" to regulation admitted that "it would be unrealistic and wrong to aim for a zero-failure regime." It rightly stated that:

> We should facilitate innovation, for example by avoiding unreasonable barriers to entry or restrictions on existing market participants launching new financial products or services.
>
> The FSA must take into account the international mobility of much financial business and must avoid damaging the competitive position of the UK – which works to the advantage of consumers as well as markets.
>
> The FSA must avoid unnecessarily distorting or impeding competition. This includes unnecessary regulatory barriers to entry or business expansions.[38]

However, these aims are not spelt out as objectives: indeed, they run counter to its objectives as currently set out. If the FSA really were to take a light touch approach to regulation, it could reasonably be said that it was failing to meet its statutory objectives. If the regulator "fails" even once, it can expect parliamentarians to be amongst the most shrill in their calls for scapegoats.

With the development of its risk-based approach in its latest policy paper, the FSA is trying to introduce the notion of competition by attaching it to the "market confidence" objective. It would be far clearer to add a separate competition objective. It would also provide greater reassurance that the FSA will be required at all times to seek to strike the right balance between competition and regulation, and that it will be publicly accountable for it. With the Bill as it stands, the industry remains uncomfortably dependent on a broad-minded reinterpretation of the existing Bill to strike that balance and make those difficult judgements and trade-offs. The pressures on the FSA will always be to slip towards excessive regulation.

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38 Financial Services Authority, *A New Regulator for a New Millennium*, January 2000

Cost-benefit analysis

Cost benefit analysis, if properly undertaken, could make a huge contribution to improving the quality of regulation. If thorough cost-benefit analysis of all existing and proposed regulation was done, and if the methodology was sound, it would go some way towards compensating for the imbalance in the FSA's statutory objectives. Cost-benefit analysis would bring transparency to the trade-off between the value of a regulation in terms of increased confidence and the cost in terms of business discouraged or priced out by compliance costs or barriers to entry.

At least, it will do so in theory. To gain the full value of cost-benefit analysis, it is crucial that the right yardstick is used to assess the overall impact of a regulation. How should such a yardstick be defined?

A logical approach would be to assess whether any regulation is likely to increase or decrease the volume of legitimately transacted business.[39] Such analysis would need to take account of the effects of a regulation on costs and also its effects on overall demand. A regulation which increased the competitive position of UK firms (while not restricting foreign competition), which stimulated innovation, or which increased consumer confidence would clearly increase overall demand and therefore the overall level of business.

On the cost side, a regulation which reduced competitive pressure by making it more difficult for new firms to enter the market, which inhibited the introduction of innovative products or which distorted business methods would reduce the amount of business conducted. Compliance costs imposed on the industry and the costs of running the FSA itself will also add to business costs and reduce the amount of business transacted.

Where, on balance, taking into account all these effects, a regulation can be shown to increase overall activity, it is almost certainly a good regulation. Where activity has been reduced, it is probably a bad regulation.

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[39] Robin Laslett, Director of Financial Services at London Economics, suggested a similar approach in a speech to the City Forum Conference, 18 November 1997

Of course, a number of caveats apply.[40] A potentially serious objection is that a set of rules which operated at the optimal point implied by such cost-benefit analysis, and which therefore maximised the activity legitimately conducted (and which therefore also maximised the benefit to the consumer in terms of widest choice and lowest cost), might still be accompanied by regulatory failure or fraud. A small number of consumers would therefore still be "taking a hit", even if the overall majority were better off. Would such a distributional outcome be acceptable?

This is exactly what investor compensation schemes try to address. It is right that they do so. Compensation schemes take a small part of the economic gain away from the market as a whole as an "insurance premium" to compensate those hit by regulatory failure. The alternative approach is virtually to eliminate the risk of fraud and other regulatory failure with ever stiffer rules, but only at huge cost to the industry and consumers as a whole.

It is not intended here to develop a fully comprehensive cost-benefit framework but merely to point out some of the ways the FSA should be asked to go about it. Unfortunately, although the Bill does deal with cost-benefit analysis, its provisions are defective.

First, the Authority is obliged to conduct cost-benefit analysis only for new rules.[41] This is not adequate. The FSA should be obliged to provide such analysis for all rules, including existing ones.

Secondly, and more worryingly, little information on the proposed methodology has been provided. There is no way of knowing whether or not the FSA will use a methodology similar to that outlined above. If it were not to do so, it is vital to know how the FSA does intend to define the optimum point on the trade-off. If the FSA were to seek to regulate in a manner which cost-benefit analysis could show was not necessarily consistent with maximising business legitimately conducted, we would want to know the other "good" the FSA was hoping to obtain from its regulation.

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[40] For example, an increase in business activity through "churning" would clearly be unwelcome

[41] Clause 146.

In the absence of guidelines from the FSA or the Treasury on how they intend to go about cost-benefit analysis, we are left with another form of "trust us". One may draw the conclusion that the insertion of the cost-benefit provision was little more than window-dressing by the Government.

Compliance costs

As already mentioned, part of the cost-benefit analysis will concern the issue of compliance costs. Frequent and thorough measurement of these costs is required.

The Burns Committee recommended that there should be a statutory obligation to address the question of the regulatory burden and compliance costs – particularly the extent to which they have risen in the past years and how they stand in comparison with competitors – in the FSA's Annual Report. This was supported recently by the Cruickshank Review of Banking Services in the UK,[42] but received less than enthusiastic support from the Government.

The Government's response stated that if the FSA did not include such information, the Treasury would use the powers reserved to it (in Para. 10 (1)(c) of Schedule 1) to oblige the Authority to do so. A statutory requirement would be preferable: it would have been an important signal that matters of competition and competitiveness were important both to the Government and to the Authority. Moreover, a requirement to analyse the issue with particular reference to small firms and new entrants, both of which suffer disproportionately from the burden of compliance costs, might have assuaged fears in the small business community.

Along similar lines was the suggestion that the non-executive committee of the FSA's Board should be statutorily required to report on compliance cost issues each year. Once again, however, the proposal has not been taken up.

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42 Op cit.

CHAPTER 6

LACK OF ACCOUNTABILITY

Summary
A body exercising the degree of public powers given to the FSA needs to be properly accountable. However, the mechanisms in place to make the FSA accountable are weak. Changes need to be made to ensure that the executive directors are accountable as directors of a private company; the provisions for public accountability, especially to Parliament, and for review, also need to be strengthened; input from practitioners needs to be improved; and the complaints mechanism should be amended.

Problems of accountability

As an amalgam of nine predecessor bodies, the FSA was always going to be something of a leviathan. There are obvious dangers in the creation of such a huge body: the possible bureaucratisation of the regulatory machine, a loss of focus and clarity, and the difficulty of adopting a "one-size-fits-all" approach in a sector which covers everything from one-man independent financial advisers to the biggest multi-national banks in the world.

But the principle of a single regulator for the financial services sector – first floated in the Treasury Select Committee's 1995 Report[43] – may well prove to be sound, albeit something of an experiment. The diversification of the market has meant that a system which drew boundaries for regulatory purposes was proving cumbersome. The Government's proposals were broadly welcomed in the press and by practitioners.[44]

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[43] Op cit.
[44] See Chapter 2 of the Government's Progress Report

Almost all of those who expressed reservations about the new scheme said that the Government could allay their fears by making the Authority accountable. Even if it was a hugely powerful body – which was undeniable – a proper structure of accountability would allow these powers to be kept in check. Someone had to regulate the regulator.

The accountability of regulators has always been problematic. In a book written before the advent of the FSA "super-regulator", Andrew Marr criticised the system of regulation in which accountability was only "fourth hand" – regulator to minister to Parliament to voter. A stronger system, he submitted, had to be found.[45] This is even more pressing in the light of the unprecedented power of the FSA.

