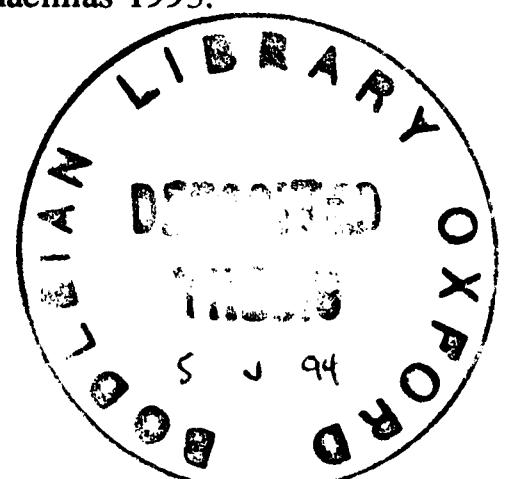


**REGULATORS AS RULE MAKERS: THE FORMATION OF THE
CONDUCT OF BUSINESS RULES UNDER THE FINANCIAL
SERVICES ACT 1986**

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ABSTRACT

Regulators as Rule Makers: The Formation of the Conduct of Business Rules under the Financial Services Act 1986

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This thesis is a study of rule making by regulators operating under the Financial Services Act 1986. It examines the formation of one set of rules, the conduct of business rules, which regulate firms authorised under the Act to conduct investment business. The thesis focuses on rule making by the core regulators, the Securities and Investments Board and the self-regulatory agencies which authorise and regulate investment firms.

The thesis considers firstly from a theoretical stance what rule making consists of, what issues fall to be decided when a rule is being formed, what the implications of different rule making decisions might be, and what factors would influence that decision. In order to discuss rules and rule making with some degree of analytical rigour, the thesis develops a framework for analysing rules which identifies four dimensions to rules, substance, status, character and structure.

The thesis then studies the rule making of these agencies empirically in an attempt to develop a more sophisticated and conceptual understanding of this regulatory function. It first explores the reasons why the regulation was instituted, and why the institutional structure combining statutory and "self" regulation was created. It then examines the formation of the initial rules and the reasons for the change to the new rule system which was introduced shortly after the initial rules were introduced. It analyses the formation and nature of the principles, core rules and self-regulatory rules made under the new powers. Finally it studies the formation of rules in particular substantive areas, the soft commissions rule and the rules regulating the retailing of some investment products.

Throughout this study, the thesis examines the use which has been made of different types of rules within this system. It considers the different functions of the rules and identifies several factors which have influenced their formation. These include the substantive area in which the rules operate, the institutional framework and the dynamics of the relationship between the regulators, the political context, and the norms and perceptions of the regulators, regulated and the wider community. It also examines the manner in which rule makers have considered the implications of using rules of different types. These include the use of rule type to confer discretion or decisional jurisdiction between both the different regulators and the regulators and the regulated, to affect interpretation and compliance, and to achieve predictability and flexibility of the rule system. The thesis concludes that although rule making by regulatory agencies is a relatively unexplored aspect of their functions, its study can be profitable for both those interested in regulatory agencies in general, and in financial services regulation in particular.

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GLOSSARY OF TERMS

<i>brokers</i>	Those who link buyers and sellers in return for a commission.
<i>broker/dealer</i>	A member of the Stock Exchange who may deal as agent or principal but is not obliged to deal when an offer is made.
<i>collective investment schemes</i>	Any arrangement with respect to property the purpose of which is to enable participants to participate in or receive profits or income from that property, and in which the participants do not have day to day control over the management of the property, the contributions of participants are pooled, and the property is managed as a whole by or on behalf of the operator of the scheme.
<i>friendly society</i>	Societies formed for the purpose of insurance against sickness.
<i>investment trust company</i>	Limited companies with a fixed share capital which hold and manage a portfolio of investments for the benefit of their shareholders.
<i>investment trust savings schemes</i>	Investment schemes which invest in investment trust companies.
<i>jobbers</i>	Under the old Stock Exchange rules, those who dealt as principal but could only deal with outside investors through brokers.
<i>life policies</i>	Insurance policies which in return for a single or regular payment of premium promise to pay a sum on death or on a fixed maturity date.
<i>market maker</i>	A person who deals as principal and who is obliged continuously to quote and deal at the price quoted in normal marketable quantities regardless of what market conditions prevail.
<i>packaged product</i>	Under SIB rules, a life policy, unit in a regulated collective investment saving scheme or an investment trust saving scheme.
<i>packaged product provider</i>	A company which designs, issues or operates the life policy or saving scheme.
<i>personal equity plan</i>	An investment scheme subject to tax relief in which up to £6,000 may be subscribed for investment in securities, authorised unit trusts or investment trust savings schemes.
<i>stabilisation</i>	The maintenance of a price of a newly issued security or bond which does not necessarily reflect its true market price.

<i>spread</i>	The difference between the buy and sell price.
<i>unit-linked policies</i>	A life assurance product in which a specified number of units in a specified unit trust are attributed to the policy. The sum paid out will reflect the value of the units at that time.
<i>unit trust</i>	A collective investment scheme in which the property is held under a trust for the participants in the scheme. Only collective investment schemes which take this form may be authorised in the UK.
<i>with profits policies</i>	A life assurance product which promises to pay the holder a stipulated sum, with an expectation that bonuses will also be paid at the discretion of the life office annually (reversionary bonus) and/or on death or maturity of the policy (terminal bonuses).
<i>without profits policies</i>	A life assurance product which promises to pay the holder a stipulated sum on death or maturity.

TABLE OF CASES, STATUTES AND EC DIRECTIVES

Cases

Anglo African Merchants Ltd. v. Bailey [1970] 1 QB 311
Bank of Scotland v. IMRO 1989 SLT 432
Boardman v. Phipps [1967] 2 AC 46
City Index v. Leslie [1991] BCLC 643 (CA)
Jones v. Canavan [1972] 2 NSWLR 238
Lee (David) & Co (Lincoln) Ltd v. Coward Chance [1991] Ch 259
North South Trust Co. v. Berkely [1971] 1 WLR 470
R v. AFBF, ex p. Mordens Ltd, The Times 6.9.90
R v. Fimbra, ex p. Cochrane, The Times 23.6.89 (CA)
R v. ICS, ex p. Bowden and others, The Times 22.1.93
R v. Lautro, ex p. Ross [1993] 1 All ER 545 (CA), [1992] 1 All ER 422
Re a Firm of Solicitors [1992] 1 All ER 353
Re a Solicitor (1987) 131 S.J. 1063
SIB v. Fimbra [1991] 1 All ER 398

Statutes

Banking Act 1979
Banking Act 1987
Building Societies Act 1986
Companies Act 1989
Competition Act 1980
Employment Act 1980
Fair Trading Act 1973
Financial Services Act 1986
Friendly Societies Act 1974
Insurance Companies Acts of 1974, 1980 and 1981
Insurance Brokers Registration Act 1977
Policyholders Protection Act 1977
Prevention of Fraud (Investments) Act 1958
Restrictive Trade Practices Act 1976
Securities and Exchange Act 1934 (US)

EC Directives

Capital Adequacy Directive OJ [1992] C 50/5
Investment Services Directive OJ [1990] C 42/7
Misleading and Unfair Advertising Directive 84/432/EEC
Own Funds Directive 89/299/EEC
Second Banking Co-ordination Directive 89/646/EEC
Solvency Ratio Directive 89/647/EEC
UCITS Directive 85/611/EEC (as amended by 88/220/EEC)

LIST OF ABBREVIATIONS

ABI	Association of British Insurers
ACAS	Advisory, Conciliation and Arbitration Service
ACH	Accepting Houses Committee
AFBD	Association of Futures Brokers and Dealers
AIBD	Association of International Bond Dealers
APA	Administrative Procedure Act 1946
ASLO	Association of Scottish Life Offices
BEQB	Bank of England Quarterly Bulletin
BJIBFL	Butterworths Journal of International Business and Finance Law
BMBA	British Merchant Bankers Association
BSA	Building Societies Association
CA	Companies Act 1989
CP	Consultative Paper
CR	Core Rule
CSI	Council for the Securities Industry
DGFT	Director General of Fair Trading
DoT	Department of Trade
DTI	Department of Trade and Industry
Fimbra	Financial Intermediaries, Managers and Brokers Regulatory Association
FOX	London Futures and Options Exchange
FSA	Financial Services Act 1986
FTA	Fair Trading Act 1973
IBRA	Insurance Brokers Registration Act 1977
IBRC	Insurance Brokers Registration Council
ICS	Investors' Compensation Scheme
IDC	Indirect Customer
IFA	Independent Financial Adviser
IMRO	Investment Managers Regulatory Organisation
IOSCO	International Organisation of Securities Commissions
ISD	Investment Services Directive
ISRO	International Securities Regulatory Organisation
Lautro	Life Association and Unit Trust Regulatory Organisation
LD(CB)Rs	Licensed Dealers (Conduct of Business) Rules
LOA	Life Offices Association
MCA	Maximum Commissions Agreement
MCP	Market Counterparty
MLR	Modern Law Review
MIBOC	Marketing of Investments Board Organising Committee
NASDIM	National Association of Dealers and Investment Managers
OFT	Office of Fair Trading
OJLS	Oxford Journal of Legal Studies
PF(I)A	Prevention of Fraud (Investments) Act 1958
PIA	Personal Investor Authority
RCH	Recognised Clearing House
RIE	Recognised Investment Exchange
RIY	Reduction in Yield
ROLAC	Register of Life Assurance Commissions

RPB	Recognised Professional Body
RPC	Restrictive Practices Court
RTPA	Restrictive Trade Practices Act 1956
SEAQ	Stock Exchange Automatic Quotation system
SEQ	Stock Exchange Quarterly
SFA	Securities and Futures Authority
SIB	Securities and Investments Board
SRA	Self Regulatory Association
SRO	Self Regulating Organisation
TSA	The Securities Association
UCITS	Undertakings for Collective Investment in Transferable Securities
UTA	Unit Trust Association

Introduction

This thesis is a study of the formation of the rules which regulate the conduct of business of firms authorised under the Financial Services Act. The thesis is concerned with rule making as a form of regulatory decision making. It examines the different interests and considerations involved in the regulatory policy formation process, but goes beyond this traditional policy making focus into a study of the issues involved in the formal expression of that policy in rule form, examining the principal factors which have affected the form and structure of the rules. It emphasises that drafting rules involves decisions both as to the substantive content of the rule and as to the type of rule which should be used. The latter involves decisions as to the legal status of a rule, its degree of detail and its prescriptiveness. Different types of rules may be used to further the regulatory purpose rather than others, or to perform different functions in the system of regulation. The thesis constructs a framework for analysing rules, which it then applies to analyse the different types of rules used in conduct of business regulation. It examines the reasons why one type of rule was chosen over another in particular circumstances, looking at the limitations of different types of rules and the factors and constraints which operate on the rule making process.

The thesis examines the rule making activity of those regulatory agencies operating under the Financial Services Act 1986. The Act established a framework of regulation for the financial services industry which aimed both to protect the investor and provide a regulated market which would promote London's position as a leading financial centre. Its four stated objectives were efficiency, competition, confidence and flexibility.¹ The Act gave legislative, monitoring and enforcement powers to the Secretary of State, and enabled him to delegate these to a designated agency which had to meet a range of criteria, set out in the Act. This agency could in turn

¹ DTI, *Financial Services in the UK: A New Framework for Investor Protection*, Cmnd. 9432 (London, 1985), Chapter 3.

recognise other bodies as competent to carry on regulatory activities.

These agencies collectively regulate investment business. All persons who carry on investment business in the UK must be authorised, and authorisation is conferred either by the designated agency or by membership of one of the recognised bodies. The designated agency is a limited company, named in the Act as the Securities and Investments Board (SIB). It regulates a few firms, but its principal responsibility is the recognition and monitoring of the self-regulating organisations (SROs), professional bodies, exchanges and clearing houses which are responsible for regulating their members. There are currently four SROs, organised on a functional basis to regulate different types of investment activity. These are the Securities and Futures Authority (SFA),² which regulates brokers, dealers, advisers and market makers in securities and those operating on the futures markets; the Investment Managers Regulatory Organisation (IMRO) which regulates fund managers; the Life Assurance and Unit Trust Organisation (Lautro) which regulates the marketing activities of life companies, unit trusts and friendly societies; and the Financial Intermediaries, Managers and Brokers Association (Fimbra) which regulates independent intermediaries, and managers and brokers who operate on a smaller scale than SFA or IMRO members. A new SRO for the retail sector, the Personal Investment Authority (PIA) is in the process of being formed, which will regulate areas at present covered by Fimbra and Lautro.

It is the rule making function of these bodies, SIB and the SROs, which is the subject of the thesis. The Act grants legislative, monitoring and enforcement powers to the Secretary of State which have been delegated to SIB.³ The legislative powers enable SIB to make rules and regulations and issue statements of principle, codes of practice and guidance to regulate the conduct and financial standing of firms. The Act sets out principles to which these rules should conform and indicates provisions which they may make. The nature of SIB's rule making powers

² Formed in 1991 after a merger of the Association of Futures Brokers and Dealers (AFBD) and The Securities Association (TSA).

