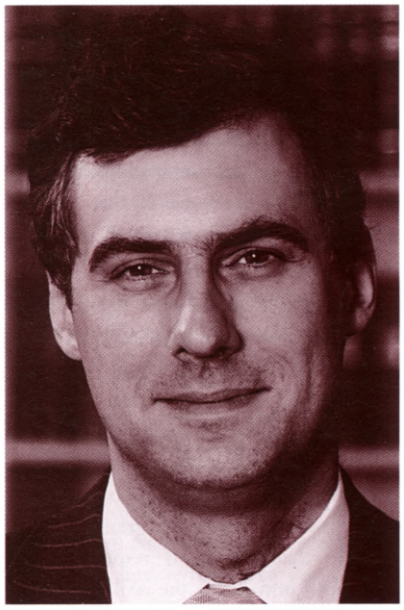
Financial Services

The new face of regulation

by Simon Gleeson



Simon Gleeson

On 28 October 1997, the Financial Services Authority (FSA) was launched with the publication of a paper outlining proposals to re-structure the financial regulatory system. It is proposed that the FSA will be a unitary regulator which will absorb the functions of the existing securities, insurance and banking regulatory organisations and bodies. The launch of this regulator constitutes a major development in UK securities regulation. The chairman of the new authority, Howard Davies, described the paper as:

'... merely a sketch of the plan we have to implement the Chancellor of the Exchequer's intention to reform

Nonetheless, the publication of the document gave the first real opportunity to examine the direction of reform in this area.

OBJECTIVES AND OBJECTIONS

Gordon Brown's speech announcing the re-structuring of the regulatory system explained that its objective was to 'prevent affairs such as Barings and BCCI ever happening again'. Since it seemed relatively clear that restructuring London regulation would not have had much, if any, effect on either of these collapses. this was felt to be an inadequate explanation. Consequently, in his speech announcing the launch, Howard Davies took the opportunity to explain in a little more detail the objectives of the restructuring. He cited an external survey conducted by the Securities Institute which identified a lack of transparency and a perception that the city regulators had suffered from 'regulatory capture', by the interests which they were supposed to regulate as being the primary reasons for lack of confidence in the City. He went on to deal with some specific criticisms.

1. The criticism that the restructuring would lead to increased costs was accepted, but it was observed that there would be significant opportunities for improvements in operating efficiencies in the new system and for the allocation of fixed costs across a wider revenue base.
2. It is clear that the two year implementation period will lead to a regulatory stagnation. This was accepted, but once the decision to restructure had been taken this was inevitable. A more important criticism would be that the period was being unnecessarily prolonged, but it was said, quite possibly correctly, that it would be impossible to manage the introduction any more quickly than the current timetable provides.
3. Professor Michael Taylor, in his 'Twin Peaks' report, argues that prudential and conduct of business regulation should be effected by two separate organisations, on the basis that there is a necessary conflict between these two types of regulation. Mr Davies rejected the existence of any such conflict except 'on a relatively limited' number of occasions. This seems right, as it has not been the experience of the existing regulators, which regulate both areas, that there is regular conflict between the two.
4. It is generally accepted that regulation of the wholesale and retail markets requires entirely different bases. This was fully accepted, but dealt with by observing that this form of differential regulation could be accomplished perfectly satisfactorily within a single unitary financial services regulator, without having either to exclude the wholesale markets completely from the scope of regulation, or to render them subject to the entire slew of regulatory rules and policies.
5. The new regulator will be an extremely large organisation. This point was elegantly dealt with by observing that there is no necessary connection between size and efficiency.

THE TIMETABLE

The timetable for the introduction of the Financial Services Authority is largely unchanged from that given in the July 1997 paper *Reform of the Financial Regulatory System*.