Giving evidence to the Joint Committee, Patricia Hewitt agreed that "getting the accountability of the FSA right is crucial."[46] Alan Milburn told the Commons that "the Bill will increase accountability."[47] But the Government's plans have managed only to compound the problems created by the Authority's size. Already, the Practitioner Forum's survey of industry opinion found that well over half disagree with the proposition that enough safeguards were in place to make the regulator accountable.[48]

Accountability as a private company

The FSA takes an odd form: despite the fact that it exercises very considerable public power, it is a private company limited by guarantee. This creates both challenges and opportunities. It could end up the worst of both worlds or the best of both worlds.

Tim Herrington explained to the Burns Committee that:

> The legal structure chosen for the FSA creates challenges in establishing clear accountability arrangements. It is a hybrid; a private body exercising public functions.[49]

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45 A. Marr, *Ruling Britannia*, 1995
46 Minutes of Evidence of Joint Committee, p 22
47 Hansard, 28 June 1999, col 38
48 *FSA Practitioner Forum/BRMB Survey of Financial Services Firms*, August 1999
49 Minutes of Evidence of Joint Committee, p 105

A normal private company has familiar mechanisms under company law for ensuring the accountability of those exercising power in the company (the executive directors). The most important of these is the accountability of the board of directors to the shareholders, who can remove them. The FSA, however, in spite of its status as a private company, has no shareholders.

Another common accountability mechanism is the separation of the roles of Chairman and Chief Executive. The Chief Executive takes the major operating decisions of the company, but is responsible to the Chairman of the board. This split of functions is now well-established corporate practice and has been supported by the Cadbury and Hampel Committees on corporate governance. Howard Davies, the Chief Executive of the FSA, however, will undergo no such scrutiny: he is also the Chairman.

This makes him a very powerful man. He will make the key operational decisions of the Authority in his capacity as Chief Executive, and will also lead the board in its scrutiny and approval of those decisions in his capacity as Chairman.

The issue was explained by Sir Nicholas Lyell in the House of Commons:

> There is a considerable advantage in having a Chief Executive, however good he is, who also has a Chairman to whom he must answer… The advantage of having the two, especially when setting up a large and complex organisation such as the FSA… is that the City, those regulated by it and those outside it, especially independent financial advisers who can work in small firms, have in the Chairman somebody whom they can approach with their anxieties but who, if he is not instantly responsible for the issues, can take them up with the Chief Executive so that the system can work better.[50]

Lord Eatwell put it to the Economic Secretary to the Treasury that this was "very bad governance practice."[51]

She replied:

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[50] Hansard, 28 June 1999, col 63

[51] Minutes of Evidence of Joint Committee, p 25

> In the interests of accountability, it seems to me that there is a good case for having one person who fulfils the functions of Chairman of the Board and Chief Executive of the Authority and he is the person with whom the buck stops.[52]

This argument has a number of flaws. It entirely ignores the different functions of the Chairman of the Board and the Chief Executive. Furthermore, it assumes full accountability of the FSA Board to ministers and to Parliament. The Bill fails to provide this. Finally, it is not a scheme that has been applied to other public or quasi-public bodies. Powerful quangos, such as the Environment Agency, and the FSA's regulatory predecessors such as IMRO, the SIB (the FSA's previous incarnation) and the SFA all operated on a system which split the functions of chairman and chief executive. Research by Tim Loughton MP found only two quangos which operated on a similar basis: the Central Laboratory for Research Councils and the Trinity Lighthouse Service.[53] The Government's other regulatory reforms all appear to have accepted the need for a split; indeed there has been a movement away from single regulators towards regulatory boards, in an effort to remove issues of personality.

The Burns Committee generously recognised that since Howard Davies (who would be Chief Executive if he was restricted to a single role) was now in place in this anomalous dual role, it was probably best not to change the system immediately. However, it did recommend that there should be a separation of roles in the longer term. The Cruickshank Banking Review made exactly the same recommendation. The Government declined to take this up, stating that it was "mindful of the fact that parallels with other models of corporate governance are not exact."[54] On this point the Government is right: they are not. But given the lack of accountability in other areas, the dismantling of traditional lines is particularly troubling.

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52 Ibid.
53 Hansard, 27 January 2000, col 606
54 Government Response to the Reports of the Joint Committee, p 10

The role of non-executive directors

Another check on the power of the executive directors comes in the shape of the non-executive directors. Recently, the Cadbury and Hampel Reports on corporate governance have emphasised the importance of the role of non-executives. In the case of the FSA, they – like all the directors – are Treasury appointments. A step in the right direction is that a majority of the Board must be made up of non-executive directors. There is also to be a special committee of non-executives.

However, the proposed system is flawed. The role of the non-executive committee is heavily circumscribed by the legislation. Paragraph 4 of Schedule 1 states that the remit of the non-executive committee is limited to internal financial controls, remuneration and examining whether the Authority is exercising its remit efficiently. Proposals to extend the non-executive committee's role to general issues of the conduct of the executive directors were rebuffed. In fact their remit is narrower than that which the FSA considers non-executive directors of a regulated firm should discharge. An FSA Consultation Paper states that the role of non executive directors should include:

> …assisting their colleagues within the firm's governing body in setting, and monitoring, the firm's strategy;
>
> …providing an independent perspective to the overall running of the business, scrutinising the approach of executive management, the firm's performance and standards of conduct.[55]

Moreover, the non-executive directors are in a sense already complicit in the actions of the board as a whole. If a scandal occurs, they too will be in the firing line of the press. Hence, they too will be more interested in avoiding scandal than in providing any sort of balance to the impetus to regulate in a heavy-handed manner.

[55] See FSA Consultation Paper 35, p 14

Accountability as a body with public powers

Given the powers of the FSA – especially the powers to make new rules binding the markets – one would expect high levels of accountability to Parliament and to Ministers. The picture, however, is decidedly mixed. The highly respected House of Lords Delegated Powers Committee commented in its submission to the Burns Committee:

> The FSA's "legislation" will not be set out in statutory instruments and so is not intended to be subject to direct parliamentary control, yet is of far greater practical importance than the statutory instruments which Ministers are empowered to make under the draft bill and which are rightly to be subject to parliamentary control. If powers of this kind were to be invested in Ministers, we would undoubtedly advise that there should be a measure of Parliamentary control.[56]

Much of the detail of the regulation of the financial sector is left entirely to the discretion of the FSA. The Treasury also has wide powers to amend the scope of the Bill without primary legislation.

Conscious of this power vested in the Board of the FSA to enact far-reaching quasi-legislation without proper parliamentary scrutiny, the Burns Committee suggested that the Government should consider the idea of confirmation hearings at least for the Chairman and Chief Executive of the Authority.[57] This would allow a measure of direct parliamentary accountability, rather than the very indirect responsibility of Treasury Ministers for their appointments. The Treasury Select Committee suggested that it might also be an appropriate procedure for *all* board members.[58] Arguably this should be on a discretionary basis. The Government, however, refused to follow the recommendations.

Scrutiny exerted by the Select Committees will therefore be the only real means of direct parliamentary accountability. Much will depend on the enthusiasm of the Treasury Select Committee and

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56 Report of Joint Committee, Annex B, p 72

57 Ibid., p 35

58 Treasury Select Committee, Financial Services Regulation, 1999, p xix

the time available for this task. Other regulators have tended to be invited to appear before Select Committees only in the aftermath of some scandal. This should not be the case with such a powerful body as the FSA: it should be subject to rigorous and regular scrutiny (perhaps comparable to that of the Governor of the Bank of England since the Bank was given control of monetary policy). It is essential that the Authority's Annual Report is fully scrutinised by the Select Committee and that regular evidence is called from board members and from consumers and practitioners. The need for this was recognised by the Government in its response to the Burns Committee's Report.

Nonetheless, this should not be the only form of accountability. The powers of a select committee are not sufficient to satisfy the burden of accountability which a powerful body like the FSA must discharge. It is an essential mechanism, but can only be part of a wider picture.