³ Powers delegated under s.114. See Chapter 2.

has altered since 1986. Initially SIB could only issue rules and guidance, which applied only to its members. Other authorised persons were subject to the rules of their regulatory body, which had to provide a level of investor protection equivalent to that provided by SIB's rules. In 1989 the Companies Act amended the FSA 1986 to permit SIB to issue a wider range of rules applying directly to authorised firms, though covering the same substantive areas. SIB was given powers to issue principles which apply to all authorised persons,⁴ designate conduct of business rules, financial resources rules, client money and unsolicited call regulations as directly applicable to members of SROs,⁵ and issue codes of practice relating to provisions in the rules or principles.⁶ It retained the ability to issue guidance. The Act specifies that breach of the statements of principle by a firm gives rise to disciplinary proceedings by the SRO of which it is a member, of designated rules to a civil right of action for damages for private investors who suffer loss, and the codes of practice have evidential status akin to the Highway Code. Pursuant to these powers, SIB has issued a statement of ten Principles and forty Core Conduct of Business Rules, but no codes of practice. The amendments also altered the relationship between SIB's rules and those of the SROs. SROs, which are companies limited by guarantee, are empowered by their constitutions to make rules governing their members, which have a contractual status. Initially, SRO members were not subject to SIB's rules, but SRO rules had to provide investor protection equivalent to that provided by SIB's. SRO members are now subject to both SIB and SRO rules and the SROs have to ensure that their rules together with those of SIB provide adequate investor protection.

The thesis is concerned with the formation of the Principles and Conduct of Business rules of SIB and the SROs under the initial and amended powers. The purpose of the thesis is not to provide an account of the substance of the regulation. Given the frequency of changes in the

⁴ S.47A FSA 1986, inserted by s.192 CA 1989.

⁵ S.63A, inserted by s.194 CA 1989.

⁶ S.63C, inserted by s.195 CA 1989.

requirements, encyclopedias which may be frequently updated are far more useful accounts of the regulation for those interested in its detail.⁷ Rather the purpose is to examine the decisions involved in the rule making process, asking why, in any particular situation, the regulators adopted a particular policy and expressed it in a certain rule form. The thesis analyses the nature of the rules used in the rule system, and the reasons for the adoption of these types of rules. It explores the range of considerations involved in rule making in different policy areas, and the perceived advantages and limitations of using different types of rules.

There are several justifications for this approach. First, in the context of public law literature, as a study of a system of regulation the thesis fits with the literature on regulation and regulatory agencies.⁸ Regulation, to adopt Kagan's definition, is "the control of economic activity by means of direct legal orders."⁹ Regulatory agencies may be defined as non-departmental bodies which act in some sense on behalf of government, make rules backed by force of law, exercise continuing control over an industry, trade or practice and decide issues between parties or enforce particular bodies of law.¹⁰

The studies of regulatory agencies which have been conducted in the UK have on the whole focused on two issues, firstly, the relationship of these bodies to the courts and the impact of judicial review on their operation,¹¹ and secondly, their enforcement activities. This study differs from these in that its concern is with the rule making activities of regulators. Delegated legislation, which at its broadest definition encompasses rules of varying status made in consequence of primary legislation, has received attention, most notably from Baldwin and

⁷ See, for example, Butterworths' *Financial Services Law and Practice* (London, 1987, updated), and E.Z. Lomnika and J.L. Powell, *Encyclopedia of Financial Services Law* (London, 1987, updated).

⁸ R. Baldwin and C. McCrudden, *Regulation and Public Law* (London, 1987) and R. Baldwin, *Regulating the Airlines* (Oxford, 1985) and *Rules and Government*, forthcoming. On enforcement see K. Hawkins, *Environment and Enforcement* (Oxford, 1984), G.M. Richardson et al., *Policing Pollution* (Oxford, 1983), B.M. Hutter, *The Reasonable Arm of the Law* (Oxford, 1988).

⁹ R.A. Kagan, *Regulatory Justice* (New York, 1978) p.8, emphasis omitted. For a discussion of definitions of regulation, see T.C. Daintith, "A Regulatory Space Agency?", (1989) 9 *OJLS* 535.

¹⁰ See Baldwin *op. cit.*, p.4 and Baldwin and McCrudden, *op. cit.*, p.3.

¹¹ For the most comprehensive collection of studies, see Baldwin and McCrudden, *op.cit.*

Houghton,¹² and from Ganz.¹³ These studies have been principally concerned with the types, status and legitimacy of delegated legislation and the constitutional implications of its use.¹⁴ However, few studies have been concerned with the rule making functions of particular agencies. Studies have been conducted on agency decision making in the application of rules, particularly of the police, parole officers and environmental regulators, but not on agency decision making in their formation. The exceptions to this are Baldwin's work on the Health and Safety Commission¹⁵ and McCrudden's work on the Commission for Racial Equality.¹⁶ The thesis thus draws attention to a function which is not exercised by all agencies, and which has thus far been little explored.

Secondly, in the context of financial services regulation, the Financial Services Act specified that the development and operation of the regulation was to be through rules and although the agencies perform other tasks of licensing, adjudication and enforcement, rules and rule making have been the centre of attention of the regulators and its critics since its inception; only recently has attention been switched to difficulties with enforcement. In a recent report on the regulatory system, SIB's current chairman Andrew Large characterised its history and future thus: "[i]f chapter one has been about creation and setting the system up, chapter two will be about really making the system work well in future."¹⁷ Moreover, the rule makers have been concerned not just with what the rules say, but the way in which their substantive provisions are expressed. Focusing on rule making therefore follows the principal concerns of the regulators themselves in

¹² R. Baldwin and J. Houghton, "Circular Arguments: The Status and Legitimacy of Administrative Rules", 1986 *Public Law* 239.

¹³ G. Ganz, *Quasi-Legislation* (London, 1987).

¹⁴ See also J. Beatson, "Legislative Control of Administrative Rule Making: Lessons from the British Experience" (1979) 12 *Cornell Int'l LJ* 199, and R. Baldwin, "Accounting for Discretion", (1990) 10 *OJLS* 422.

¹⁵ R. Baldwin, "Why Rules Don't Work", (1990) 53 *MLR* 321.

¹⁶ C. McCrudden, "Codes in a Cold Climate: Administrative Rule Making by the Commission for Racial Equality", (1988) 51 *MLR* 409.

¹⁷ A. Large, *Financial Services Regulation: Making the Two Tier System Work* (SIB, May 1993) Foreword, para 24.

their first years of operation, and explores why the rule system which regulates this important area of economic activity takes the form that it does, and why particular rules were adopted to regulate different issues.

The thesis does not cover all aspects of the financial services regulation. It is confined to the conduct of business rules, and so does not examine the formation or operation of other SIB and SRO rules, for example those on client money, capital adequacy and the rules governing the statutory compensation scheme. The thesis does not take a comparative stance, and does not apply the same analysis to the rules of other securities regulators, for example the US Securities and Exchange Commission, or other UK regulators, for example the City Panel on Takeover and Mergers. Finally the thesis is not an empirical study of the impact or interpretation of the rules, nor the effectiveness of the regulation or of the decisions of rule makers. The reason for these exclusions is practical rather than analytical and all these subjects would be fruitful areas of further research in which to develop the findings and conclusions of this study.

The principal source material for the thesis is the rules, consultation papers and policy documents of SIB and the SROs, and in Chapters 6 and 7, the reports of the Office of Fair Trading and responses of the principal trade associations to the consultation papers. A list of these is contained in the Bibliography. This documentary evidence was supplemented by interviews conducted with past and present staff and Board members of SIB and the SROs over the period May 1991 - July 1993.

The thesis has two main themes. The first is concerned with the nature of rules and the different effects and implications of different types of rules. The second is concerned with the factors which affect the rule making decisions of an agency.

The first chapter of the thesis explores the theoretical aspects of rules and rule making by regulatory agencies. It argues that in order to study and understand rule making we need to move away from a monolithic conception of rules and recognise that many different types exist. The Chapter identifies and analyses four different dimensions to rules, and argues that making rules

involves making decisions as to each dimension: substance, character, status and structure. It explores the implications of different types of decisions in relation to each of these dimensions focussing particularly on the structure of the rule. These include the nature of rules themselves and their limitations, their relationship with discretion, the interpretation of rules, and cost, enforcement and compliance considerations.

Chapter 1 also considers the different factors which could impact upon the rule making decisions. It suggests five groups of factors, all of which are interrelated. These are the substantive framework of the regulation, which includes the enabling legislation, the substantive context in which the agency operates, and the objectives of the regulation; political considerations, which include the history of the agency and the expectations and perceptions different political actors have of the regulation; organisational factors, which include inter-organisational or institutional factors (the relationship of the agency to others involved in regulating the same area); decision making procedures; and the norms and attitudes of officials and the regulated and wider communities, the impact of which would depend on the agency's interpretation and responsiveness to them.

The framework of analysis proposed in Chapter 1 could be applied to rules and rule making in a variety of contexts. The thesis uses it to explore the formation of the conduct of business rules by the financial services regulators. In order to provide a context to this study, Chapter 2 sets out the substantive market, legal and institutional framework. It considers the rationales for financial services regulation and the main statutory and regulatory provisions concerning the conduct of investment business. The Chapter also sets out the institutional structure, that is the relationship between the Government, SIB and the SROs, and the rule making powers of these bodies.

Chapter 3 explores the reasons why this particular system of regulators and rule makers was adopted, and what was expected of them. It examines why such a radical overhaul of the previous system of regulation was introduced, the situations with which it had to deal, and the

factors which influenced its formation. The debate on the appropriate form and structure of regulation was essentially one of formal versus informal regulation. The institutional pattern was quickly established, what the debate centred on was the relative powers of the umbrella regulator, SIB, and the SROs and the status of their rules. At the heart of the debate lay the issue of which types of rule would be most appropriate. A particular rule type was presumed to follow inexorably from a certain institutional structure, and have to certain consequences. The chapter indicates the conflicting objectives and expectations of those involved in the formation of the Act, and the consequences for the institutional structure and the rule makers' operation.

Chapter 4 examines the formation of the initial rule books and the reasons for their subsequent redrafting. It analyses the factors and considerations which underlay the two different rule systems and the reasons for their adoption, arguing that the change in the nature of the rules was directed principally at addressing the tensions in the institutional structure and defining the relative roles of SIB and the SROs. The chapter illustrates the attempts made to influence the attitudes and conduct of both the regulators and regulated through rule structure and form, indicating the manner in which rules may be used to perform a variety of functions, not merely that of prescription of conduct.

Chapter 5 analyses the nature of the conduct of business rules adopted through the course of the regulation, drawing on the analytical framework proposed in Chapter 1. It examines the structure of the rules in the initial rule books, and that of the Principles, Core Rules and third tier rules, illustrating the use which has been made of certain types of rules and guidance and their interaction as a system of rules. It indicates the factors involved in the rule formation process, and with Chapter 4 illustrates the manner in which the range of objectives which the rules were required to meet affected their structure and status.

Whereas Chapters 4 and 5 focus on the conduct of business rules as a whole, Chapters 6 and 7 examine the formation of the particular rules regulating what have proved to be two of the more contentious issues: soft commissions and the marketing of retail products. Chapter 6

explores the formation of rules regulating soft commissions. Through an analysis of the policy formation process, the chapter illustrates both the tensions which exist between different regulatory objectives, the factors which impact on the policy formation process, and the use regulators make of different types of rules to address difficult regulatory issues. Chapter 7 examines a much larger area of regulation: the retail markets, analysing the different types of regulation which have been employed and the particular problems encountered in regulating highly technical areas of market operation. It illustrates how regulatory objectives can change as the regulation has unintended affects, how requirements can be distorted in practice, and the extent to which rules can be used in an attempt to ensure compliance. Both chapters highlight the limitations of certain types of rules, and the advantages of others. Finally, the Conclusion draws from this study the principal factors which have impacted on decisions on the different dimensions of the conduct of business rules, highlighting the types of constraints and influences which operate in this particular area of agency decision making and suggesting areas for future research.

Chapter 1: Rule Making by Regulatory Agencies

The thesis is concerned with the financial services regulators in their capacity as rule makers. The aim of this chapter is to provide a basis for examining the exercise of that rule making function by exploring the types of decisions which rule making by regulatory agencies comprises, the implications of using different types of rules and the range of influences which may impact on the rule making process of an agency. Rule making involves making decisions both as to what the regulatory policy should be on an issue, and how that policy should be expressed in rule form.

The chapter constructs a framework for analysing rules which identifies four dimensions to rules: substance, status, character and structure. This analytical framework enables a debate about rules to be entered into with some degree of analytical rigour. Discussions of rules usually begin with a definition of a rule, and although rules and standards are usually distinguished there is little further breakdown of rules into different types. The chapter aims to construct a more detailed framework for analysing rules to provide a means of characterising and classifying rules so that when discussing rules we may distinguish different types and be clear what is meant by descriptions of rules such as vague, complex or precise. The analytical structure thus facilitates dialogue about rules and may be applied to rules operating in different contexts.

The analytical framework also shows the range of decisions involved in rule making. It is argued that as each element described is a dimension of a rule, when making a rule a decision must be made along each of these dimensions. Forming a rule thus involves a decision not only as to what the rule should prescribe and who or what it should affect (the substance of the rule), but decisions as to the rule's status: should the rule be of legislative force or a code of practice? Regarding its character, should it be recommendatory or prohibitive, exhortatory or mandatory, for example. Regarding its structure: should the rule be vague or clear, specific or general, simple or complex? This analytical framework thus enables us to explore all the elements of rule making

more thoroughly than a monolithic conception of rules permits and to examine the implications of using different types of rules. These include the relationship between rules and discretion, the predictability that rules may or may not provide, the interpretations different types of rules may be given, their influence on the compliance behaviour of the regulated, and their implications for the enforcement process.