The most important point to make in respect of the timetable is that weasel words have crept into the text of the document with respect to its implementation. In particular, it is now said that 'early introduction of the [Financial Reform Bill] in Parliament *might* lead to enactment in 1999', and it seems clear that the new regulator is prepared at least to contemplate a delay in the implementation date for the new regulatory system. It appears most likely that this is a response to the feeling amongst the regulated that the timetable for the introduction of the new regulator provided for a time-period in which the industry could comment, but no time-period for the regulator to take any action in response to any comments received, and that this indicated that the consultation exercise was purely cosmetic. Admitting the possibility of the implementation of changes to the proposals in response to industry submissions has probably strengthened the hand of the new regulator.

REGULATORY SCOPE

Under the proposed financial regulatory reform bill, the Authority will, in broad terms, acquire the regulatory and registration functions currently exercised by the Self-Regulating Organisations, the DTI Insurance Directorate, the Building Societies Commission, the Friendly Societies Commission and the Registry of

Friendly Societies. There is only one surprise in the proposed scope of the regulators' activities. This is in respect of accountants, solicitors and others regulated by a professional body. The FSA only exempts professionals in respect of acts which are a 'necessary' part of their ordinary professional business. The extremely narrow interpretations of this exemption taken by the Law Society and the accountancy institutes means that most accountants and solicitors have maintained 'precautionary' FSA authorisations on a 'just in case' basis. It is proposed that the exemption embedded in the new act will be widened, and any professional firm which does investment business outside the terms of this wider exemption will be required to be authorised directly by the new regulator.

The effect of these changes will therefore be to deprive the Law Society and the various accountancy institutes of their regulatory authority. The primary impact of this change will be felt by the corporate finance practices of the large chartered accountancy firms who have put considerable resources into building up corporate finance teams.

NEW PROPOSALS AND DEVELOPMENTS

Firm authorisation

It is intended that there is to be a consolidated authorisation procedure. This is in an effort to eliminate obstacles preventing firms already authorised to conduct one business entering another. During the transitional phase the new regulator says that it will take particular care to minimise the burden on firms wishing to expand their authorisations.

Individual registration

There will be arrangements made for the consolidation of individual registration across industry boundaries. The integrated approach to firm authorisation is to be based on a fundamental test that the applicant must be honest, solvent and competent. but in the context of individual registration it is clearly much more important to ensure that the individual has a level of skill and knowledge in the area in which he is to practice. Thus the consolidation of individual registration is to be left until some time after the implementation of the new Act.

Training and competence

The issue of promoting training and competence has been postponed for consideration after the implementation date of the Act. It is clear that the new regulator is strongly in favour of programmes to ensure high levels of training and competence amongst employees of authorised bodies, but this is not a priority.

Supervision

Prudential supervision (that is, the regulation of capital adequacy) and conduct of business supervision (that is, regulation of trading practices) are to be combined within the supervision units. The training required to perform the two roles is somewhat different, but the effect of the combination will undoubtedly be to give any supervision team a better perspective as to the overall activity of the regulated company.

Unquestionably, the most interesting suggestion in the report is that concerning the organisation of the supervision of complex groups. It is suggested that this could be approached by means of a matrix structure, whereby individual 'centres of excellence' in particular disciplines within the new regulator could be called upon to assist in the regulation of complex groups by ad hoc teams. This structure would enable the concentration of resources within the regulator and enable the collection of a substantial body of knowledge which could then be drawn upon by team leaders tasked with maintaining an overview of complex groups and dealing with supervision on a risk-related basis. In particular, in the sphere of value at risk pricing, a combination of the resources available to the various different regulators should result in a greater capability in the UK with respect to dealing with and approving such models that exist in any other financial centre. If correctly implemented, the result of this development might be substantially to increase the appeal of the UK as a home location for large financial services groups. The process of approving collective investment schemes for distribution to the public, currently undertaken by SIB, will continue to be undertaken directly by the new regulator.