The FSA will also be responsible to Parliament through Ministers. There is a degree of accountability to Ministers on the part of the FSA. The board members are all appointed by and can be dismissed by the Treasury. Other posts, like the Chairmanship of the Consumer and Practitioner Panels and the Investigator are all FSA appointments, which is less than satisfactory (though the requirement of Treasury approval mitigates this somewhat). The FSA must also submit an Annual Report to the Treasury (which will be laid before Parliament) – though only a few requirements as to its contents are set out in the Bill. The Treasury can also commission independent reports on the economy, efficiency and effectiveness with which the FSA has used its resources in discharging its functions, which may prove useful in the event of apparent failings.

However, the fact remains that the FSA retains almost complete operational independence. Its decisions are its own. Ministers will not willingly resign over a badly handled investigation. Yet a single misguided intervention by the FSA into the affairs of a firm could be its ruin. The chain of accountability is far too long.

The need for a review

There has been considerable support for the inclusion of a provision requiring a review of the FSA's performance and the regulatory regime as a whole after two or three years. This would at least provide a degree of formal accountability: those running the FSA would know that a detailed investigation into their work was to be conducted after an appropriate period. When the mechanisms for ongoing review are so relatively weak, this sort of formal statutory mechanism would be a useful check on their actions. It would provide an opportunity to look again at some of the more contentious clauses of the legislation.

The recent Cruickshank Banking Report agreed, stating:

> The Government should monitor the impact of the FSMB on competition in financial services markets, and conduct a formal review, two years after the commencement of the legislation.

In the Bill as currently drafted, the Treasury has complete discretion regarding reviews. It has the power to decide whether a review will take place and what the terms of that review will be; moreover, the independence of the person or body conducting the review is also expressed as being "appearing to be independent in the judgement of the Treasury." For the good of the FSA itself, it is imperative that the Government amends the legislation to provide for a fundamental review of the FSA's operations – covering not just economy, efficiency and effectiveness, but also general policy and principles. The Government has, however, refused to change the legislation in this respect.

A common means of accountability for bodies exercising public powers is scrutiny by the Comptroller and Auditor General. The National Audit Office (NAO) conducts a review of the budget and spending of public bodies – including the other principal regulators such as those for the electricity, gas, rail, telecommunications and water industries – to ensure that public money is being properly spent. Moreover, the NAO already oversees the work of formally private bodies exercising quasi-public functions, such as Camelot and the Student Loans Company. The Government, however, has declined to allow them to review the work of the FSA. If a provision for a compulsory review were to be added, the NAO might well be the best body to conduct it.

The powers of the Treasury

As already noted, the Treasury is also given very substantial powers by the Bill. These include the power to determine what is to be a regulated activity, what activities should be exempt, in what circumstances the financial promotion prohibition will not apply and what is meant by carrying on a regulated activity by way of business.

There is also a quite remarkable catch-all provision in Clause 402. This entitles the Treasury to make any:

> …incidental, consequential, transitional or supplemental provision as they consider necessary for the general purposes, or for any particular purpose, of this Act or in consequence of any of its provisions or for giving full effect to it.

The sheer breadth of this provision could give the Treasury legislative *carte blanche*.

It is imperative that some measure of scrutiny and accountability is injected into these provisions. The FSA is obliged, when making new rules, to carry out proper public consultation, and to undertake and publish a full cost-benefit analysis. The Treasury should be placed under a similar obligation.

Accountability to practitioners

It is essential that adequate accountability to the practitioner community is injected into the new scheme. Their voices must be heard above the clamour for regulation. Unfortunately, the mechanisms for involving the practitioner community are not entirely satisfactory.

The intentions of the Authority appear to be good. They say in their consultation document on the issue that they want to encourage practitioner involvement so as to "practice cost-effective, proportionate and practicable regulation in the interests of firms, markets and their customers."[59] They could scarcely have put it better.

However, the mechanisms set up by the Bill do not quite meet these good intentions. Clause 7 contains a general duty to consult practitioners (and consumers) "on the extent to which [the Authority's] general policies and practices are consistent with its general duties under section 2." Those general duties, it must be remembered, are to comply with and promote its objectives, which do not include the vital practitioner interest of the maintenance of the City's competitive position. There is also a duty to carry out a public consultation exercise before the FSA uses its extensive powers to make new rules.[60] The Authority is obliged only to "have regard" to representations and to publish a general statement as to the representations made and its response.

Clause 8 gives the Authority a specific duty to set up what is known as the "Practitioner Panel", which is designed to represent the interests of practitioners (and which sits alongside the Consumer Panel).[61] The Authority is obliged to "have regard" to any representations made to it by the Panel; but that is the extent of its statutory consultation duties. There is no obligation on the FSA actively to consult the Panel.

The Authority should be obliged to consult the Panel in advance of any general public consultation. Moreover, APCIMS, LIBA and the Burns Committee have all recommended that, at the very least, if the Authority does not act on recommendations made by the Practitioner Panel it should be obliged to publish its reasons for not doing so.

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59 FSA Consultation Paper 2, *Practitioner Involvement* (1997)

60 Clause 146

61 The Practitioner Panel is temporarily operating under the title of the "Practitioner Forum" until the legislation is passed

The Chairman of the Panel, David Challen, expressed his fears to the joint committee that in the absence of strong statutory obligations to involve practitioners, they could easily end up being marginalised. He argued that the Bill should include an obligation on the FSA to give reasons if submissions by the Panel were ignored.[62] The first Annual Report of the Forum reiterated concerns that:

> In the absence of this requirement [to publish reasons for ignoring Forum/Panel submissions], we feel it would be possible for a future administration to sideline the Panel and make it difficult for the Panel to assert its viewpoint.[63]

The Government, however, has refused to strengthen the consultation obligation.

Moreover, all the Panel's members – and crucially its Chairman – are appointees of the FSA itself. Independence would be better assured if the members were appointed by the Treasury (or at least were appointed by the FSA but only after statutory consultation with the industry). The Panel's members should also have the right to elect their own Chairman and not have him/her appointed for them. The Burns Committee suggested that the Treasury should appoint the Chairman.[64] The Government, however, was willing only to concede that the FSA's appointment of the Chairman should be subject to Treasury approval.

The Panel's budget is also a matter of concern. Resourcing will have a major impact on the Panel's effectiveness and its ability forcefully to communicate the concerns of practitioners. It currently seems less than fully able to maintain the public profile it needs to be a success: its recent survey of practitioners found that only a quarter of small organisations and a third of chief executives had heard of it. The worth of its Annual Report which it intends to publish will equally be limited by its resources. At

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62 Minutes of the Evidence of the Joint Committee, p 108

63 Financial Services Practitioner Forum, *Annual Report 1999,* p 5

64 Report of the Joint Committee, p 36

present the Forum has no defined budget at all, and no staff. All its activities are being paid for on an *ad hoc* basis by agreement with the FSA.[65] This situation leaves the Forum/Panel entirely dependent on the largesse of a body towards which it is meant to adopt an independent stance. The Annual Report admits that it is not equipped to comment fully on all the issues under consideration by the FSA.[66]

The proposed scheme for consulting practitioners is inadequate. In many ways it represents a step back from the levels of practitioner involvement amongst the predecessor bodies. Lord Eatwell, a member of the Burns Committee, was drawn to criticise the FSA's relationship with practitioners as "a bit arm's-length",[67] while Simon Morris of lawyers CMS Cameron McKenna described the Panel as "a poor substitute for the significant practitioner involvement with the existing SROs."[68] Angela Knight of APCIMS argued that: "there needs to be a far greater emphasis placed upon the requirement for ongoing consultation with the regulated community."[69] Given this degree of unanimity, it is remarkable that the Government has chosen to ignore their representations. It does not bode well for the impact of future representations from the City.

Accountability to law

Accountability to law is rightly regarded as a prerequisite of the exercise of public power. And the greater the power that is exercised the more important it is that this accountability is strong.