As the focus of the thesis is the dynamic process of rule making, the subsequent chapters will not only analyse the types of rules adopted to regulate a particular area, but will examine the reasons why these rules have been adopted: why the rule says what it does in the way that it does. Rule making is thus seen as a particular form of agency decision making. It is assumed that the agency, or rule maker within the agency, has discretion in forming rules. The exercise of this discretion will be influenced by a variety of factors, only one of which will be the legal framework of the enabling statute. This chapter will indicate some of the factors which may influence that process. Amongst these are the decision making procedures adopted by or imposed on the agency, the political and institutional context, the objectives of the regulation and the regulator's own aims.

What is a "rule"?

What do we mean when we speak of rules? Can they usefully be distinguished from standards or some other norm guiding behaviour? Many writers have a conception of a rule which envisages a precept or directive which is quite precise. Pound's definition is frequently employed: "a legal precept attaching a definite legal consequence to a definite detailed state of fact."¹ In the narrow definitions, rules are seen as precepts which are specific, setting out certain identifiable factual circumstances which, if they arise, give rise to certain consequences, also set out in the rule. Rules thus defined are commonly contrasted with standards. Standards are seen as less

¹ R. Pound, *Jurisprudence* (St Paul, 1959) vol 1, p.124. See also J.L. Jowell, *Law and Bureaucracy* (New York, 1975) p.135.

precise, requiring in their application not the simple matching of circumstances to rule, but some exercise of judgement. To some writers, a standard indicates the kinds of circumstances which are relevant to a decision; it does not prescribe the decision in unequivocal terms. Applying a standard involves a finding of fact, and a qualitative appraisal of the facts in terms of the probable consequences of the rule's application or its moral justification.²

The distinction between rules and standards is also used not in a descriptive but a normative sense, to indicate the degree to which a precept is dispositive or may be overridden. This is the basis of Dworkin's distinction between rules and principles.³ To Dworkin, rules dictate an outcome, they are applicable in an "all-or-nothing fashion".⁴ He uses the rule's "hardness and fastness" to distinguish it from a principle. If the facts a valid rule stipulates are given, the answer it supplies must be accepted or the rule declared invalid. Principles, on the other hand, do not necessitate particular decisions, they simply state a reason which argues in one direction.⁵

We are not concerned with this normative view of the categorisation of precepts according to their authoritativeness, however; we are instead seeking a definition which can be used descriptively. Twining and Miers have a much broader definition of a rule than those indicated above. They define a rule as "a general norm mandating or guiding conduct or action in a given type of situation."⁶ In that definition, the term "rule" refers to "the genus of which precepts, regulations, conventions, principles, and guiding standards are species".⁷ This definition will be adopted for two reasons. Firstly, no rule is ever entirely clear and categorical, nor is its

² H. Hart and A. Sachs, *The Legal Process* (Tentative ed., 1958) p.157; Jowell, op.cit. p.137; D. Kennedy, "Form and Substance in Private Law Adjudication", (1976) 89 *Harvard LR* 1685.

³ R. Dworkin, *Taking Rights Seriously* (Duckworth, 1977), pp.22-8, 72-80.

⁴ *Ibid.*, p.24.

⁵ For criticisms of Dworkin's analysis, see for example, J. Raz, "Legal Principles and the Limits of the Law" (1972) 81 *Yale LJ* 823, C. Tapper, "A Note on Principles" (1971) 34 *MLR* 628.

⁶ R. Twining and D. Miers, *How to do things with Rules* (London, 3rd ed. 1991), p.131.

⁷ *Ibid.*

application mechanistic, as the narrower definition tends to suggest.⁸ The narrow definition of rules implies too dramatic a distinction between "rules" (or as they will be referred to here, detailed rules) and "standards". These are not analytically distinct, rather they represent opposite poles on a continuum. Secondly, one of the principal arguments of the chapter is that in order to talk about rules in any depth, we need to recognise and distinguish between different types. The broad definition is useful as it recognises that when speaking of rules we may be implicitly referring to one of a wide range of rule types.

In the context in which we are discussing rules, we are talking of prescriptive rules: rules which are used "to guide, control or change the behaviour of agents with decision making capacities."⁹ They exert pressure or influence persons to act in a manner that in the absence of the rule they would not. Such rules are prospective; they regulate future conduct and situations. To borrow Hart and Sach's phrase: they speak from one point of time to another.¹⁰ Their formation therefore involves an anticipation of circumstances which will arise, rather than a settlement of a situation which has already occurred. They are also general. Rules are not particular directions given to one particular person but group together types of persons, events, objects and prescribe standards of behaviour for those groups. In this sense, they use abstractions: the language used in rules abstracts from the common elements of certain instances and experiences and develops a symbol to stand for the pattern of instances characterised by those elements.¹¹ Just as generalisations include certain situations or properties, they exclude others. Which elements are chosen depends on the aim of the rule. The generalisations used focus on those aspects of a situation which are perceived to increase the likelihood of causing a harm which

⁸ Though not all who use it agree that rules are capable of mechanical application: see for example Jowell, *op.cit.* p.135.

⁹ F. Schauer, *Playing by the Rules* (Oxford, 1991), p.2. It is not the intention of this chapter to examine the philosophical debates which distinguish prescriptive from descriptive rules.

¹⁰ *Op.cit.*, p.124.

¹¹ Hart and Sachs, *op.cit.* pp.126-7.

is sought to be prevented, or promoting a situation which is sought to be achieved.¹²

Rules are thus general and prospective. They gather together a series of factors or incidents, and state that when these pertain, the stated consequences should follow. In forming these generalisations, it is inevitable that the rule will include situations in which the application of the rule will not further its purpose, and exclude situations which, if the goal of the rule is to be achieved, should be included. This is frequently described as the over- or under-inclusiveness of rules.¹³ In addition, it is impossible for the rule maker to anticipate all the circumstances which should activate the rule. The ability to predict is dependent on a number of factors. These include the complexity of the subject matter of the rule and changes in the conditions in which the rule operates, the knowledge of the rule maker, technical obstructions to prescribing certain behaviour, and difficulty in ascertaining the facts or circumstances which will trigger the operation of the rule.

By their very nature, therefore, rules may cover situations in which the application of the rule will not further, or could be conflict with, the rule's aim or purpose. In addition, it may be uncertain whether or not the rule does apply to a particular situation as the meaning of the words may be unclear. Hart describes this as the "open texture" rules.¹⁴ Words, he argues, have a core meaning and a penumbra of uncertainty. So in the classic example of the sign, "no vehicles in the park", "vehicles" obviously includes cars, trucks and motor bikes; whether electric wheelchairs, skateboards, pushchairs or trucks without engines are also included is more doubtful. The open texture of rules arises from the use of generalisations: "uncertainty at the borderline is the price to be paid for the use of general classifying terms in any form of communication concerning matters of fact. Natural languages...are when so used irreducibly open textured."¹⁵ Even if it

¹² See Schauer (1991), op.cit., Chapter 2.

¹³ See I. Ehrlich and R. Posner, "An Economic Analysis of Legal Rulemaking" (1974) 3 *J Legal Studies* 257.

¹⁴ H.L.A. Hart, *The Concept of Law* (Oxford, 1961).

¹⁵ Ibid., p.125.

were possible to identify every type of situation in which the rule were to apply, in other words, to reduce the degree of generalisation to a minimum, the application of a rule may still be uncertain in some future situation. This is simply because rules are prospective, and the limits of human foresight, knowledge and imagination mean that even the least vague term will turn out to be vague when it is applied to a situation unforeseen when the term was defined.¹⁶

How the rule should be interpreted and whether it should be applied in a particular situation is an issue which is the subject of strong debate in jurisprudential literature. Instrumentalism, or functionalism, requires that in applying a rule the purpose of the rule should be the guide, not just the language of the rule. If applying the rule strictly according to its terms would lead to a result inconsistent with the purpose of the rule, then it should not be so applied. "Where the reason stops, there stops the rule".¹⁷

This approach to interpretation differs from the "formalist" approach. There is little agreement on what formalism is,¹⁸ but the term is generally used in a pejorative manner to describe the literal application of a rule where some other substantive consideration would mitigate against the rule's application in the particular circumstance.¹⁹ So, in the classic example, the rule "no vehicles in the park" would be applied in a formalistic manner if it was interpreted as including a commemorative statue of a truck; it would be applied in an instrumental manner if it was interpreted as permitting such a statue.²⁰ Schauer argues that formalism should not be seen in a pejorative fashion, however, but as a natural consequence of rules. Rules deny the decision maker choice. The language of a rule prevents consideration of every fact and principle relevant

¹⁶ See Schauer (1991), op.cit., pp.34-7.

¹⁷ See, for example, Llewellyn's "Grand Juristic Style", K. Llewellyn, *Common Law Tradition* (Boston, 1960).

¹⁸ For an analysis of formalism see, F. Schauer, "Formalism", (1988) 97 *Yale LJ* 509 at 531 and Schauer (1991) op.cit., especially ch.9.

¹⁹ See the definitions cited in Schauer (1988), op.cit., n.1, also P. Nonet and P. Selznick, *Law and Society in Transition* (New York, 1978), and J. Schklar, *Legalism* (Harvard, 1964).

²⁰ H.L.A. Hart, "Positivism and the Separation of Law and Morals", (1958) 71 *Harvard LR* 593 and L.L. Fuller, "Positivism and Fidelity to Law - A Reply to Professor Hart" (1958) 71 *Harvard LR* 630.

to a particular application of a rule; applying rules when their prescribed treatment appears unsuitable is a natural consequence of rules. Rules are thus imperfect tools of decision making. "[R]ules function as impediments to optimally sensitive decision making. Rules doom decision making to mediocrity by mandating the inaccessibility of excellence."²¹ However, their nature as rules means they must be applied, as rules provide reasons for action which are independent of their purpose. "The view that rules should be interpreted to allow their purpose to trump their language in fact collapses the distinction between a rule and a reason, and thus loses the very concept of a rule."²² Schauer thus gives a descriptive account of formalism, seeing it as no more, and no less, than decision making according to the literal language of the rule. Whether, given this rigidity, decision by rule is desirable is a separate, normative, issue.

Why have rules?

Rules thus by their nature impose restrictions on the considerations that may be taken into account in decision-making. To formulate a rule is to select in advance the relatively few factors that are relevant to the decision. They restrict consideration of wider factors and may prevent the making of decisions in a way which provides the best accommodation of values and purposes. The criticisms of rules are usually based on this exclusion of an individualised treatment of claims. When the question of the rule's application to that situation arises, the decision maker is constrained by the rule. The rule closes off options that might otherwise be available.

The application of rules in circumstances in which its application may be inappropriate, that is incongruent with the rule's purpose, is seen as an unwelcome aspect of rules, leading to criticisms of rigidity and legalism. Moreover, in an administrative context, the rigidities of rules may be enhanced as officials may apply them with considerations of routinisation and bureaucratic procedure ranking higher than the goals of the agency, and use the rule as a shield against

²¹ Schauer (1988), p.539.

²² Ibid., p.534 and Schauer (1991) op.cit., p.210.

criticisms of inappropriate behaviour.²³ Organisational structure can also influence the manner in which rules are applied. Subordinates may develop an exaggerated attachment to rules to protect themselves from criticism or chances of error.²⁴

The most emphatic normative claim for rules comes from the rule of law. The essence of the rule of law demand is that law should be capable of providing effective guidance.²⁵ This may be based on respect for the dignity and autonomy of the individual, or it may be given a more commercial justification. Hayek, for example, demands predictability for the smooth working of economic life.²⁶ For Fuller, the internal morality of law requires there to be rules which are publicised, clear, stable, prospective. These rules must not be contradictory, they must not require conduct beyond the power of the affected party and there must be a congruence between law and official action.²⁷

In the context of administration, rules are often spoken of in the context of controlling official discretion. The advantages of rules are here related to concepts of justice. The most renowned proponent of rules was Davis, who saw rule making as "one of the greatest inventions of modern government."²⁸ Davis saw discretion as present in any situation in which "the effective limits on...[an official's] power leave him free to make a choice among possible courses of action or inaction", a good deal of which was "illegal or of questionable legality".²⁹ The discretion of administrative officials, he argued, should be confined and structured at the earliest

²³ The rule will shield the enforcer, but not the rule maker, however. It may not shield the agency as a whole, therefore.

²⁴ E. Bardach and R.A. Kagan, *Going by the Book* (Philadelphia, 1982).

²⁵ See, for example, J. Raz, "The Rule of Law and its Virtue", (1977) 93 *LQR* 195.

²⁶ F. Hayek, *The Road to Serfdom* (London, 1964), *The Constitution of Liberty* (Chicago 1960).

²⁷ L.L. Fuller, *The Morality of Law* (Yale, Revised ed. 1969), Chapter 2.

²⁸ K.C. Davis, *Discretionary Justice* (Illinois, 1971), Chapter 3. See also K.C. Davis, *Administrative Law Treatise* (West Publishing, 1958).