Investigation, intervention and discipline

The investigation and enforcement teams of the various different regulators will be pulled together into a single large entity which, it is hoped, will act in close co-operation with the criminal authorities. A common approach will be taken to investigating and dealing with all the various potential breaches of the regulations policed by the new regulator including illegal deposit taking and unauthorised investment business.

Until the implementation of the new Act, investigations will continue to be carried out in accordance with the rule book of the governing entity – for example, an investigation commenced tomorrow into an FSA member will be conducted according to FSA rules. It is not clear whether, if the investigation were to last until after the implementation date, the rules applicable to it would then change, but it must be hypothesised that they would not.

It is clear that the new regulator has asked for substantially increased powers in the new Act; although it is not clear what these powers are. However, it seems relatively clear that the request would not have been flagged in this document unless there were a fairly high probability that such powers would be granted. It is notable that the main request is for 'enhanced powers for the civil disposal of cases of serious market misconduct'. This is a plea for the decriminalisation of the s. 47 offence of misleading the market and, by implication, of insider dealing. It is undeniable that the fact that these provisions are rendered criminal offences provides the regulators with an almost impossible obstacle to enforcement. The criminal standard of proof translates into a requirement to prove an intention to mislead or dishonesty beyond reasonable doubt. In practice, this has resulted in very few cases being brought, and those cases which are brought being regularly unsuccessful. It is undoubtedly right that the removal of these prohibitions from the criminal into the civil sphere would enable the regulator to prosecute them with considerably greater vigour and with a better chance of success. It is notable in this context that the US Securities and Exchange Commission (SEC), which has a much better record of success in challenging market manipulation and insider dealing, has no criminal sanction available to it in respect of either act. However, what is not clear is whether what is being sought here is a power to proceed in the ordinary civil courts, or a power to remove such issues into the regulator's private tribunal.

An issue which is still to be decided within the new system is the status of the cause of action which is at the moment embodied in s. 62 and 62A of the Financial Services Act. This creates a private right of

action for the benefit of a 'private investor' in respect of any rule made under the act; it is available to any private investor who suffers loss as a result of breach by a person authorised under the act.

The importance of this right of action is that the forthcoming and widespread replacement of the legal aid scheme with 'no win, no fee' arrangements for litigation could reasonably be expected to produce a substantial increase in private securities litigation. At the moment s. 62 is extremely rarely used. It is not clear whether the financial services authority considers it desirable to retain and enhance the possibility of such 'self-help' by consumers, or whether it expects to absorb this right of action into its own jurisdiction.

Tribunals and appeals

The regulator has requested that a new financial services appeal tribunal be created with power to hear appeals against the regulator's decisions as to the grant and revocation of authorisation and against the exercise of intervention and disciplinary powers. The question as to the regulatory disciplinary structure within the new disposition is therefore left in doubt. It is clear that the existing system of private tribunals has resulted in a relatively low cost system. However, it has had the corresponding disadvantage of preventing the development of a body of regulatory jurisprudence. It is occasionally suggested that the development of such a body of jurisprudence would do no more than to advantage the regulated at the expense of the regulator by circumscribing the regulator's powers. This argument cannot stand as no regulator deliberately demands the power to be capricious. Further, an enormous amount of time is spent re-arguing points in these tribunals which have already been argued in a very large number of previous hearings. The commonly cited remedy for this would be the abolition of the regulatory tribunals and the removal of these decisions into the ordinary civil courts. This would unquestionably create an enormous gain in transparency and perceived fairness. but at the cost of a substantially greater financial burden for all those concerned, both regulator and regulated. A properly conceived and public regulatory tribunal, whose decisions were published and binding as precedents, would go a very long way towards developing the detail of regulation which cannot adequately be dealt with by rules and pronouncements. The new regulator has in effect reserved its position on this point.