Given the extent of the FSA's powers, one might think that accountability to law would be an important element of the scheme. Since an investigation by the FSA can do untold damage to an individual or to a firm, it would seem only proper that the subject of an investigation should be able to pursue a normal damages claim where that investigation was wholly misconceived.

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65 Financial Services Practitioner Forum, *Annual Report 1999,* p 4
66 Ibid., p 5
67 Minutes of the Evidence of the Joint Committee, p 11
68 CMS Cameron McKenna, *Memorandum on Financial Services and Markets Bill*, 1999
69 Minutes of the Evidence of the Joint Committee, p 106

However, the Government has granted the FSA a wide ranging immunity from liability in damages. Tucked away in paragraph 19 of Schedule 1 is the stipulation that:

> Neither the Authority nor any person who is, or is acting as, a member, officer or member of staff of the Authority is to be liable in damages for anything done or omitted in the discharge, or purported discharge, of the Authority's functions.

This provision is subject to the proviso that it does not apply to acts or omissions either in bad faith or which breach the Human Rights Act 1998. Nonetheless, it means that damages cannot be obtained from the Authority for a vast range of misfeasances. Investigations begun or conducted negligently and even recklessly by the Authority – which could destroy a company without the slightest wrongdoing – will not entitle those who suffer to a penny in damages.

The protests against this immunity have been loud and sustained. Law firms Clifford Chance and Herbert Smith both stated that it was unacceptable and unnecessary, with the representative of the former commenting that:

> Accountability under the law is vitally important for any public authority and we do not believe that the case for immunity has been made in the light of the increased powers of the FSA.[70]

Even the police, some pointed out, do not enjoy this sort of immunity. Lord Lester QC, the highly experienced human rights lawyer, expressed concern that the statutory immunity might well breach Article 6 of the European Convention (see below).[71] This view was shared by the City law firm, Herbert Smith.[72]

LIBA made it clear that they believed that the FSA's immunity should be lifted for cases in which the FSA acted recklessly;[73]

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70 Minutes of Evidence of Joint Committee, p 105

71 Appendix 2 to the Minutes of Evidence of the Joint Committee, Second Report

72 Appendix 4 to the Minutes of Evidence of the Joint Committee, Second Report

73 Minutes of Evidence of Joint Committee, p 67

APCIMS went further and proposed that it be removed also in cases of negligence.[74] An amendment was put down to achieve this, but was defeated by the Government.

Defenders of the Government's position have pointed out that the FSA's predecessor, the SIB, has enjoyed immunity from actions for damages since it was set up by the 1986 Financial Services Act. The immunity of the FSA is, they claim, merely continuing what has gone before. However, as Clifford Chance pointed out in the quotation above, the matter requires reconsideration in the light of the huge expansion of the powers of the FSA. Moreover, in his evidence to the Joint Committee, Geoffrey Turner, the Chief Executive of the Securities Institute, explained why this immunity was added to the 1986 Act:

> Why we have statutory immunity in the current system… is because way back in 1985 nobody would agree to play, if I can put it like that. Practitioners would not take part without the assurance of immunity from discharging their role in SRO boards and committees.[75]

No one, however, is suggesting that officers or directors of the FSA should be made personally liable. It is the FSA as a body corporate which should be amenable to actions in damages, at least for investigations conducted or initiated recklessly – in itself a high legal threshold.

There are legitimate concerns about the danger of the regulator having always to look over its shoulder in fear of a legal action initiated by a major City firm. Balance is what is required: if there were other safeguards in place, this immunity might not be such a concern. Given the lack of checks and balances in the new system it is unacceptable that the FSA is free to engage in very wide-ranging investigations whilst practitioners have no recourse to law.

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74 Ibid., p 106

75 Ibid., p 92

The Authority will, of course, still be amenable to actions for judicial review. But the range of activities which can found a case for judicial review is much narrower than for a substantive action in negligence. The range of remedies is also narrower. The primary judicial review remedy, the injunction, is not very useful in actions against the FSA since the damage will have been done almost as soon as the FSA has begun investigating a firm. Moreover, the Bill is often phrased in such a way as to limit the susceptibility to judicial review to the greatest possible extent. The review of the propriety of its actions will be severely hampered by the fact that the Authority is only obliged to act in such a way as *it* considers appropriate for the fulfilment of its objectives. This subjective approach to the exercise of power is a well-known drafting mechanism which significantly limits the availability of judicial review.[76] An amendment stating that nothing in the Act should restrict the right to judicial review has not won Government support. Nor has an amendment requiring that the Authority act in a manner which is fair, reasonable, open and proportionate.

A flawed complaints system

Even those who have not expressed outright disagreement with the statutory immunity granted to the FSA have made their approval conditional on a considerable strengthening of the complaints mechanism. As envisaged in the original draft Bill, the mechanism for making complaints against the Authority was feeble: complaints were to go to the Authority itself; there would be no standing independent investigator to deal with them; in appropriate cases the FSA itself could appoint an *ad hoc* investigator to deal with a specific problem.

Practitioners expressed serious concern about this scheme. The Treasury Select Committee demanded that the procedure be more clearly defined in the Bill.[77] The LIBA stated that the

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76 See e.g. *R. v. Secretary of State for the Home Department, ex parte Khawaja* [1984] AC 74

77 Treasury Select Committee, Financial Services Regulation, 1999, p xxiii

complaints mechanism had to be "substantially more robust and independent."[78] The Burns Committee also took the same view: "We agree with those who see a robust complaints procedure as an essential counterbalance to the FSA's statutory immunity."[79]

After this barrage of complaint, the Government conceded that the investigator should be put on a permanent footing. The FSA is now required to maintain on a continuing basis an independent investigator who must have the means to conduct an investigation of complaints referred to him by the FSA.

However, major flaws remain. Even though his appointment and dismissal is now subject to Treasury approval, it remains in the first instance an FSA appointment. Moreover, his terms and conditions are to be those which *in the opinion of the Authority* are reasonably designed to secure his independence and his ability to act without bias. That the body which is to be investigated has such power over his terms and conditions is remarkable: it is quite clear that these should be set out much more clearly in the Bill and should be a matter for the Government rather than the regulator.

Furthermore, complaints cannot be submitted directly to the investigator. Aggrieved parties – who by the time they feel they have to make a complaint against the Authority are not going to have the fullest trust in it – must first make their complaint directly to the FSA, which can investigate the matter itself. The FSA's only duty is to inform the investigator of the complaint to see if he wants to take the matter up. In many cases this will act as a deterrent: practitioners will not want to complain to the same Authority which will still be regulating them at the end of the whole affair.

The biggest fault of the complaints scheme, however, is that the investigator has no power to award any sort of compensation to an aggrieved firm or individual. When added to the immunity against damages, this places the FSA in a remarkably secure position. It can act in any way it wants without fear of financial penalty. This is unacceptable.

78 Minutes of Evidence of Joint Committee, p 67
79 Report of Joint Committee, p 39

The only sanction that the investigator has at his disposal is the publication of a report into the complaint. If the Authority is criticised in the report, it is obliged to report back to say how it intends to address the matters raised. Many of those who gave evidence to the Burns Committee argued that the investigator should be able to award compensation. This would not be punitive in function. Its purpose is merely to give some recompense to those who have suffered as a consequence of wrongful action by the regulator.