²⁹ K. Davis (1971), *op.cit.*, p.4.

opportunity by the agency through the formulation of rules and principles.³⁰ Friendly also demanded the gradual definition and clarification of general standards over the course of the agency's operation, but saw advantages in both rule making and adjudication for these purposes.³¹

Rules in this context are seen as a means of reducing the free exercise of discretion and providing specific standards against which official decisions may be measured. They are perceived as ensuring that like situations will be treated alike, as providing accountability, uniformity and prospective guidance and ensuring administrative integrity by encouraging congruence between the goals of the agency and its actions. So they reduce arbitrariness and limit the distortion of official goals in the course of the administrative process.³² Rules can thus support and promote values of justice. Moreover, the rule making process is praised as fulfilling the requirements of participation and openness. Those who may be affected by the rule may be able to contribute in its formation, and the public are made aware of the agency's proposed actions and policies; such advantages are however dependent on the procedures adopted.³³

Efficiency claims are also made of rules. Rules enable agencies to deal on a routine basis with a large number of similar claims, so conserving resources. They facilitate planning in a way that ad hoc settlement of claims or disputes does not. A more sophisticated version of this view constructs a matrix which indicates when it is efficient for agencies to make rules.³⁴ Gifford identifies particular characteristics of agency caseload that are or might be expected to be

³⁰ For a criticism of Davis and a call for a more complex conception of legal decision making, see R. Baldwin and K. Hawkins, "Discretionary Justice: Davis Reconsidered", (1984) *Public Law* 570. See also J.F. Handler, *The Conditions of Discretion* (New York, 1986) and D.J. Galligan, *Discretionary Powers* (Oxford, 1986) pp.167ff.

³¹ H.J. Friendly, *The Federal Administrative Agencies* (Harvard, 1962).

³² For a summary of these arguments, see J.L. Jowell (1975), *op.cit.*

³³ Much of the debate has been conducted in the US context, where the Administrative Procedure Act 1946 stipulates an "informal" rule making procedure of notice and comment. There is no parallel in the UK, and so such claims for participation rights may not be satisfied in the UK context.

³⁴ D.J. Gifford, "Discretionary Decisionmaking in the Regulatory Agencies: A Conceptual Framework", (1983) 57 *South Calif LR* 101 and "Communication of Legal Standards, Policy Development and Effective Conduct Regulation", (1971) 56 *Cornell LR* 409.

associated with differing decisional approaches or techniques. These are the extent to which an agency's caseload consists of non-repeating fact situations or recurring situations, and the level of importance of the decision to the agency. A decision is important if it has a large impact on the agency's regulatory goals, enables the agency to formulate standards or guides for resolving future cases or serves as a precedent that disposes of an entire class of cases. Where a situation is non-recurring but important he argues that the agency should formulate a standard; where is it recurring and important, use adjudication and rules. Where the situation is recurring but unimportant the agency should formulate standards and rules and can delegate decisional responsibility to lower echelon personnel with standards to guide them. Where the issue is non-recurring and unimportant, the agency may delegate the decision but without meaningful standards.³⁵

Finally it is argued that making rules involves a superior method of decision making to ad hoc settlement of disputes for their formation involves evaluation and consideration of a range of information and options, and one which enables the multi-faceted, or poly-centric nature of administrative decisions to be realised. Adjudication, it is argued, focuses too much on individual rights and one aspect of the decision to the detriment of the policy as a whole.³⁶ Discretionary decision making, it is argued, has the potential to lead to the introduction of factors in the decision making process which do not contribute to the long term development of policy.

Rules and Discretion

The advantages of rules are largely seen to be the reduction of discretion; their disadvantages its preclusion. Discretion can avoid the rigidities of rules, but is seen to have its own disadvantages. These can be gleaned from the perceived advantages of rules: discretion can

³⁵ Baldwin's account of rule making by the Health and Safety Executive appears to fit this pattern: R. Baldwin, "Health and Safety at Work" in R. Baldwin and C. McCrudden, *Regulation and Public Law* (London, 1987).

³⁶ For a summary of the arguments relating to adjudication see D.L. Shapiro, "The Choice of Rule Making or Adjudication in the Development of Administrative Policy" (1965) 78 *Harvard LR* 921 and L.L. Fuller, "The Forms and Limits of Adjudication" (1978) 92 *Harvard LR* 353.

give rise to inconsistent decisions or decisions based upon criteria that do not relate to organisational ends and the private nature of the decision process raises concerns about legitimacy and justice, and the subsequent lack of accountability.

Definitions of discretion focus on the relationship between rules and discretion. Dworkin defines it as a relative concept: "[d]iscretion, like the hole in the doughnut, does not exist except as an area left open by a surrounding belt of restriction."³⁷ This appears to conceive of a clear distinction between rules and discretion, however, which Galligan has argued is misleading. He argues for a conception of discretion which is interrelated with legal principles, rather than distinct from them.³⁸ He defines discretion as not just the creation of new standards, but the individualisation and interpretation of loose standards and the assessment of the relative importance of conflicting standards.³⁹ Discretion is the subject of two variables. One is the scope for assessment and judgement left open to the decision maker. This may be a function of the type of rule used, or it may be affected by principles derived from wider political or other sources, internal codes or guidance or the purposes of the rules.⁴⁰ The second is the attitude of the officials themselves as to how those issues are to be resolved. Officials use many types of factors as relevant in making a decision, only one of which may be rules.⁴¹

Discretion in this sense is interstitial. It is "the space..between legal rules in which legal actors may exercise choice."⁴² The relationship between rules and discretion is not one of mutual exclusion, however. Rules and discretion are inextricably interwoven. This is masked in some of the more traditional rules *versus* discretion debates as these tend not only have a narrow

³⁷ Dworkin, op.cit., p.31. Dworkin argues there are two senses of discretion: the weak sense, which means the use of judgement in applying a standard, or the absence of appeal from the decision; and the strong sense, which is the making of a decision unconstrained by standards.

³⁸ Galligan, op. cit., Chapter 1.

³⁹ Ibid., pp.20-4.

⁴⁰ Ibid., pp.23-4.

⁴¹ D.J. Gifford, "Decisions, Decisional Referents, and Administrative Justice", (1972) 37 *Law and Contemp Problems* 3.

⁴² K. Hawkins, "The Use of Legal Discretion: Perspectives from Law and Social Science" in K. Hawkins (ed.), *The Uses of Discretion* (Oxford, 1992), p.11 (footnote omitted).

conception of what discretion is and how it is exercised,⁴³ they also presume a particular type of rule. Rules are of many different types and forms, and which type is used will affect the validity of the claims made for, and criticisms of, rules as a genus. For example, the advantages of rules of ensuring officials remain true to the goals of the agency and are accountable to them depends on the type of rules used. Rules which are vague, general or imprecise may not act as much of a constraint on official action, may not inform the public or enable it to predict the agency's actions and may not provide benchmarks for accountability. In relation to the charge of rigidity and legalism, rules may not categorically state that when the facts are *a* and *b* the consequence is *z*. As we have seen above, they may require judgement and evaluation in their application. Their rigidity, though still present, may thus be mitigated.

From this discussion it becomes clear that to explore the use of rules and the issue of making rules in more depth, we need a more complex understanding of what rules are. By their very nature, rules do limit the decision maker's range of options; however this limitation may be of varying degrees, and the rule may not always dictate a result. Rules may take many different forms. The next part of the chapter analyses the dimensions of rules, the nature of options that each poses and their implications, and explores the implications of using different types of rules.

Analysing Rules: the Four Dimensions of Rules

In essence, a rule has two components, the operative and the consequential.⁴⁴ Any rule

⁴³ For criticism, see generally Galligan, *op.cit.*, and the studies contained in Hawkins (ed) *op.cit.*

⁴⁴ See G. Gottlieb, *The Logic of Choice* (London, 1968), especially Chapter 3, who argues that for a statement to be a rule, it must be capable of being broken down in this manner. See also Twining and Miers, *op.cit.* pp.141-4; N. MacCormick, *Legal Reasoning and Legal Theory* (Oxford, 1978), pp.43 and 45; and Schauer (1991), *op.cit.*, pp.23-24.

may be stated in the form "if X, then Y". "If X" is the operative part of the rule, the *protasis*.⁴⁵ It indicates the range of situations envisaged by the rule itself for triggering its own application. "Then Y" is the consequence or *apodosis*,⁴⁶ what happens if the conditions anticipated in the *protasis* obtain. It states whether the type of behaviour governed by the rule is prohibited, permitted or required. Gottlieb describes it as that which the rule seeks to attain, which may be a decision, choice or attitude. This aspect of rules is one which should be borne in mind as it indicates the purposeful and influential function of rules. Although rules may not be formulated with such a sharp distinction between operative and consequential being apparent, almost any rule can be reformulated so that the consequent is simply the obligation or prohibition or permission, and everything other than that appears in the operative part.

Gottlieb's analysis can apply to any rule: legal, moral, social etc. In this chapter we are focussing on legal rules, and it is in relation to these that the following analytical framework is constructed. The framework identifies four dimensions or main characteristics of legal rules: substance, status, character and structure. Although these are discussed separately they interact, and together they form an analytical framework for rules. Each refers to one aspect of a rule, and each may affect the rule's operation. Moreover, as will be discussed below, each represents a choice or decision to be made in the rule making process. This analysis of rules differs from others in the literature, which tend to focus on only one or two of the dimensions identified here, or instead focus more on rule function in talking of rule types.⁴⁷

⁴⁵ The *protasis* is the introductory clause expressing a condition. Gottlieb, op.cit., p.39. Schauer, ibid., refers to this as the factual predicate.

⁴⁶ The *apodosis* is the consequent clause of the conditional sentence.

⁴⁷ See C.S. Diver, "The Optimal Precision of Administrative Rules", (1983) 93 *Yale LJ* 65 and "Regulatory Precision" in K. Hawkins and J.A. Thomas, *Making Regulatory Policy* (Pittsburgh, 1989), Baldwin, op.cit, R. Baldwin and J. Houghton, "Circular Arguments", (1986) *Public Law* 239 and P.S. Atiyah and R.S. Summers, *Form and Substance in Anglo American Law* (Oxford, 1987), Chapter 1.

1. *Substance*

The substance of the rule refers to the range of fact situations in which the rule is applicable. It is thus the "if X" part of the rule, the *protasis*. It contains the generalisation which is the necessary part of any rule, and which is based on the purpose or aim of the rule (above). It represents the set of facts whose existence indicates that the evil at which the rule is targeted or the goal at which it is aimed is likely to occur, and which must therefore be prohibited or promoted. That set of facts may or may not in fact give rise to the evil which is sought to be prevented, and other facts not included in the substance of the rule may. To the extent that the rule covers facts which will not give rise to the evil/goal at which the rule is aimed, it may be termed over-inclusive; to the extent that it does not cover facts or situations which will give rise to that goal or evil, it is under-inclusive.⁴⁸ The manner in which the substance of the rule is expressed is determined by the structure of the rule (see below).

The substance of the rule is thus related to the rule's aim or purpose. From a rule maker's point of view, rules are an instrument of policy.⁴⁹ In rule making terms, therefore, the substance of a rule is its policy content. Deciding when or to whom the rule should apply is the core of policy decisions. To the extent that determining the substance of the rule requires a determination of its policy, rules may be seen as the embodiment of policy decisions, and their success measured in terms of the extent to which they ensure that the policy is achieved. It is in the assessment of rules in these terms that the terms over- and under-inclusive may be used in a normative sense: to judge the extent to which the application of a rule in a particular circumstance furthers the aim of the rule. In relation to the interpretation of rules, the fundamental normative demand for congruence between the application or non-application of the rule to a particular circumstance and the policy embodied in the rule derives from a view of rules as purposeful, or instruments of policy. One further point which needs to be borne in mind is that the person who is the subject

⁴⁸ See Schauer, *op.cit.*, Chapter 2.

⁴⁹ See below.

of the rule should be distinguished from the rule's addressee. Rules may be addressed to many persons, not just the person whose behaviour is the substance of the rule. These include those who will apply the rule, in an administrative context frequently agency and enforcement officials, and those who may be called upon to determine the application of the rule in case of dispute, arbitrators or judges.

2. *Status*

The status of a rule refers here to its legal status, the degree to which it is recognised as legally authoritative.⁵⁰ In this classification we will adopt a positivist approach to status. In other words, a rule's legality and status are determined by factors external to the rule's structure and content.⁵¹ A rule's status may be determined by its source: statutory, administrative or delegated, or common law. Status may be ranked if there is a hierarchical ranking of sources within a legal system. For example, in English law the formal principles of statutory interpretation rank statutory law as the highest form, overruling common law where the two clash. Delegated legislation is not presumed to override common law unless its authorising statute makes this clear.⁵² Delegated legislation may itself have levels of different status, which may be inferred from the consequences of its breach. It may be of full legal force, evidentiary status or for guidance purposes only.⁵³ Rules may be internal to an agency, for examples rules of operation or practice and have no independent legal effect.⁵⁴ The status of a rule may not always be clear, however. How this uncertainty will be resolved will depend on the rules which exist in the legal system for determining status, the rules of statutory interpretation, for example, and how they are

⁵⁰ It is not the intention of this discussion to enter into the jurisprudential debate on the distinctions between moral, social and legal rules or norms.

⁵¹ See Hart (1961), *op.cit.*

⁵² F. Bennion, *Principles of Statutory Interpretation* (London, 1984).

⁵³ See G. Ganz, *Quasi-Legislation* (London, 1987) and Baldwin and Houghton, *op.cit.*

⁵⁴ They may acquire this through the application of another legal principle, for example, legitimate expectations. See generally, G. Ganz, "Legitimate Expectation" in C. Harlow, *Public Law and Politics* (London, 1986).

interpreted.⁵⁵

3. *Character*

The character of a rule refers to the nature of the rule. This may be the nature of its prescription, the "then Y" part of the rule or *apodosis*. A rule may be prohibitory, preventing certain conduct, or permitting it. It may be categorical (no vehicles in the park). It may recommend rather than require conduct. The rule may demand a course of conduct or give discretion to follow that course, by using the words "shall" or "may", for example.