Investor Compensation

Another of the more important initiatives in the new paper is the provision of a single integrated compensation scheme. The existing schemes will remain in place until the implementation date of the new Act, but after that date, the old schemes (including the policyholders' protection scheme and the deposit protection scheme) will be transferred to a single new scheme. The new regulator has undertaken to consult in greater detail about contributions and liabilities amongst the regulated in respect of this scheme with particular reference to issues arising out of potential cross subsidies.

Consumer education

The new regulator intends to take a lead role in the raising of levels of consumer knowledge as to financial products through campaigns of promotion, provision of information and by acting as facilitator to educational working collaboration with other bodies. Following the lead of the SEC. the new regulator will also apply itself to the promotion of plain English in consumer documentation. This is, to some extent, a new role for a regulator, and a most welcome one.

Practitioner involvement

The new regulator wishes to have practitioners involved with its activities by recruitment, training and two-way secondment policies. There also appears to be a desire to emulate the internal arrangements of the SEC. It is widely accepted that the SEC gains a substantial increment in staff quality through the fact that a period with the SEC is a recognised stepping stone to a number of careers in the financial services industry in the US, whether in banks, law firms or otherwise.

THE TRANSITIONAL MECHANISM

As envisaged in the earlier document, integration will proceed through a subcontracting mechanism. The new regulator will take on the staff of the existing regulators as soon as possible. The existing regulators will remain in business as authorising bodies until N2 (the as yet unspecified date when the functions of the regulatory bodies, other than the Bank of England, are transferred to the FSA) however, but they will 'exist' only as headquarters staffs, with the actual act of regulation subcontracted to the new regulator. It is unlikely that this will make any difference in terms of monitoring enforcement at prosecution, since a self-regulatory body is only required to have access to sufficient resources in order to perform these tasks, and not to have these resources under his own hand (see para. 1.3 of the SIB *Standards of Regulation for Self Regulating Organisations Guidance Note 3/95*, and para. 4, sch. 2 to the *Financial Services Act 1986*). It is clearly highly arguable, on the basis of Schedule 2 and of the guidance notes. that there are some obligations which the self-regulating organisations (SROs) are not permitted to delegate. In particular, those relating to policymaking and the duties to ensure that particular tasks are performed in particular ways. As a matter of general administrative law it is not considered acceptable to delegate completely a statutory discretion, and a fruitful source of challenge to regulatory acts may well be being laid down here for the interim period:

'Normally the courts are rigorous in requiring [a statutory] power to be exercised by the precise person or body stated in the statute, and in condemning as ultra vires action taken by agents, sub-committees or delegates, however expressly authorised by the authority endowed with the power' (Wade & Forsyth, *Administrative Law* (7th Ed.), at p. 348).

ORGANISATIONAL STRUCTURE

Michael Foot, the former head of supervision at the Bank of England, takes over responsibility for supervision and Philip Thorpe, the former head of IMRO, takes over responsibility for enforcement along with authorisation and consumer relations. Given the excellent reputation of the IMRO enforcement team his appointment seems eminently rational. Foot's appointment is equally appropriate. It seems clear that the activities of the group which he controls will be oriented primarily towards the development of more sophisticated and more informative monitoring and risk measurement techniques, a discipline in which the Bank was unquestionably the most advanced of the existing regulators.

Political control

The new regulator clearly expects to be subject to a great deal more political control than its predecessors. It envisages that the Treasury Select Committee will wish to take evidence regularly from it, and it will make an annual report to the Treasury which Ministers will lay before Parliament. It is likely that in practice this will enable the government of the day to intervene 'on the side of the consumer'. It

is an open question as to whether such a structure might have had any impact upon the conduct of the current pensions mis-selling difficulties.

International co-ordination

Contemporaneously with the launch of the new regulator a memorandum of understanding was announced between the SEC and the Commodities and Futures Trading Commission (CFTC) (which regulate the US securities and derivatives markets respectively) and the Bank of England and the new regulator. This is a very important development, since regulatory co-ordination between the US and UK regulators is of great importance to the industry and also suggests that SEC and CFTC have been to some extent involved in the planning process for the new regulator, since it is unlikely that they would have agreed such a memorandum of understanding with an unknown body. It is important, and very welcome, that the process of reform in the UK should begin with a vote of confidence from the US.