The Burns Committee agreed with the evidence presented to it.[80] However, the Government rejected the proposal:

> Those regulated by the FSA will be able to refer any enforcement decisions against them to the independent Tribunal, which will have the power to examine the case and to award costs against the FSA. The Government sees the (enhanced) role of the complaints investigator as being primarily to ensure that any alleged shortcomings can be investigated in a transparent way, not as a route to additional recompense for firms and consumers.[81]

This response failed to address legitimate concerns. The power of the independent Tribunal to award costs against the FSA is inadequate: it cannot cover situations where the case never reaches the Tribunal. The damage may already have been done, but no recompense of any kind will be available, even if the FSA has acted in a reckless fashion. The Government's concern that the complaints mechanism could become a "route to additional recompense" is absurd: in many cases there is no other route to recompense. As Peter Vipond of the BBA put it to the Joint Committee:

> The FSA can come into your offices, it can trash them, it can go around and do a full investigation and then they can walk away and say, "Sorry, we got it wrong, we came to the wrong offices". There has got to be some redress.[82]

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80 Report of Joint Committee, p 40
81 Government Response to the Reports of the Joint Committee, p 14
82 Minutes of Evidence of Joint Committee, p 92

The Government declined to adopt what was perhaps the most suitable suggestion: that the investigator should not award compulsory compensation but the Authority should offer *ex gratia* payments where the finding went against it. This would avoid time-consuming legal disputes over the compensation payments, but would offer reassurance that damage done by the FSA would be covered.

Furthermore, the Government declined the most minimal increase in the potential impact of the investigator: it refused to act on the suggestion that the FSA's Annual Report should include a full report from the investigator. In past years, the reports of the Complaints Commissioners (the predecessors of the proposed scheme) have in practice been included, but they have been insubstantial.

All in all, not one of the potential mechanisms for securing accountability in the exercise of its huge powers has been properly put in place. Howard Davies' comment to the Treasury Select Committee that the accountability mechanisms were "appropriate and robust" is hard to reconcile with the evidence.[83] Closer to the mark was the comment of APCIMS to the Treasury Select Committee to the effect that:

> The proposed accountability of the FSA appears to be considerably less than that of PLCs, quangos and of the existing SROs.[84]

It is right that the Government try to ensure that the regulator has flexibility on its side. An environment in which the regulator had all manner of supervising bodies looking over his shoulder would not be conducive to good regulation. Once again, what is needed is a balance between flexibility and accountability. The Government has failed to strike this balance.

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[83] Treasury Select Committee, Minutes of Evidence, 2 November 1999, Q7

[84] APCIMS Memorandum to Treasury Select Committee, Minutes of Evidence of Treasury Select Committee Third Report 1998-99, p 22

CHAPTER 7

THE COSTS OF REGULATORY UNCERTAINTY

Summary
The value of certainty to the financial sector is huge; the Bill does not provide enough. The market abuse scheme needs fundamental re-examination; and the role and status of guidance must be reformed.

The value of certainty

One of the most important commodities in a financial market is certainty. Uncertainty can be expensive. For example, in the last few years uncertainties in legislation led to interest rate swap transactions entered into by banks and local authorities being voided several years later, with massive unexpected financial consequences.[85] Firms involved in hugely complex transactions – often breaking new ground – do not want suddenly to find that they have been on the wrong side of the law. Nor do they want to be faced with the potential unenforceability of what was believed to be a legitimate transaction.

Clarity and certainty carry economic as well as regulatory value. As the Burns Committee's report put it:

> Certainty as to what conduct is permitted and what is not is desirable for the sake of business confidence, compliance costs and the encouragement of innovation.[86]

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85 See *Westdeutsche Landesbank Girozentrale v. Islington LBC*

86 Joint Committee Report, p 57

Complete legal certainty is inevitably elusive but a Bill such as this should try particularly hard to come close to it. The Financial Services and Markets Bill could do better.

Market abuse

The provision which has attracted the most concern is that relating to "market abuse", a new catch-all provision not seen in any of the previous regulatory systems. Unlimited fines can be levied by the Authority on those who transgress.

Market abuse is given a very wide definition in Clause 109, and covers situations where anyone (whether or not actively involved in the market and, in the case of the UK markets, whether or not in the UK) engages in behaviour which is likely to be regarded by "a regular market user" as a failure to reach the standard of behaviour reasonably expected of him. The behaviour involved must also:

(a) be based on information which is not generally available to market participants, but which would be likely to be regarded by them as relevant in deciding on the terms of a transaction; or

(b) be likely to create a mistaken impression about the market for that type of investment; or

(c) be likely to distort the market for that type of investment.

This wording casts the net very widely indeed. It relies on speculation as to the views of others and – most importantly – contains no requirement of intent. A person can breach the prohibition on market abuse without even intending to do any of the things which constitute it. In an effort to clarify this, the Authority will also publish a Code of Market Conduct intended to fill out some of the generalities of the clause.

The Code will certainly help in the interpretation of the core provision. Nevertheless, significant concerns remain. The Code cannot be expected to be all-embracing, particularly in an area as dynamic as the financial markets. Practice is continuously changing and developing.[87] How are practitioners to know in a novel situation whether what they are doing is allowed or not?

Guy Morton of City law firm Freshfields pointed out the problem to the Joint Committee:

> The market code obviously only covers the areas which it covers and the Government is making it quite clear that it wishes the possibility to be open to sanction people purely for breaching the definition of market abuse.[88]

Even Patricia Hewitt was forced to agree:

> The Code can never be completely comprehensive. It is quite impossible to anticipate fully everything that market participants might get up to in the years to come.[89]

Moreover, the Bill makes it clear that in most cases, the Code is of evidential value only. It only acts as a safe harbour in cases where it states expressly that the behaviour in question "does not amount to market abuse."[90] This will leave too many situations unclear, and practitioners will have to rely on trying to interpret the main provision.

The same problem is apparent with respect to compliance with the FSA's rules. Although compliance with the rules of the FSA will act as a safe harbour,[91] it has since suggested that this too will only apply where the rules expressly provide that compliance with them does not constitute market abuse. This will not often be the case. The Government has also refused to accept that compliance with the rules of a Recognised Investment Exchange would constitute a safe harbour.

The leading human rights lawyer, Lord Lester QC, took the view that the underlying provision (in its previous form – though the new draft is little changed) was so vague that it would breach

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87 Indeed, the FSA is obliged to have regard to the importance of facilitating innovation when issuing codes and rules.

88 Minutes of Evidence of Joint Committee p 64

89 Minutes of Evidence of Joint Committee, Second Report p 12

90 Clause 112

91 This was a late concession by the Government

the requirement of legal certainty laid down by the European Convention on Human Rights:

> It is strongly arguable that the very high level of generality of the market abuse offences… offends against Article 7(1) [of the ECHR]… Not only are the offences far less clearly defined than their criminal counterparts contained in the Criminal Justice Act and Financial Services Act, but, most strikingly, the FSA's own consultation document on the proposed Code on Market Abuse illustrates the range of open questions as to whether a particular course of action not only *will be* but *should be* treated as falling within the market abuse offences. The point is not merely that the statutory precepts are capable of more than one interpretation; it is rather that they are framed at such a high level of generality that they leave entirely undetermined whether particular conduct falls within the offence.[92]

The addition of the Code was not sufficient, he added:

> There is a real risk that the Code will not meet the objections to the uncertainty of the statutory precepts. It would, in our view, be a breach of Article 7 for a person to be convicted of a market abuse offence where this conduct did not fall within conduct indicated by the Code to constitute an offence.[93]

The Law Lord, Lord Steyn, agreed. He stated that there was a "substantial risk that in respect of market abuse the system will be held not to comply with the principle of certainty."[94]

There is also the problem of the scope of application of the clause. Given its lack of explicit territorial scope, it seems that anyone in any country whose conduct had the "market abuse" effect stipulated in the clause could be found to have breached it, even if they were entirely unaware of the UK law on the subject and unaware that their conduct was having such an effect. Chris Bates of Clifford Chance condemned the impracticability of the clause:

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92 Report of Joint Committee, Annex C, p 92
93 Report of Joint Committee, Annex C, p 93
94 Memorandum to the Joint Committee, Second Report, p 18

> Parliament is being asked to prescribe a standard which is a very, very broad generality which applies to anyone anywhere in the world and on which anyone anywhere in the world can be called upon at a later stage and told, "sorry, your conduct was unacceptable by British standards."[95]