4. *Structure*

The structure of the rule refers to its language and syntax. This is the most complex dimension of rules, containing itself several further elements. Rules are often described as general, vague, precise, narrow, complex, or unintelligible. These descriptions refer to the rule's structure, how it is phrased. In order to describe rules coherently, we need to understand what is meant by these descriptions, or as they often are, criticisms.

The structure of the rule encompasses both the "if X, then Y" elements. It is necessary to maintain an analytical distinction between a rule's substance and its structure, however, for two reasons. Firstly, the structure of the rule has a bearing on the rule's congruence and its interpretation (below). Secondly, the structure of the rule can perform the independent function of determining the amount of discretion which the applier of the rule is given (below).

We may identify four elements of rule structure: scope, simplicity, intelligibility and precision. Although these aspects will be described in terms of opposites (precise/vague, simple/complex, for example), these should be seen as two ends of a continuum rather than two separate "either/or" categories. Precision or vagueness, for example, is a matter of degree.

⁵⁵ The issue of rule interpretation is explored below.

(i) *Scope: narrow/general*

The scope of the rule relates directly to a rule's substance. It refers to the range of persons or actions to which the rule applies: to the width of the generalisation. A rule may be narrow or general. The more general the rule, the wider its range of application or scope; the more specific it is, the narrower is its range. As we have seen, this is often termed the inclusiveness of the rule. Descriptions of rules as under- or over-inclusive are often normative, judging whether the range of persons or behaviour that the rule covers is appropriate, whether the application of the rule to those situations achieves the rule's purpose. An under-inclusive rule does not cover all the fact situations which it is normatively judged that it should; an over-inclusive rule covers too wide a range of situations.⁵⁶ The phrase can also be used descriptively, and that is the sense in which it is used here.⁵⁷ All rules, due to their use of generalisations, are either over- or under-inclusive.

The scope of a rule may be positively or negatively defined. A negative definition of scope is one which sets a very wide scope, which is then circumscribed by a series of exceptions. Thus a rule which states "all persons shall...., except those acting on instructions from professional customers....." has a negative definition of scope. A positive definition of scope is one which states in positive terms to whom or what the rule applies: "all persons advising private customers shall....".

(ii) *Simplicity/complexity*

The simplicity or complexity of a rule relates the degree to which the rule is applicable to concrete situations without excessive difficulty or effort.⁵⁸ The ease of application here is a

⁵⁶ See, for example, Ehrlich and Posner, *op.cit.* Similarly, Diver's dimension of congruence, though used to refer to the scope of a rule, is a normative dimension, asking whether the rule is congruent to its purpose, Diver (1983) and (1989) *op.cit.* For a similar use, also see Twining and Miers, *op.cit.*, and Kennedy, *op.cit.*

⁵⁷ See Schauer (1991), *op.cit.*, p.33.

⁵⁸ This corresponds to Diver's dimension of accessibility. Diver (1983), *op.cit.*

factor of the number of factual situations involved in a determination of the rule's applicability. For example, a simple rule would be one which provided, "no licenses may be granted to firms with less than 25 employees". A complex rule would be one which stated, "licenses may be granted to firms which comply with the following conditions..." and sets out a list of factual situations, each clear on its own, or which provided that a certain action was prohibited unless a series of conditions was met.

(iii) *Clarity/opacity*

The clarity or opacity of a rule relates to the degree to which it contains words with well-defined and universally accepted meanings.⁵⁹ A clear rule sets out a list of easily distinguishable factual aspects of a situation which determines the rule's application. It is distinguished from simplicity in that it does not refer to the number of conditions, but the manner in which they are expressed. A rule is not clear if it includes words such as "fair", "due care", or "reasonable", unless such a phrase is accepted in a community to have a particular meaning. The aspect of the rule focused on here is the actual words used to describe the substance and the nature of prescription of the rule. Rules which use terms such as "reasonable" are often spoken of as "open textured", although the term is sometimes used to refer to the inherent uncertainty of language.⁶⁰

(iv) *Precision/vagueness*

The precision or vagueness of a rule relates to the degree to which behaviour under the rule is prescribed. For example, a rule which requires that a seller "provide information" on a life assurance product is less precise than a rule which requires the seller to "provide written information on costs and expenses within fourteen days of sale". Precision refers to the extent to which the behaviour or conduct prescribed or prohibited by the rule is set out.

⁵⁹ Though with the proviso of their open texture, see above.

⁶⁰ Hart (1961), op.cit.

The different aspects of a rule's structure are interrelated to differing degrees. A rule may be precise yet opaque; in the example above, "costs and expenses" may be uncertainly defined. Increasing the precision of a rule can make it clearer: "motorised vehicles" is more precise and clearer than "vehicles"; it also narrows its scope. Similarly a rule may be complex but clear, or simple but opaque. Simplicity relates to the number of different conditions set out for application of the rule, clarity to the manner in which they are defined. A rule which states that licenses may be granted to persons filling a list of conditions is complex; it is clear if those conditions are defined in terms which are well understood. If the conditions are defined in terms of reasonableness, then the rule is both complex and opaque. A rule which states licenses to conduct business may not be granted to companies with a turnover of under £25,000 per annum is simple and clear; one which states that licenses may only be granted to "fit and proper persons" is simple but opaque. The open textured nature of the rule is a function of its clarity, and so may be inherently limited given the indeterminacy of language,⁶¹ or affected by the choice of the rule maker. A rule may be precise but simple: "send information within fourteen days", but the greater the degree of precision, the increased likelihood that the rule will become increasingly complex. The combination of different elements of the rule's structure will affect its accessibility or comprehensibility: the ability of the reader to understand at first sight the rule's application to a particular set of circumstances.

Detailed Rules and Standards

The distinction between detailed rules and standards in the analytical framework proposed relates only to this dimension of structure. The other dimensions are logically distinct. There can be general rules and specific standards, prohibitory standards and permissive rules. The dimensions interact, however, as we will see below. The substance and character of the rule may have affected its structure. However, it is the structure which determines the position of the rule

⁶¹ See, for example, Fuller (1969), *op.cit.*, and Hirsch., *op.cit.*

on the "detailed rule - standard" continuum, not its substance, character or status.⁶²

The structure of a rule has four aspects: scope, simplicity, clarity and precision. The scope of the rule is not envisaged as affecting the characterisation of the rule as a detailed rule or standard. The position of the rule (broadly defined) on the continuum between detailed rules and standards is a function of its position on the three continuums of complexity/simplicity, clarity/opacity and precision/vagueness. The simpler, more opaque and more vague the structure, the more the prescription is a standard. The position of the rule on each of the three continuums of structure will determine the position of the rule on the overall continuum of detailed rule/standard. The nearer the rule is to the complex, clear and precise end of the spectrum, the more it may be characterised as a detailed rule rather than a standard.

Making Rules

The above exploration of the nature of rules and their dimensions gives some clues as to the issues, and difficulties, involved in making rules. Forming rules involves making a decision firstly, as to whether or not there should be a rule at all, and secondly, if that is answered in the positive, decisions on each dimension of the rule. What should the rule say? Of what status should it be? Should it prohibit or permit conduct; what should be the sanctions attaching to its breach? Finally, how should the rule express its policy aim? Should it be widely drawn and err on the side of over-inclusiveness, or should it be narrowly drawn, and risk excluding situations which possibly should be included? Should the rule be simple, or is it necessary to have a complex rule? Should the rule be clear, or include opaque terms which require more judgement to be involved in the rule's application? Should it indicate precisely what conduct is required, or is it sufficient to express this only vaguely?

⁶² The definitions used here correspond to those set out at the beginning of the chapter: "rule" has the broad definition of Twining and Miers, *op.cit.*, "detailed rule" corresponds to Pound's definition and "standard" to the conventional opposite of detailed rules.

The issue of whether or not to have a rule and what that rule should say, what in other words should be its substance, is the most obvious decision which has to be made. It is this which is usually the fundamental issue in agency rule making, and it is decisions on this dimension which form the main focus of Chapters 6 and 7. The structure of the rule can itself be the principal focus of a rule making decision, however. This involves a decision not so much as to what the policy should be, but what is the optimal way of expressing it. As we will see in Chapters 4 and 5, the use of different types of rule structure and rules of different status to express the same policy content can be the sole focus of agency decision making.

The financial services regulators have consciously used a wide range of rule types to regulate investment business. The subsequent chapters will analyse the nature of the rules used and indicate the reasons why particular rules were chosen to meet different situations. The nature of these decisions has involved a consideration of all aspects of rules, particularly their policy content, their status and their structure. The next part of this chapter will indicate in more general terms the nature of the decisions involved in rule making. The policy issues involved will be discussed in Chapter 2, which explores some of rationales for regulation of the financial services industry. We will therefore focus here on the implications of making rules of different status and structure.

The Nature of the Decision: Dimensions as Choices

The nature of rules indicates some of the inherent difficulties in forming rules. The rule maker has to decide what the aim of the rule is, and then form a generalisation which encompasses as many as possible of the situations which are likely to give rise to the evil which is sought to be avoided, or goal achieved. This characterisation of rules and rule making presumes that rules have such a policy directed purpose. Rules as a genus are indeed most frequently conceptualised

as having the purpose of ordering society.⁶³ For Llewellyn, for example, they were one of the tools available for performing the "law jobs" of channelling behaviour, settling disputes, making smooth adjustments to change and providing for acceptable ways of reaching decisions.⁶⁴ Summers identifies five different techniques that law employs in this task of social management: grievance-remedial, penal, administrative-regulatory, public benefit conferral or distributional and facilitative of private arrangements, and argues that for any given social function, any one or more of the five or some variant or combination may be used, though each has its own limits.⁶⁵ Judgements about rules tend to presuppose such a social management and instrumental function. Rules are seen as the embodiment of policy decisions, and their success is measured in terms of the extent to which they ensure that the substance of the policy is achieved. The fundamental demand for congruence between the application of the rule in a particular circumstance and the policy embodied in the rule derives from this view of rules as instruments of policy.

For the administrative rule maker, using rules to embody policy decisions will be the most frequent concern. However, to see rules purely as instruments used to further directly a particular policy is to take too simple a view of rules. Rules may be made by an agency not to further its stipulated policy goals but rather as compromises between competing interest groups. They may represent merely the public conferral of private benefits rather than instruments aimed to further policies formed in the public interest.⁶⁶ Rules may be made for the purposes of the agency: to convince people that "something was being done" or as an exercise in self-aggrandisement and to extend their own area of operation. They may serve to communicate approval or disapproval of

⁶³ For example, Hart (1961), op.cit. p.121, R. Cotterell, *The Sociology of Law, An Introduction* (London, 1984), p.55.

⁶⁴ K. Llewellyn, *Jurisprudence* (Chicago, 1962), Chapter 15. See also L.M. Friedman, "Legal Rules and the Process of Social Change", (1967) 19 *Stanford LR* 786.

⁶⁵ R.S. Summers, "The Technique Element in Law", (1971) 59 *Calif LR* 733 and R.S. Summers and C. Howard, *Law, its Nature, Function, and Limits* (1972).

⁶⁶ This view of the nature of agency decisions was propounded by G. Stigler, "The Theory of Economic Regulation" (1971) 2 *Bell J Econ and Man Sci* 1, and developed by R.A. Posner, "Theories of Economic Regulation", (1974) 5 *Bell J Econ and Man Sci* 335, S. Peltzman, "Towards a More General Theory of Regulation", (1976) 19 *J Law and Econ* 211, and J.Q. Wilson, *The Politics of Regulation* (New York, 1980).

an action, or that an agency is taking a particular approach to its task. Alternatively, there may be no purpose behind them: rules may have been made unthinkingly, as an instinctive response by an agency to a situation. Moreover, one rule can combine a complex set of functions and purposes. We will see in the subsequent chapters, particularly Chapter 4, how rules have been used to perform a wide variety of different functions, some of which are clear, others more intangible.

It is worth asking why a rule maker should, and as we will see does,⁶⁷ pay attention to a rule's status and structure. Rules may be seen as "intermediate goods", the product of a rule making process and an input into compliance and enforcement processes.⁶⁸ There are several implications involved in using rules of different types. These relate principally to the amount of discretion, and thus power,⁶⁹ which the person subject to the rule or applying the rule has, and the related issues of the interpretation that the rule may be given and the amount of predictability that the rule affords. Other implications relate to the costs of forming and applying different types of rules, compliance with the rule and the impact different rule types have on enforcement activities. These are interrelated and their division here should not be seen as requiring any form of analytical distinction between them.

Types of rules and amounts of discretion

One of the main answers to the question of why the rule maker should pay attention to the type of rule used lies in the relationship between rules and discretion. As we have seen, discretion is a concept which is relative to its context.⁷⁰ One element of this context is rules. This is not to suggest that the exercise of discretion is only constrained or affected by rules, or that a rule will always affect how discretion is exercised: enforcement studies have shown the

⁶⁷ See Chapters 4 and 5 particularly.

⁶⁸ See Diver (1989) op.cit., p.203.

⁶⁹ See below.