BANK OF ENGLAND RESTRUCTURE

Simultaneously with the publication of the documents relating to the new regulator, the government published a Bank of England Bill, to implement the restructuring of the Bank of England. The Court of Directors of the Bank will continue in place; however, a statutory Monetary Policy Committee will be established which will be responsible for the design and implementation of the Bank's monetary policy.

The Monetary Policy Committee is given statutory objectives. These are:

'To maintain price stability and, subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment'.

This formulation, in particular the use of the words 'subject to that', appears to go a very long way towards giving the Bank an overriding statutory obligation to combat inflation, a requirement which is widely viewed as being at the core of central bank independence.

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International Trade Law

The GATT/WTO system and environmental standards

by Erasmo A Lara-Cabrera

Only five years after the United Nations was established, a comprehensive text on the law of the UN had already been written, by Hans Kelsen. In his *Preface on Interpretation* Kelsen stated that:

'... [s]ince the law is formulated in words and words have frequently more than one meaning, interpretation of the law, that is determination of its meaning, becomes necessary' (The Law of the United Nations, ed. G W Keeton & G Schwarzenberger, Stevens & Sons Ltd, London, 1951at p. (xiii))

and that:

'... it is considered to be the specific function of interpretation to find and establish the one, "true" meaning of a legal norm.'

However, he continued, 'there is almost always a possible interpretation different from that adopted by [a] law applying organ in a concrete case.' In this context, Kelsen concluded that 'law' as a 'means', is in reality subordinated to 'politics' as an 'end' and, in that context:

'... the choice of interpretation as a law-making act is determined by political motives. It is not the logically 'true', it is the politically preferable meaning of the interpreted norm which becomes binding' (at p. xv).

In the context of the World Trade Organisation (WTO), this difference between juridical and political acts is not as clear that which Kelsen suggests for the UN. However, it is believed that within the context of the WTO law-making and law-applying institutions, the decisions of the latter are to be 'guided' to a certain extent by the 'practice' determined by the former; although the latter do complement and can set 'precedents' for the actions of the former. This assertion can be illustrated by an exploration of the WTO constitutional structure

WTO CONSTITUTIONAL STRUCTURE

Within the WTO both the 'political' and the 'judicial' bodies are constantly faced with interpretative tasks. Within the trade/environment discussion, the problems relating to interpretation are particularly significant, specifically with regards to the balance between the values and principles of both fields. In the GATT/WTO context, this discussion has been acquiring greater relevance. It is considered necessary that the WTO system take a more determined 'environmental' approach. Following Kelsen's arguments, it is believed that for that to happen in a 'juridically certain' way, the WTO 'political' body will be the body which will need to adopt this approach as the 'end' to reach. It seems then that the adoption of waivers, interpretative decisions, or treaty amendments (for details see art. IX and X of the *Marrakesh Agreement Establishing the World Trade Organization* (hereinafter WTO Charter)), by the WTO Members will be a possible answer. Nevertheless, the Dispute Settlement Body (DSB) – motivated by the panels and Appellate Body (AB) – may decide to reach the 'finishing line' in advance of this.

WTO POLITICAL AND JUDICIAL BODIES

In the spirit of establishing a functional distinction, the WTO 'political' body can be deemed to be the Ministerial Conference and the General Council (however they act), while the WTO panels and Appellate Body can be considered as the WTO 'juridical' or 'judicial' body.

WHO INTERPRETS LAW?

Within the constitutional structure of the WTO, there are different bodies whose functions relate to the task of interpreting the law. The Ministerial Conference (MC) and the General Council (GC) have wide powers of interpretation; the DSB a more restricted one. In relation to this, the WTO Charter