The offence of market abuse could be committed outside the UK if the relevant market was in the UK. For example, it could be committed by a silver producer in Canada selling his output cheaper than the current market price because he needed to pay a tax bill. Silver is the subject of futures contracts traded on the London Metal Exchange, and so he could then be guilty of market abuse: the market might think that the silver producer had an abundant supply of silver even though that was not in fact the case. The Government has now even proposed that non-UK exchanges which can be accessed electronically from the UK should be treated as "UK markets" for this purpose.[96]

Unless an intent requirement is incorporated, the offence could catch even a director of a quoted company who makes a statement which he does not know could be misinterpreted. He could be guilty if he unwittingly led analysts to think that his company had made substantial profits, even if he did not expect that he could be so misinterpreted. The Government has stated that even issuing a misleading press release could constitute abusive behaviour.[97]

The Burns Committee asked the Government to look at the clause again. The report outlined the Committee's thinking:

> We acknowledge that achieving an appropriate balance between certainty and flexibility is not an easy task. For most purposes, adequate certainty could be provided in principle by the Code. However, in some cases it will be necessary to fall back on the statutory definition; and in any case the statutory definition will set the parameters of the Code. We are therefore persuaded that a clearer statutory definition of market abuse is required.[98]

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95 Minutes of Evidence of Joint Committee, p 65

96 C. Abrams, *World Securities Law Report*, June 1999 and November 1999

97 See the letter of Charles Abrams to the *Financial Times*, 23 February 2000

98 Report of Joint Committee, p 64

The Government's response has not gone far. Their determination to keep the entirety of the prohibition intact has meant that they have been unable to bring themselves to reformulate it in a clearer fashion.[99] An amendment requiring intent to breach was rejected by the Government.

Moreover, they have also rejected the recommendation of the Joint Committee that guidance on the market abuse provision be made a safe harbour. The Government said that such a change was "not necessary".

Other proposed mechanisms have met with mixed success. The Government has conceded that the FSA should take into account whether or not the person involved honestly believed that his behaviour would not amount to market abuse (but only if that belief was reasonable) and whether or not the person took care to avoid engaging in market abuse (but only if he took all reasonable precautions). These, however, are less useful than full exemptions, and do little to aid certainty.

In sum, it is clear that in this area the Bill as it stands creates only confusion. It is crucial that the Government injects a much greater measure of certainty into the market abuse provisions.

The role of guidance

The issue of the status and availability of guidance more generally has also been of concern. Firms will frequently want to seek guidance from the FSA on the exact meaning of a rule, or on whether a proposed course of action will fall within its terms. FSA guidance will provide greater certainty while at the same time retaining a measure of flexibility for the Authority. It avoids the problem of an excessive accumulation of exceptionally detailed rules (which was a problem under the old multi-regulator system), but allows practitioners to act with more security.

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99 Government Response to Joint Committee, p 19

The Authority is empowered to give guidance under Clause 148 of the Bill. It can give guidance on any matter it deems appropriate. This is very much to be welcomed.

However, guidance may be given or withheld at the FSA's discretion, even in response to a direct request. The Authority has the power to charge for guidance, and it is at its discretion whether guidance is published or not.[100]

There is a strong case for imposing an obligation on the FSA to give guidance. The Government has rejected this approach on the grounds that it would place too much of a burden on the Authority. This ignores the burden on firms, who are left to second-guess the attitude of the regulator.

The Government's response to the suggestion made it clear that they did not want the FSA spending large amounts of time and money on providing guidance.[101] This is not entirely unreasonable: there is a danger of an over-cautious attitude being forced on the FSA by continual demands for binding guidance (see below for the status of guidance). This however must be balanced by the needs of the regulated community. The Practitioner Forum's survey of industry opinion found that the regulator's ability to "provide reliable guidance" was the second most important criterion for evaluating the regulator's success, according to practitioners themselves.[102] Given the importance of certainty to the markets, guidance should be available on request unless the request is clearly frivolous.

Moreover, the status of this guidance remains controversial. Several of those who gave evidence to the Burns Committee felt that, in the interests of certainty, guidance should act as a safe harbour from future action. The representative of solicitors Herbert Smith explained:

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[100] It has been indicated that those who request guidance under the Competition Act 1998, which has just come into force, will be charged between £6,000 and £12,000

[101] Government Response to Joint Committee, p 18

[102] *Practitioner Panel/BRMB Survey of Financial Services Firms*, August 1999

> If you ask for guidance and you are given guidance, you ought to be all right if you comply with it and that is the certainty working, that in certain situations you know you are going to be on the right side of the line.[103]

Others felt that while full safe harbour status might not be necessary, some enhanced evidential status certainly was. The notion of enhanced status for guidance is not a novel one: it already operates in relation to money-laundering regulations.[104] Enhanced status was originally suggested to the Treasury by the City of London Law Society, and was taken up by others giving evidence to the Joint Committee. A memorandum from Clifford Chance stated that:

> It is unjust that the draft Bill provides no recognition of a market participant's compliance with the guidance of the regulator responsible for the administration of the statutory regime… Market participants may take little comfort from the assertion that it is "unlikely" that the FSA would take enforcement action against a firm that has complied with its guidance. Many of the requirements that will be imposed by the new Act and that are likely to be imposed by the rules, codes of conduct etc, will be very broadly drawn. Firms and individuals face unlimited fines and other significant sanctions for non-compliance. The Bill should explicitly state that, at least in some circumstances, market participants can place some reliance on what the FSA has said as to how they can comply with these requirements. In addition to securing fair treatment for market participants, giving the FSA's guidance special status under the new Act would enhance the role of guidance as a flexible means of developing the regulatory regime.[105]

Enhanced status falling short of full harbour status might also assuage some of the fears about the Authority being pushed into an over-cautious approach to guidance.

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103 Minutes of Evidence of Joint Committee, p 83

104 See Minutes of Evidence to the Joint Committee, p 67

105 Appendix 6 to Minutes of Evidence of Joint Committee, Second Report

The FSA's then Deputy General Counsel (now General Counsel) told the Committee that he had "no particular problem" with the idea,[106] but it has not apparently been accepted.

Proposals to oblige the Authority to give guidance on request, to require the Authority to publish guidance, to prevent the Authority from charging for guidance as matter of course and to make compliance with guidance a safe harbour have all been set aside by the Government.

As a result little or nothing has been done to meet the widespread concerns about the inevitable uncertainties which will arise under the new regulatory regime. In the light of the powers of the Treasury and of the FSA to change key elements of the regime, long-term certainty seems likely to be at a premium. In a dynamic market, this is not acceptable. Kit Farrow of LIBA explained the very real danger to the Burns Committee:

> One of the great concerns of my organisation is the fear of the combination of uncertainty in the definition of offences allied to very stringent penalties. It has been part of the accepted wisdom that it is very important that the market should be flexible to adapt to new circumstances and to be innovative. If you are subject to a regime which says in the most general terms, "you must not do anything which is not proper or which is not of high standard" that is such a vague requirement that you will be worried that after the event somebody may decide that you were not working to a high enough standard. You create a worry that people will not, in fact, innovate without actually going to the regulator and saying, "Look, I am thinking of doing things differently, is that all right?" In that way we could bring to the UK the regulatory tradition that in other markets has basically prohibited anything that has not been endorsed.[107]

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[106] Minutes of Evidence of Joint Committee, p 82

[107] Minutes of the Evidence of the Joint Committee, p112

By failing to provide a regulatory system with sufficient certainty or a mechanism to create that certainty, the Government may imperil the City's strong record of innovation.

CHAPTER 8

THE DANGER OF OPPRESSIVE AND ARBITRARY REGULATION

Summary
The Bill could allow it to behave in an oppressive and arbitrary manner, even to the point of breaching human rights.

Financial promotion

In some respects, the proposed legislation simply casts the net too widely. The matters which the FSA is called on to supervise are expressed in such broad terms that they could become entirely unrealistic and arbitrary.