⁷⁰ See Galligan, op.cit.

complexity of decision making concerning the application of legal rules.⁷¹ As Lempert observes, "where rules accord a range of discretion to a decision maker, the decision-maker may be both less and more constrained than he appears."⁷² A general standard may be narrowed by subsequent internal rules, for example, or by the decisional referents that officials will employ in applying the rule.⁷³ These may be considerations of negotiation, resource management, their own interpretation of the rule, their values, in short a host of factors, of which the language of the rule may be only one.⁷⁴ What is argued is that rules can affect the amount of discretion, or room for decisional manoeuvre, which both the enforcer and the person subject to the rule have,⁷⁵ although it is recognised that rules will not be the sole, nor perhaps the principal, factor affecting the amount of that discretion nor the manner in which it is exercised.⁷⁶

An obvious way in which the rule can affect the room for decisional manoeuvre of a decision maker is through its character: rules which are permissive ("may") or recommendatory rather than mandatory ("shall"), for example, give greater discretion over what course of action to adopt. The status of a rule can also affect its "ruleness", in other words it can affect the extent to which the rule should be considered authoritative or determinative. Rules may have full legal force, creating civil or criminal liabilities. They may have regulatory force, giving rise to liabilities or sanctions which are authorised by and applied only within the regulatory system. The rules may have legal status for evidentiary purposes only. Alternatively they may be merely guidelines as to interpretation, compliance and possible agency action in certain circumstances.

⁷¹ See K. Hawkins, *Environment and Enforcement* (Oxford, 1984) and *The Uses of Discretion*, op.cit.; G.M. Richardson *et.al*, *Policing Pollution* (Oxford, 1983); B.M. Hutter, *The Reasonable Arm of the Law?* (Oxford, 1988).

⁷² R. Lempert, "Discretion in a Behavioral Perspective", in Hawkins (ed), op.cit., p.227.

⁷³ See D.J. Gifford, (1972) op.cit. Also Friedman, op.cit. and Galligan, op.cit. For an account of the tendency of officials to narrow the application of a general rule, see Bardach and Kagan, op.cit.

⁷⁴ See for example Hawkins (1984) and (1992) op.cit.

⁷⁵ In the following discussion the terms "decision maker" or rule's applier will be used to refer to all who make decisions as to the application of the rule, be they bureaucratic or enforcement officials, judges or those private individuals regulated by the rule.

⁷⁶ See generally, Hawkins (ed), op.cit.

Choosing rules which have no legal status may give the agency and the regulatory system as a whole more flexibility than rules with full legal force.⁷⁷ Rules of non-legal status give less authoritative reasons for action than legal rules.⁷⁸ Non-legal rules provide only guidelines for action or decision, not mandatory directives. They may thus mitigate against the "ruleness" of rules and permit other factors into the consideration of their application. They thus provide flexibility, though at a loss of predictability.

It is the dimension of structure which gives the rule maker the greatest ability to affect the decision maker's discretion, however. When analysing a rule's structure, we noted that there were four elements: scope, clarity/opacity, simplicity/complexity and precision/vagueness. More opaque and vague rules give greater discretion to the rule's applier, be it the regulated, enforcement official or judge.⁷⁹ They thus delegate decision making power to the rule's applier, and legitimate the exercise of choice by that person.⁸⁰ Friedman calls this the "distributional" aspect of rules.⁸¹ Because standards require a greater degree of judgement in their application, they provide a greater degree of discretion to those applying them. They give the decision maker greater jurisdiction to determine the meaning of the rule and the degree to which the purpose of the rule should be relevant in its application.⁸²

Using more detailed rules may therefore be a means of controlling the rule's application, and hence the decision maker's jurisdiction, to a greater extent than if standards were used. A rule which states: "information must be given which is sufficient for an investor to make an informed investment decision" is of a different type to one which states: "the following information must

⁷⁷ Legal status should be distinguished from bindingness: non-legal statements, guidelines, circulars, etc. may still be found to bind an agency under the public law concept of legitimate expectation. See Ganz (1986) *op.cit.*

⁷⁸ See Atiyah and Summers, *op.cit.*, pp.12-3.

⁷⁹ R.E. Goodin, "Welfare, Rights and Discretion" (1986) 6 *OJLS* 232 calls this "informal discretion".

⁸⁰ See Goodin, *op.cit.*, and J. Bell, "Discretionary Decision Making: A Jurisprudential View" in Hawkins (ed), *op.cit.*, pp.95-97. For an analysis of discretion as power, see M.J. Adler and S. Asquith, "Discretion and Power", in M.J. Adler and S. Asquith, *Discretion and Welfare* (London, 1981).

⁸¹ Friedman, *op.cit.*, p.788.

⁸² See Schauer (1988), *op.cit.*, p.540, Kennedy, *op.cit.* and Bell, *op.cit.*

be given: the surrender values of the first five years, the percentage of premiums which is absorbed by commissions and other costs, the amount by which those costs will reduce the ultimate yield of the investment, the impact of tax and inflation...". In the first example, the person to whom the rule applies has to assess what constitutes an "informed investment decision" and what information should be given to meet this objective. The enforcement official is also required to exercise a greater degree of judgement in assessing the rule's objectives and whether the information given meets that requirement. In the latter example, the application of the rule is more "mechanical" and less subjective.

Where a rule is detailed, there is thus less room for decisions as to its meaning and application than where the rule is vague and imprecise. In the former case the rule's applier may only need to evaluate whether or not the rule applies. In the latter the rule's applier has to interpret the rule, assess its objectives and determine how to achieve them.⁸³ The rule maker therefore has to consider whether he or she wants to allow greater discretion at the point of the rule's application or not. Such an approach confers certain advantages to the rule maker. It enables him or her to postpone the decision of the rule's actual application until a particular situation has arisen.⁸⁴ The rule maker is then not required to anticipate every circumstance in which the rule should apply, and the problems of rigidity are mitigated through the more flexible application which the structure of the rule permits. However, these efforts may mis-fire. Rules which are highly detailed and complex may actually afford greater discretion to the regulated. The more complex the rule, the greater may be the discretion available to decision makers in its interpretation and application. Breyer found in relation to the US Federal Communications Commission (which until 1965 had fourteen different criteria for granting licences) that "the effect of many standards...is virtually the same as having none at all.... The existence of so many

⁸³ For a discussion of the different types of discretion which may be involved in legal decision making, see Bell, *op.cit.*, pp.98-99.

⁸⁴ Presuming the rule maker, or rule making agency, is the principal enforcer and arbiter of the rules.

standards effectively allows the agency near total discretion in making a selection."⁸⁵ Studies of US tax legislation also suggest that rules which are very precise and complex may have the affect of creating discretion in practice.⁸⁶

Finally, rules could affect the exercise of discretion in unanticipated and unintended ways. Rules which aim to reduce or control discretion may in fact displace it to other areas of decision making within a legal system.⁸⁷ The structure of the rule could also affect discretion in a way that subverts the purpose of the rule. Enforcement studies have shown that where officials are responsible for enforcing both bright line rules and more qualitative rules, it is the former which are enforced, with a result that the achievement of policy goals is skewed in favour of those regulated through clear and precise rules.⁸⁸ We will see throughout the subsequent chapters how the rule makers have perceived and dealt with these issues.

The interpretation of the rule

As we have seen, rules as well as facts need to be interpreted before their application to a particular circumstance can be determined. Rules are inherently uncertain given the open texture of language. The indeterminacy or uncertainty of rules may be an unavoidable consequence of language, the "disorderly nature of words",⁸⁹ but it is also a function of the rule itself. Rules may be more or less uncertain depending on their structure and the language which they use. In employing terms which are ambiguous or require judgement in their application, for example, "reasonable", "fair" or "due process", the uncertainty of the rule is increased.⁹⁰

Rules which are more similar to standards thus have different implications for the

⁸⁵ S. Breyer, *Regulation and its Reform* (Harvard, 1982) pp.78-9.

⁸⁶ S. Surrey, "Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail", (1969) 34 *Law and Contemp. Probs* 673.

⁸⁷ Baldwin and Hawkins op.cit., pp.582-3 and Hawkins (1992), op.cit., p.36.

⁸⁸ See Hawkins (1984) op.cit., and R. Baldwin, "Why Rules Don't Work", (1990) 53 *MLR* 321.

⁸⁹ Hart and Sachs, op.cit., p.125.

⁹⁰ See K. Kress, "Legal Indeterminacy", (1989) 77 *Calif LR* 283.

decisional jurisdiction of the regulated or applier of the rule than detailed rules. The rule maker therefore has to consider when deciding what structure a rule should have how the rule's applier will use any decisional jurisdiction which he or she is given, and whether or not the rule maker wishes to permit such latitude in the application of the rule. The rule maker, in other words, has to consider the mode of interpretation which will be used. Although the debate over interpretation occurs principally in the jurisprudential context, and within that the focus is almost uniquely on the judiciary as rule appliers and interpreters, modes of interpretation are important for the administrative rule drafter. Rule makers undoubtedly conceive of rules as instruments of policy. They also have to consider rules as reasons for action in themselves, however. It is because the rule will stand and be interpreted according to its language that a rule maker has to pay attention to his or her formulation of the rule. The rule maker may want to promote a purposeful interpretation of the rule to counter a formalist approach which may be adopted by the regulated, officials or judges. Empirical studies have shown that some officials may adopt formalist approaches as part of the routinisation of decision making.⁹¹ Other work indicates how rule addressees adopt formalist approaches to avoid the substantive effect of the rule.⁹² Forming rules for Holmes's "Bad Man" may thus prompt the rule maker to draft rules which have injected into them a degree of their substantive purpose.⁹³

Rules which have the structure of standards may also be used to avoid the disadvantages of rigidity and "unfair" applications of the rule. The rule maker may prefer to permit considerations of the purposes of the rule in its application by indicating in the rule that such an approach is to be taken. Rules which use more opaque terms, such as "reasonableness", "fairness", "due course" are requiring such judgements to be made in their application. They thus permit for a wider range of circumstances, factors and considerations to be taken into account at the point

⁹¹ Bardach and Kagan, *op.cit.*

⁹² D. McBarnet and C. Whelan, "The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control", (1991) 54 *MLR* 848.

⁹³ This issue is related to a further implication considered below: compliance with the rule.

of application than more detailed rules. Choosing more detailed rules is a decision to exclude the purposes of the rule or other factors in the rule's application; the use of standards is a decision to permit these factors some relevance.

Predictability and certainty

Alternatively, the rule maker may wish to use more detailed rules in an attempt to provide predictability, which is after all one of the main acclaimed advantages of rules. Rules are predictable if those relying on a rule may identify certain situations as instances of the general category prescribed for by the rule, and decision makers and the regulated have the same perception of the application of the rule and know that each has this perception.⁹⁴ So the more clearly and precisely the rule maker defines the fact situations covered by the rule and the required or prohibited conduct, the easier the determination of whether a particular situation is one covered by the rule.⁹⁵

There are two problems with providing predictability, however. The first can be discerned from the above discussions of discretion and interpretation: detailed rules could lead to rigidity and incongruence in their application. Standards provide less *ex ante* indication of the rule's application through providing more *post hoc* flexibility. The rule maker may prefer to provide for less predictability in order to attain greater congruence between the application of the rule and its purpose. Secondly, it is not immediately apparent what form of rule provides the greatest predictability in a given circumstance. Rules which are clear and precise may be predictable. However, the more complex a rule becomes the more uncertain it may become. There may be a point at which rules become so complex or precise that they become unpredictable in their application. A mass of complex rules may thus create as much unpredictability as a standard, and

⁹⁴ Schauer (1988), *op.cit.*, p.540.

⁹⁵ With the proviso that the facts may still need interpreting to see if they in fact are a particular instance of the generalisation contained in the rule.

its compliance-enhancing effects will correspondingly be reduced. This has been a criticism of, for example, the US tax code.⁹⁶ It was with this view in mind that Llewellyn used standards rather than detailed rules in his drafting of the US Commercial Code as he felt that imprecise, opaque and simple rules, "the rule with the singing reason", would provide greater predictability than hundreds of pages of "labyrinthine annotations".⁹⁷ We will see in Chapters 4 and 5 how the rule structure was changed in an attempt to reduce the complexity of the rules, and so increase certainty over their application.⁹⁸

Compliance implications

The compliance effects of different types of rules has been the subject of attention of a range of different writers. Some argue that detailed rules are more facilitative of self-application than standards.⁹⁹ Others suggest that the simpler the rule the more likely it is that the principle embodied in it will be adhered to.¹⁰⁰ As we will see in Chapter 4, this view has been particularly influential in rule making in financial services.

Some law and economics writers argue for detailed rules on the grounds of the consequent enhanced ability to predict the rule's application.¹⁰¹ Perfectly detailed sets of rules may discourage socially undesirable and encourage socially desirable behaviour, so bringing society nearer to its desired allocation of resources by affecting the primary behaviour of those subject to

⁹⁶ Surrey, op.cit., and S. Long, "Social Control and Civil Law: The Case of Income Tax Enforcement", in H.L. Ross (ed) *Law and Deviance* (California, 1981).

⁹⁷ Llewellyn (1960), op.cit. For Llewellyn's theory of rules, see K. Llewellyn, *Jurisprudence* (Chicago, 1962), Chapter 15 and W. Twining, *Karl Llewellyn and the Realist Movement* (London, 1973), Chapter 12. For the argument that the USCC is an expression of Llewellyn's theories, see R. Danzig, "A Comment on the Jurisprudence of the USCC", (1975) 27 *Stanford LR* 621.

⁹⁸ For a similar view see C.E. Schneider, "Discretion and Rules: A Lawyer's View", in Hawkins (ed), op.cit.