For example, the Bill purports to regulate all financial promotion originating outside the UK but "capable of having an effect in the UK."[108] At first sight, this seems reasonable: since the Government wishes to protect UK consumers, all inducements to engage in investment activity which could affect consumers ought to fall within the Bill's ambit. The implications, though, are huge.

With modern communications, the advertisements of firms anywhere in the world – firms with no wish to seek British consumers at all, and with no knowledge of the provisions of British legislation – can easily fall into the hands of UK consumers. Indeed, the financial promotion will be capable of having an effect in the UK even if it is sent from a firm in New York to a firm in Tokyo if it relates to assets in the UK (for example, UK quoted shares or a UK investment fund). They would then be subject to FSA scrutiny. The communication could constitute a criminal offence under English law. This unrealistic situation weakens the legislation.

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[108] Clause 231

The Bill also restricts the marketing of collective investment schemes from the UK to investors abroad which have not been approved for marketing to the general public in the UK. These restrictions apply even if the marketing would be permitted by regulations in the target country.

The position is made ridiculous by the "capable of having an effect in the UK" test. This means that, if the investment fund is a UK fund, the prohibition extends to the marketing of that investment fund by any branch of the authorised firm anywhere in the world (whether a UK firm or not). This is much wider than the current regime.[109]

The United Kingdom's competitive position in the burgeoning e-commerce sector could well be adversely affected. Since the financial promotion regime allows the FSA, for the first time, to regulate advertisements sent from the UK to overseas, UK firms would have to satisfy not only the regulations of the target market but also the UK legislation. At best this could be extremely costly and burdensome; at worst the two systems could directly conflict with one another.

Another test should be applied. Only regulation of financial promotion "intended to be acted on by" the UK consumer should fall within the FSA's remit.

Mortgage regulation

Arbitrariness is also evident in the provisions on mortgage regulation which the Government decided in January 2000 to introduce into the legislation, 15 months after the publication of the first draft Bill. The FSA is to be given regulatory power over mortgage providers. The announcement of the change was not made to Parliament, and the scrutiny of this crucial element has, of necessity, been minimal. This is particularly reprehensible as this is the part of the new regime most likely to affect ordinary people. It is essential that the Government gets it right.

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[109] See C. Abrams et al, *Guide to Financial Services Regulation*, CCH, 1997 p 342

However, the Government has chosen an odd and limited approach to regulation of this industry. While mortgage *providers* will have to be authorised by the FSA, mortgage *advisers* will not. This will create many anomalies. Mortgage advice will not be regulated unless it covers investment products for repaying the mortgage (such as endowments). However, the FSA will require certain information about each mortgage to be made available to borrowers. It is not clear, however, at which stage this advice will have to be passed on. If it is at an early stage, the responsibility may fall on brokers. If it is at a later stage (e.g. at the mortgage offer), then it may remain with the lender. In principle, under the proposed scheme, a lender should not process a loan unless it is satisfied that this information has been passed on. Apparently the old mortgage code will probably still continue to operate in tandem with the new scheme. Advice from brokers will often be dealt with not under the new system but under the old one.

This is a very confused regulatory structure. Considerable concerns have already been expressed. Steven Geraghty, Managing Director of Direct Line Financial Services, called the new measures "a missed opportunity" and stated that the change "doesn't affect the practices that sparked the mortgage review in the first place."[110] The Council of Mortgage Lenders commented that it was "surprised that the Government has decided not to regulate mortgage advice" and that it was "disappointed that the Government has not decided to rationalise the various different strands of regulation into a single system."[111] All in all, the regulation of mortgages is now in a mess. Such ill-thought-out legislation reflects what the academic commentator Alistair Alcock has referred to as the Government's "policy-making on the hoof" approach to this Bill.[112]

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[110] BBC News Online report, 26 January, 2000
[111] Council of Mortgage Lenders, Press Release, 26 January 2000
[112] A. Alcock, [1998] JBL, July issue

The Ombudsman scheme

Ombudsman schemes are now a common feature of public life. Their role is to provide a quick and informal means of resolving disputes between members of the public and a particular person or body carrying on business in a regulated industry. The Financial Services and Markets Bill contains provisions to bring together all the ombudsman schemes operating under the previous multi-regulator system, and create a new super-ombudsman to hear complaints about acts or omissions of authorised persons.

The Government's proposed scheme, however, is unsatisfactory. The central problem is that only the complainant can refer a dispute to the Ombudsman and the decision will be binding only on the practitioner. If the complainant is unhappy with the decision, he can go to the courts in the hope of getting an alternative result. The practitioner cannot.

This may well cause injustice and there is a prospect that it will be struck down by the European Court of Human Rights. The asymmetry of treatment also has a more insidious damaging effect. The Ombudsman will not wish to see a series of challenges in the courts. These would be costly and would project a bad image. There is therefore a danger that excessive caution will be the result. It could also undermine the point of having an Ombudsman process: if the need to watch his back means that investigations become more drawn out and costly, the rationale for having an Ombudsman is prejudiced.

The Government contends that this system – unsatisfactory as it clearly is – merely replicates those existing under the old model. This is true of some of the schemes being replaced, but not all. Even for those for which it is true, there is one key difference. In the old system, membership of the Ombudsman scheme was voluntary for some of the most important areas, including banking and general insurance.[113] If the Ombudsman developed

[113] Where membership was not voluntary, for example in the case of building societies, members were not obliged to comply with the ombudsman's findings

an obvious pro-consumer bias, firms could in principle opt out. This created a useful countervailing pressure: the need to keep practitioners on side and within the scheme balanced out the wish to prevent consumers challenging the Ombudsman's decisions in the courts. There is no such balance in the new Bill.

Human rights and the enforcement function

Another area of concern is the enduring problem of the FSA's enforcement function. The Government's original proposals disregarded commonly held principles of justice and due process. The original scheme would have made the FSA not just judge and jury, but investigator, prosecutor, and executioner as well. There was no adequate mechanism for securing the independence of the decision on "guilt", which was to be made internally by the FSA. The "appeals process" was also unsatisfactory.

There is little doubt that this scheme would have breached the provisions of the European Convention on Human Rights.

After sustained protest from all sectors of the regulated community, the Government was forced to concede in its Progress Report that:

> The main focus of comment on the draft Bill has been on the disciplinary process. There has been a perception that the FSA's internal procedures may lack fairness and transparency, or be unduly costly and burdensome, and that the FSA is able to act as "prosecutor, judge and jury.[114]

A number of changes followed. Remarkably, it was only at this stage that the Government chose to oblige the FSA to establish definite procedures and to act in accordance with them. In the first internal stage, "defendants" were now to be allowed to see the evidence against them, and publicity (which can itself destroy defendants) was to be limited until the full process was complete. In addition, oral evidence obtained under compulsion would not

[114] Financial Services and Markets Bill – Progress Report, HM Treasury, p 19

generally be admissible (see below). After consultation, the FSA decided that this internal procedure would operate on an administrative rather than a quasi-judicial basis; but the new safeguards would all remain in place. This comes closer to satisfying Article 6 of the ECHR.

The proposals for the "Tribunal" were also altered. Its status was changed from an appeal body to a "first instance" body, "fully able to consider the merits and facts of each case and with the authority to substitute its own conclusions for those of the FSA".

However, the proposals remain less than satisfactory. The Burns Committee specifically recommended that the Bill should be amended so that it explicitly required the FSA to set up an independent Enforcement Committee.[115] Instead the Government chose to alter the Bill merely to include a lesser stipulation that the decision taken at enforcement level must be taken by a person not directly involved in establishing the evidence on which the decision is based.[116]

The unsatisfactory nature of this compromise is clear. The Government's contention that these changes met the concerns of the Joint Committee (and those of the House of Lords Committee on Delegated Powers and Deregulation) is not true. While the FSA is to be commended for setting up a broadly satisfactory internal system, it is unacceptable that the Government should have failed to provide a clear statutory framework for the scheme. The principle of the independence of those making the relevant decisions is central to the understanding of individual rights; merely to require that it be taken by someone "not directly involved" in the investigation is unsatisfactory. That the FSA's internal procedures could be altered unilaterally by the Authority to the detriment of those under investigation is improper. The FSA has the power completely to ignore the separation between investigation and enforcement if they so wish. As City lawyers Denton Hall put it:

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115 Report of Joint Committee, p 52

116 Government Response to Joint Committee, p 15

> Even if the FSA is required to consult and publish such policy, it is not right that it should have a broad discretion to determine (and change) it as is currently proposed.[117]

The Treasury Select Committee made plain the importance of establishing the independence of the disciplinary process at the outset:

> Given the substantial powers given to the FSA and the complaints from independent financial advisers about the current disciplinary process run by the PIA, it is easy to perceive the disciplinary process as one in which the FSA holds all the cards. For that reason, the initial process, not just the Appeals Tribunal, must be – and be seen to be – fair, accessible, inexpensive and transparent.[118]

These concerns have not been met.

The procedural safeguards attached to this internal stage of the disciplinary process are also unsatisfactory. The subject of an investigation has no express right to make oral representations to the Enforcement Committee prior to a decision. The restrictions on publicity apply only once the defendant has referred the matter to the Tribunal. The provisions on the disclosure of evidence are also the subject of some concern.[119]

Equally, the Government has refused to follow the recommendation of the Joint Committee that the Chairman of the Enforcement Committee be a legally qualified person, appointed by the Lord Chancellor.[120] It remains open to the FSA to appoint anyone it wishes. The President and Deputy President of the Tribunal should also be required to have adequate legal experience. Ideally, they should be High Court Judges.[121]

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117 Minutes of Evidence of Joint Committee, Appendix 31

118 Treasury Select Committee Third Report, p xxiii

119 See *Rowe and Davis v. UK* (ECHR Application No 28901/95)

120 Government Response to Joint Committee, p 16

121 Currently they are required only to have ten years legal experience (Schedule 12, Para 2)

Civil or criminal?

Another enduring problem has been the characterisation as civil or criminal of the various disciplinary and other proceedings which the FSA is to investigate under the Bill. While the Government has maintained throughout that they are of an entirely civil character, a number of experts have expressed the opinion that the European Court of Human Rights would find, for the purposes of the protections afforded by the Convention, that they were of a criminal nature. This characterisation would require stronger safeguards to meet the terms of the Convention. In response, the Government eventually conceded that those provisions most likely to be characterised as criminal (those relating to market abuse) should carry additional safeguards. Crucially, protection against self-incrimination, a requirement of Article 6(1) of the Convention, is now included in relation to statements made to investigators.

However, doubts remain in the case of other disciplinary proceedings, which generates uncertainty. Even if they are not ultimately judged to be criminal, it is clear that they are very close to the line. Given also the severity of the penalties which can be levied – an unlimited fine and expulsion from the industry – the lack of full safeguards is most unwelcome. Clifford Chance expressed exactly this concern to the Joint Committee:

> Given what is at stake, both for the individual firms and persons involved in any case, and for the confidence of the industry ... is a minimalist approach to the application of the ECHR appropriate? At the very least, many of the particular disciplinary cases involve alleged offences of such gravity, high stakes for the individual or firm, and potential sanctions of such severity, that as a matter of fundamental fairness (irrespective of the requirements of Convention law), the additional Convention protections should be applied.[122]

[122] Second Report of Joint Committee, Appendix 5, p 20

As it stands, for example, individuals could be compelled to give self-incriminating evidence leading to their being found to have breached these provisions. Lord Lester of Herne Hill told the Joint Committee that:

> While many of the disciplinary offences are likely to be classed as civil in nature, some serious disciplinary offences are likely to be classified by the courts as criminal, whether because they effectively cover misconduct which is criminal, or because of the risk of the infliction of drastic fines with a dominantly punitive, rather than compensatory or restitutionary purpose.[123]

This is not an isolated view. City law firms Freshfields, Herbert Smith and Clifford Chance all took the same view. The view of Clifford Chance was set out in a memorandum sent to the Joint Committee:

> The key issue is whether it is worth the risk that the FSA disciplinary regime will be challenged, potentially successfully, at some time in the future in the context of a particular case on the grounds that one or more rights under the ECHR were violated because those particular proceedings fell to be characterised as criminal rather than civil for the purposes of the Convention.[124]

Some have argued that even if the proceedings were classified as civil, key elements of the additional safeguards are required.

The uncertainty created here and the real possibility of injustice demand that the Government extend the safeguards it has put in place for the market abuse regime across the whole range of disciplinary offences.

The question of costs

The question of costs in the enforcement process has also provoked concern. While the Tribunal has the power to order costs against either side if they act vexatiously, frivolously or unreasonably, the Enforcement Panel has no power to award costs in favour of the

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[123] Second Report of Joint Committee, Appendix 2, p 17
[124] Second Report of Joint Committee, Appendix 5, p 19

"defendant", even when the FSA has acted in an unsatisfactory fashion, or has brought a case without proper evidence. The Bill should be amended to allow the "defendant" to elect to have costs awarded on the usual basis at the discretion of either body.

The Government's approach to fines levied by the Authority has also left something to be desired. Originally it was proposed that the FSA should be allowed to keep the income from the fines it imposed – the clearest possible conflict of interest. After much pressure, the Government conceded that income from fines should be recycled to the regulated community. The FSA has yet to consult on how this would be done.

Concerns were also raised regarding the possibility that the FSA might include its costs in the amount of any fine imposed. Since the provisions for the recovery of costs *against* the FSA are so weak, this would not have been acceptable. The Government responded by providing that the FSA's policy on fines should not take costs into account. This rather vague provision should be revoked to make it clear that both the fining policy of the Authority *and its decisions on individual fines* should not take its costs into account.

Legal aid

Legal aid was initially to be denied. Recently, however, the Government has announced a scheme whereby the regulated community will in effect pay for legal assistance for those unable to afford representation – but it will only be available in proceedings for market abuse. This restriction on the availability of legal assistance may well breach the European Convention. Whether practitioners should have this further cost heaped upon them is also a controversial point. Moreover, the fund will only be available once the FSA has decided that a case will go ahead. The inevitable legal costs in the early stages of an investigation are not covered.[125] There is a case for a government-funded legal aid scheme, covering all aspects of the FSA process.

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125 See *The Times,* Law Supplement, 8 February 2000, p 17

CHAPTER 9

CONCLUSION

> The FSA's declared aim is to be a world-leading regulator, respected for its effectiveness, integrity and expertise both at home and abroad.
>
> *A New Regulator for the New Millennium*, FSA, 2000.

The FSA's aim is worthy but incomplete; it should also be an aim of the FSA to maintain the competitiveness of the UK's financial sector. The new legislation creates an unprecedentedly powerful institution on whose self-restraint and skill in the execution of its powers the City will now become uncomfortably dependent. Many will feel too intimidated to engage in lengthy disputes with the FSA – the risks are too great and manifest, the rewards too small and uncertain. There are scant checks in place to redress any future failing of the FSA. Practitioners will largely be denied access to the courts for judicial review and may be subject to arbitrary, even reckless investigations without the right to compensation. Most important of all, the essential balance between regulation and its economic effects has not been adequately established.

Penalties on the FSA for losing business through over-regulation scarcely exist. However, penalties on it in the form of bad publicity in the event of a regulatory failure could all too easily lead inexorably to ever-greater regulation.

The post-war era has seen huge relocations of financial activity in response to changes in regulatory environments. The United Kingdom has, for the most part, been the beneficiary of others' mistakes, particularly those of the United States and continental Europe. If the UK is not to risk repaying some of her competitors with interest, the Government should reconsider its opposition to the 29 amendments proposed in this paper.

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