⁹⁹ See D.J. Gifford (1971) op.cit.

¹⁰⁰ See Schneider, op.cit.

¹⁰¹ Ehrlich and Posner, op.cit., and R.A. Posner, *An Economic Analysis of Law* (Boston, 1986), ch.20.

the rule.¹⁰² This is because detailed rules increase the probabilities, as perceived by an actor, that non-compliance with the rule (undesirable behaviour) is punishable, and compliance (desirable behaviour) is not. Johnston calls this an "artificial incentive" to comply, because compliance reflects not the social costs and benefits of actions in a particular case, but the rule's determination of liability.¹⁰³ Where complying with a rule imposes more cost on a person than not complying, he or she will breach it.

Costs are determined by weighing the value of the non-complying activity to the actor against the cost of punishment for non-compliance. Ehrlich and Posner argue that the cost of punishment is dependent on the likelihood of apprehension, and the likelihood that the activity will be found to be covered by the rule.¹⁰⁴ The greater this possibility, the greater the cost of non-compliance. Rules which are certain or predictable in their effects, therefore, will be more effective at discouraging undesirable behaviour than those which are not. This is particularly so if the sanction is punitive and the costs of transacting around the rule, that is ordering one's affairs so as not to infringe the rule, are high.¹⁰⁵ However, if the rule is uncertain in its effects, this may result in over-compliance as it will be less clear that mere compliance will be sufficient,¹⁰⁶ and activity which falls within the penumbra of the rule will be discouraged.¹⁰⁷ This is particularly so if the activity has no private value, and especially if the activity is also socially desirable: for example the expression of ideas.¹⁰⁸ Moreover, rules are never perfect, they are always either over- or under-inclusive. Over-inclusive rules should be avoided where they may deter socially desirable behaviour;¹⁰⁹ under-inclusive rules pose the risk of loopholes and should

¹⁰² Ehrlich and Posner, op.cit. p.262.

¹⁰³ J.S. Johnston, "Uncertainty, Chaos, and the Torts Process: An Economic Analysis of Legal Form" (1991) 76 *Cornell LR* 341 at 349-357.

¹⁰⁴ Ehrlich and Posner, op.cit., p.262.

¹⁰⁵ Ibid., pp.268-9.

¹⁰⁶ Johnston, op.cit. p.352.

¹⁰⁷ See also, Gifford (1971), op.cit., pp.426-30.

¹⁰⁸ Ehrlich and Posner, op.cit., p.263.

¹⁰⁹ Ibid.

therefore be backed by over-inclusive rules, though this mitigates against their predictability.¹¹⁰

Diver develops this theory and argues that increasing the complexity and precision of a rule may make it more predictable, and so increase the incentives for compliance.¹¹¹ So where there are compliance problems, more detailed rules should be used. This may arise in relation to regulating conduct (as opposed to licensing rules) where the rule is directed at an audience which is large, diverse and remote, or where the incentives for non-compliance are otherwise high, for example where compliance with the rule requires a person to forgo considerable benefits, or where non-compliance is difficult to detect.¹¹² However, he does not consider that the more complex the rule, the less easy it is to remember what its requirements are, and so compliance, even if intended, may be more difficult to achieve.¹¹³

Compliance may not be intended by the regulated, however. McBarnet and Whelan have shown that those who are subject to the rule may deliberately adopt a literal interpretation to avoid legal control.¹¹⁴ "The combination of specific rules and an emphasis on legal form and literalism can be used artificially, in a manipulative way to circumvent or undermine the purpose of regulation...detailed rules contribute to the defeat of legal policy."¹¹⁵ A rule maker may then have to formulate the rule in more vague terms, referring to more substantive notions of "reasonable" or "fair" in an attempt to inject more of the underlying purpose into the structure and form of the rule and so pre-empt this behaviour or "creative compliance".

¹¹⁰ This effect is enhanced if certain attitudes of actors are presumed. If rule compliers are risk averse, and rule breakers are risk preferring, the more unpredictable the rule, the more rule compliers will over comply. Risk preferers will however carry on conduct which falls within the penumbra of the rule, as the likelihood of that the rule will be found to apply to them will have decreased. Ehrlich and Posner, *op.cit.* p.262.

¹¹¹ Diver (1989), *op.cit.*, pp.223-5.

¹¹² *Ibid.*, p.223.

¹¹³ Gifford (1971) *op.cit.*

¹¹⁴ McBarnet and Whelan, *op.cit.*

¹¹⁵ *Ibid.*, p.849.

Costs

Forming rules involves costs of obtaining and evaluating information on the instances when the rule should apply, which increases with the complexity or heterogeneity of the subject matter or conduct which is sought to be regulated. It also involves the transaction costs of negotiation, which will increase with the number of people involved, and the extent of the differences in view between them. Economists use these considerations to predict when different types of rules will be formed. When transaction costs are high, for example, economists argue that rules which require less agreement to be reached in their formation will be made, and on this basis explain the decision of legislatures to delegate rule making powers to agencies to deal with the issue, thereby shifting the rule making costs to the agency.¹¹⁶

Rules also involve costs in their application, both to the agency and to the regulated. To the agency, standards may be costly to apply due to a need for further elaboration and clarification by the agency. Detailed rules may avoid this cost. However, if the rule or system of rules becomes so complex that it is uncertain what the rules require in a particular situation (see above) then further interpretation and elaboration may be necessary. Detailed rules may also involve costs where the substance of the rule is one of great complexity and diversity, and subject to changing conditions. In this situation, the rules will either have to be frequently updated and amended, with costs to both the agency and the regulated, or the agency will have to mitigate the effect of these rules through the use of waivers and exceptions, which could be costly to the agency.¹¹⁷

Ehrlich and Posner argue that detailed rules improve the efficiency of the legal system by increasing the probability of convicting the guilty and acquitting the innocent. They reduce the cost of law enforcement activities and encourage settlement rather than litigation of legal disputes by making it easier to predict the outcome. They also increase the speed of legal dispute

¹¹⁶ See Posner, *op.cit.*

¹¹⁷ For the use of exceptions and waivers in mitigating the effect of rules, and the costs to the agency of operating such a process, see P.H. Schuck, "When the Exception Becomes the Rule: Regulatory Equity and the Formulation of Agency Policy through an Exceptions Process", (1984) *Duke LJ* 163.

resolution.¹¹⁸ Detailed rules, economists further argue, can also facilitate the efficient allocation of rights and duties when private parties are contracting between themselves, and so reduce uncertainty about the behaviour of the other party. Uncertainty poses a cost as it increases the costs to private transactors to transact around the rule, and therefore affects the efficiency with which society transacts its business.¹¹⁹ Uncertainty about law also redistributes income as some income groups can cope with these costs better than others.¹²⁰

Diver uses such a cost/benefit analysis to develop a model to predict and explain the use of different types of rules on the basis of transaction costs, both in forming and applying the rule. On the assumption that the costs of forming a rule increase with the number of persons involved he predicts that rules thus formed will tend to be more opaque, imprecise and simple. The number of persons involved in interpreting and applying the rule will also affect the transaction costs in applying the rule. Where the number of persons involved is high, for example liability rules which are interpreted by the regulated as well as enforcement officials, rules should be more opaque. Where only a few are involved in interpreting and applying the rules, for example, sanctioning rules, the rule can be more detailed. Similarly, licensing rules, which are addressed more to licensing officials than the general population, can afford to be more detailed than prohibitory rules.¹²¹

Enforcement implications

Studies of regulatory enforcement have indicated that enforcement should be recognised as a serial, incremental and continuing process relying heavily on negotiated conformity and concerned with the attainment of the goals of the legislation and the prevention rather than

¹¹⁸ Ehrlich and Posner, op.cit.

¹¹⁹ See W.Z. Hirsch, "Reducing Law's Uncertainty and Complexity", (1974) 21 *UCLA LR* 1233.

¹²⁰ Hirsch is only concerned with the "facilitative" technique of law (see Summers, above) and so evaluates the costs and benefits of rules only in the context of private ordering.

¹²¹ Diver (1983), op.cit. pp.77-79.

sanctioning of a breach, "with repair and results, not retribution".¹²² Agencies tend to adopt a style of enforcement which relies on negotiation, bargaining, education and advice. The use of formal legal methods, particularly prosecution, is seen as a last resort, even a failure.¹²³

Different types of rules may impede this enforcement process in a variety of ways of which the rule maker may need to be aware. Rules will inevitably be over-inclusive and their application may in some circumstances not further the rule's objective. This over-inclusiveness and formalistic approach to interpretation could be heightened by a wide scope and precise and complex requirements.¹²⁴ Such rules may need to be accompanied by the grant of discretion in their enforcement, or the ability to issue waivers or exceptions.¹²⁵ This may be necessary either to mitigate their effects, or to facilitate the negotiated approach to enforcement adopted by agencies.¹²⁶

Vague and imprecise rules may also affect the enforcement process by providing an insufficient definition of the aims and policy of the rule, so requiring greater interpretation by officials. This may affect the consistency with which the rule is applied and co-ordination between officials in enforcement. Hawkins and Thomas argue that such rules may fail to recognise the limited ability of both officials and the regulated to cope with uncertainty.¹²⁷

From his study of the enforcement of health and safety legislation, Baldwin concludes that "[e]ffective rule use demands that those who design rules take into account the enforcement strategies that will have to be used to achieve compliance."¹²⁸ However, he also concludes that "the role of the rules and the nature of the optimal rule differs according to a number of variables,

¹²² Hawkins (1984) op.cit., p.4.

¹²³ See generally Hawkins (1984) op.cit.; Richardson et al., op.cit., Hutter op.cit., and for a study of a US agency, R.A. Kagan, *Regulatory Justice* (New York, 1978).

¹²⁴ See above.

¹²⁵ On the mitigation of over-inclusive rules through the granting of waivers and exceptions, and the costs involved, see Schuck, op.cit. On the use of this approach by the SEC, see Diver (1989) op.cit.

¹²⁶ See Hawkins and Thomas, op.cit., and Baldwin (1990), op.cit.

¹²⁷ See Hawkins and Thomas, op.cit.

¹²⁸ Baldwin (1990), op.cit., p.337.

notably the favoured enforcement strategy, the type of regulatee and the type of hazard."¹²⁹ The empirical evidence as to what enforcers themselves prefer varies. Baldwin shows that rule makers and enforcers may have different perceptions of the virtues of different types of rules. Whilst the former may prefer vague and imprecise rules, an enforcement official may wish to be able to adopt a literal approach to facilitate enforcement and so require "bright line rules" which clearly stipulate the behaviour required and consequences of non-compliance.¹³⁰ Hutter found that whilst some officials did not like the responsibility of having to interpret ambiguous rules and preferred to work with closely defined standards, many felt that it would be impossible to work with closely defined rules and preferred rules which were sufficiently flexible to be applicable to a variety of situations.¹³¹ Contrary to the findings of Hawkins and Richardson, she found that the consequent lack of uniformity or tensions between equity and efficiency in application did not exert a significant influence over the enforcement process.¹³²

Finally, if the rule is uncertain in its application it may fail to provide the legitimization and moral authority an enforcer needs in areas where breach of the rules involves conduct which is not regarded as morally reprehensible. Hawkins has stressed the extent to which the enforcement approach is shaped by the moral ambivalence which characterises regulation itself, and which affects both the legitimacy of enforcement agencies and the light in which regulatory rule breaking is viewed.¹³³ This moral ambivalence surrounding the enforcement, Hawkins argues, compels the use of a compliance approach to enforcement as it maintains the consent of the regulated where there is ambivalence about an enforcement agency's legal mandate.¹³⁴ "Bright line" rules may afford the enforcement official clear legal authority, but the structure of the rule cannot

¹²⁹ Ibid., p.328.

¹³⁰ Ibid.

¹³¹ Hutter, op.cit.

¹³² Ibid., p.60-61. Hawkins (1984), op.cit., pp.24-26 and Richardson *et al.*, op.cit., pp.96-105.

¹³³ Hawkins (1984) op.cit.

¹³⁴ Ibid., p.127.

resolve this fundamental issue.

Factors influencing Rule Making

The above study of rules and the implications of different types of rules for the distribution of discretion and decision making power within a system of rules, for a rule's interpretation, the costs to the agency and regulated of rules, and the compliance and enforcement implications of rules indicates the range and complexity of the decisions involved in rule making. Rule makers may pay attention to these implications, they may not. Baldwin has shown that they frequently ignore the enforcement implications of rules, for example.¹³⁵ The extent to which these implications are considered in the formation of rules is indicated in the studies contained in the subsequent chapters, and extends to the formation of the enabling legislation as well as the regulatory rules. The final section of the chapter focuses on rule making as a type of decision making and explores the wider factors which may influence the rule making process, providing indicators of the type of considerations which the subsequent chapters will show have been influential in financial services rule making. As we will see in chapters 4-7 these factors may have a direct or indirect influence on any of the rule's dimensions and determine on which aspect of the rule agency attention is focused.

Rule Making as Decision Making

Galligan classifies decisions into four types: adjudication, modified adjudication, specific policy issue and general policy issue. Rule making may be seen to fall within this fourth category: "decisions of general policy, the object normally being to formulate general [ie non-individualistic] standards of varying degrees of specificity for application in future cases."¹³⁶

¹³⁵ Baldwin (1990), op.cit.

¹³⁶ Galligan op.cit., p.115.

The decision is concerned with future planning and the emphasis is on the wide representation of interests.¹³⁷

Although agencies are operating within the bounds of their enabling statutes, these may place limitations on the actions of the agency, but they do not determine them.¹³⁸ Decisions are made within an organisational, social and political context with which the decision making process has a complex interrelationship. This analysis of decision making is based on the observations of decision making theories built on empirical studies of decision making within bureaucracies. These studies have been concerned with the enforcement of legal rules, particularly in the context of environmental regulation,¹³⁹ and the view of decision making which they suggest may run counter to that presumed to be involved in rule making. One of the perceived advantages of rules, as noted above, was that it involved a superior mode of decision making, one which involved the rule maker in collecting information, analysing the problem and possible solutions and thus arriving at a conclusion. As such, the perceived model of rule making corresponds to the rational model of decision making. In that model, the probable causes of the issue are identified, the goals clarified and ranked, information collected, possible solutions analysed and their consequences predicted, and that which comes closest to achieving the goal is chosen.¹⁴⁰ The non-feasibility of such an approach has long been recognised.¹⁴¹ Early modifications preserved the same presumptions about organisations and decision making, however. Even within Simon's more limited notion of "bounded rationality", a decision maker would consider the goals to be achieved, options open, constraints, consequences and trade offs and then "satisfice", that is accept certain

¹³⁷ Ibid., p.116.

¹³⁸ See Hawkins (ed), op.cit.

¹³⁹ Hawkins (1984), op.cit., Richardson, op.cit., Hutter, op.cit.

¹⁴⁰ See, eg G. Edwards and I. Sharansky, *The Policy Predicament: Making and Implementing Public Policy* (1978), C.S. Diver, "Policy Making Paradigms in Administrative Law", (1981) 95 *Harvard LR* 393. It is this type of decision making which has been required in the US by the Reagan Regulatory Impact Analysis and other impact statements.

¹⁴¹ For discussions of the evolution of decision making theories see Galligan, op.cit., pp.117-128; Hawkins (1992), op.cit.

constraints and make her decision on the basis of limited knowledge, and choose a course which leads to a reasonable accomplishment of objectives.¹⁴²

Rational decision making has been traditionally criticised by those who argue that organisations proceed on an incremental basis, making marginal adjustments to existing situations.¹⁴³ The emphasis is on finding solutions to particular problems. The method used is not a rational overview of all available alternatives, but an accommodation of conflicting interests and considerations within an established pattern of decision making.¹⁴⁴ Only a restricted number of policy alternatives and consequences are envisaged or reviewed. Analysis may be fragmented between different participants, limited to a few familiar alternatives and only some consequences explored. Goals and values may be intertwined with the empirical aspects of the problem, means and ends chosen simultaneously. Apart from the logistical or practical difficulties associated with rational decision making, administrators may not have the resources to search out the rational decision or achieve it, nor can they know the full consequences of any action. The rational model has also been criticised on the grounds that it is based on empirically questionable preconceptions about decision making.¹⁴⁵ Firstly, legal institutions or decisions rarely, if ever, have a single or clear set of purposes. Secondly, the model presumes a one-off decision making process exercised by autonomous individuals. Critics argue that this is a misconception of the nature of decision making. Decision making processes are cumulative and complex, constrained by a variety of organisational factors and norms, and involve a number of persons often with conflicting views.¹⁴⁶ Further studies have argued for an increasingly complex conception of decision

¹⁴² H. Simon, *Administrative Behaviour* (New York, 1945).

¹⁴³ See C. Lindblom, "The Science of Muddling Through", (1959) 19 *Pub Admin Rev* 79.

¹⁴⁴ For discussions of the two approaches, see for example Galligan, op.cit., pp.117-128, C. Ham and M. Hill, *Policy Process in the Modern Capitalist State* (London, 1984), Chapter 5, and G. Smith and D. May, "The Artificial Debate between Rationalist and Incrementalist Models of Decision Making", (1980) 8 *Policy and Politics* 147.

¹⁴⁵ Hawkins (1992), p.22-7, passim.

¹⁴⁶ See the studies contained in Hawkins (ed)., op.cit.

making which stress the natural processes by which decisions are made.¹⁴⁷

The decisions involved in rule making are likely to be influenced by a wide range of factors, not all of which will be of equal importance at any one time.¹⁴⁸ We may identify several broad groups of factors which may influence the decision making process: the substantive framework, political considerations, organisational factors, decision making procedures and the norms of agency officials and the community. This list is not exhaustive, and the factors interact and overlap - their separation and categorisation here is for ease of organising the material rather than necessarily representing analytical distinctions. We will see in the subsequent chapters and assess in the conclusion the extent to which these have influenced rule making in financial services regulation.

The Substantive Framework

In the context of a regulatory agency, this refers both to the terms of the enabling legislation and the area of social activity at which the legislation is addressed. The enabling statute is frequently regarded as the source of legitimacy for the agency and its actions. "Organisations with specific legal constraints operate with a mandate of public trust that serves as a tacit ground or set of rationalisations for their decisions."¹⁴⁹ The terms of the legislation are often difficult to interpret, however, and their meaning difficult to assess. The goals of the agency may be unarticulated or may conflict. The powers may be incoherently defined. This affects the legitimacy and accountability that the legislation may provide to the agency's activities.¹⁵⁰

Even where the statement of objects and purposes may be clear, interpretation and

¹⁴⁷ For a discussion of the naturalistic approach to decision making, see Hawkins (1991) op.cit., "Discretion in Making Legal Decisions", (1986) 43 *Washington and Lee LR* 1161 and P.K. Manning, "Big Bang Decisions: Notes on a Naturalistic Approach", in Hawkins (ed), op.cit.

¹⁴⁸ Some theories of agency decision making place one particular set of factors: the demands of interest groups as the primary, if not sole, determinant of agency decisions. See for example, Wilson, op.cit. developing the models of the economic theorists Stigler, op.cit., and Peltzman, op.cit.

¹⁴⁹ Manning, op.cit., p.257-8.

¹⁵⁰ See Baldwin and McCrudden, op.cit., Chapter 3.

decisions as to the means to be adopted in achieving those purposes is necessary. The legal framework is thus interpreted by the official, and may in turn affect his or her approach to the means to be adopted or goals achieved. It is thus in a reciprocal and reflexive relationship with the attitude and interpretation of officials.

The substantive context in which the agency is operating: pollution, anti-discrimination, monopolies, financial services, will inevitably influence the decisions involved in rule making. It will influence the weighing of different policy considerations and agency goals in the decision process, and may have an affect on what information is collected by the agency. This in turn will depend on the representation of different interests in the policy process, which may vary with the substantive area. If the area to be regulated is highly technical, costs of collecting information will be high and the likelihood is that consumers will be under-represented.¹⁵¹ The costs to the agency of evaluating the information will be correspondingly high, and the complexity of the area to be regulated and its heterogeneity may also delay the formation of rules as the agency may not be sure of what decision it should make. It may also have an effect upon the structure of the rules, and the rule system, which may increase with the complexity and heterogeneity of the subject matter being regulated.¹⁵²

Political considerations

This is a broad heading which includes the history of the agency and the reasons for its creation. The conditions under which the agency was formed may have determined its organisational or insitutional structure, its powers and remit and its formal relationships with other agencies. It thus embraces the situation of the agency within the governmental framework and its accountability to other political actors.

Political considerations also include less tangible factors: the perceptions others, including

¹⁵¹ See P.C. Yeager, *The Limits of the Law* (Cambridge, 1992).

¹⁵² See in relation to US tax legislation Surrey, op.cit.

political actors and those subject to the regulation, have of the agency. As Galligan observes, they "may derive from a multitude of informal sources and produce effects which are of the variable and intractable kind."¹⁵³ They may refer to conceptions of the agency's legitimacy. The delegation of responsibility to an agency does not mean that the agency is then perceived as legitimate, nor does it avoid the "agency problem": the means by which the delegating body can ensure that the agency fulfils that authority's aims and goals. This problem may have been addressed by imposing a particular structure on an agency¹⁵⁴ or requiring particular forms of oversight and control.¹⁵⁵

Political considerations also include the expectations of what the goals of the agency should be, what it should achieve, the means which it should use and the approach it should have to its task. Agencies frequently operate between two broad constituencies with competing views about the proper role of government intervention in the economy. This fundamental dilemma will necessarily have been encountered in the agency's formation and although its resolution or compromise may not be spelt out in the agency's substantive framework it will usually have exerted a strong influence on its form, structure and powers, and have a continuing influence on the definition of goals and operation of the agency. The implications of these factors for the financial services regulatory system are explored particularly in Chapters 3 and 4.

Organisational factors

Organisational factors may take two forms: those relating to the internal organisation of an agency, including its decision making procedures, the structure of an institution or agency and the arrangement of its personnel, and those relating to the relationships between organisations,

¹⁵³ Galligan, *op.cit.*, p.132.

¹⁵⁴ See M. McCubbins, R. Noll and B. Weingast, "Administrative Procedures as Instruments of Political Control", (1987) 3 *J Law, Econ & Organization* 243; R. Calvert, M. McCubbins and B. Weingast, "A Theory of Political Control of Agency Discretion", (1989) *Am J Pol Sci* 588.

¹⁵⁵ For a discussion of the various forms and their merits, see Baldwin and McCrudden, *op.cit.*, Chapter 3.

inter-organisational or institutional factors. The influence of the former type of organisational factors on agency decision making has long been recognised. The rationalist and incrementalist theories of decision making were concerned primarily with the structures of organisations, the forces operating within them and external influences on them.¹⁵⁶ More recent empirical studies have argued that these involve an individualistic approach to agency decision making which is unfounded, and have focused on organisational factors in a manner which stresses the cumulative and collective nature of the decision making processes,¹⁵⁷ where the history and background of a decision and its significance for future decisions will both affect how it is made.¹⁵⁸ Enforcement studies have shown the impact these factors can have on the exercise of discretionary powers.¹⁵⁹ The authority which officials have over one another, the extent to which they have autonomy, the level at which decisions are made, the competence of staff and the extent to which powers are diffused and decentralised may all influence the approach taken within any organisation to decision making.¹⁶⁰ Policy analysis studies have indicated the impact of a "top-down" approach to policy formation, where policy is made and then handed down for implementation.¹⁶¹ Policy makers underestimate the problems of implementation and thus minimise the policy making role of enforcers. Alternatively they may deliberately leave the enforcer discretion to apply the rule to avoid the difficulties, and costs, of forming clearer and more precise rules on an issue. However, information flows within the organisation may be such that rule or policy makers are not aware of experience and difficulties of enforcers, and so may

¹⁵⁶ See M. Weber, *Economy and Society*, ed. G. Roth and C. Wittich, (New York, 1968), Simon, op.cit., Lindblom, op.cit.

¹⁵⁷ Hawkins, op.cit., Manning, op.cit.

¹⁵⁸ Ibid.

¹⁵⁹ Hawkins (1984), op.cit., Richardson, op.cit.

¹⁶⁰ See Galligan, op.cit. p.134.

¹⁶¹ For a summary, see Ham and Hill, op.cit. On the distinction between policy and implementation, see for example, S. Barratt and C. Fudge (eds), *Policy and Action* (London, 1981).

not form a rule where one would aid the enforcement process.¹⁶²

Inter-organisational or institutional factors may also affect the rule making process. These refer to the relationships between two or more agencies which may be involved in regulating the same or overlapping areas. Decisions may be made in a network of regulatory agencies, each of which has its own autonomous drive for maintaining its own mandate, discretion and boundaries.¹⁶³ The nature and shape of the hierarchy of power between the organisations and the extent to which power is centralised may affect the individual and collective decisions of these organisations. Organisations may be located within a complex network of inter-organisational relationships which constrain the options of each organisation or decision makers within it, and which may reflect the political processes operating internally.¹⁶⁴

Decision Making Process

The rule making procedures of agencies may affect the substantive content of their rules, and may in turn be affected by organisational and inter-organisational or institutional factors. In addition to including such considerations as information flows within the organisations, these include the formal procedures which an agency may have to follow when making one particular type of decision, namely forming rules, the powers that one agency within a network of agencies may have over another, and the informal processes which an agency may choose to adopt. Studies of rule formation by UK regulatory agencies have stressed the significance of these factors on the rules which are made by the agency.¹⁶⁵ These can affect the rule on all its dimensions. For

¹⁶² See D.S. Van Meter and C.E. Van Horn, "The Policy Implementation Process", (1975) *Administration and Society* 455, 456.

¹⁶³ See Manning, *op.cit.*, p.255.

¹⁶⁴ L. Clarke, *Acceptable Risk?* (California, 1989).

¹⁶⁵ See C. McCrudden, "Codes in a Cold Climate: Administrative Rule-making by the Commission for Racial Equality" (1988) 51 *MLR* 409 and "The Northern Ireland Fair Employment White Paper; A Critical Assessment" (1988) 17 *ILJ* 162; I. Ramsay, "The Office of Fair Trading: Policing the Consumer Marketplace" in R. Baldwin and C. McCrudden, *op.cit.*, ch.9, R. Baldwin "Civil Aviation Regulation" in *ibid.*, ch.8 and "Health and Safety at Work: Consensus and Self Regulation", in *ibid.*, ch.7.

example, the negotiation process which surrounds the production of rules may change a short and relatively clear and simple statement into a more vague and possibly complex rule as interests are accommodated and controversies avoided.

Norms of agency officials and the community

This refers to the attitudes officials and the wider community to the agency's role and purposes. It includes the officials' perception of the position of the agency within the political system, and the values and goals which it should pursue.¹⁶⁶ Officials may have a sense of acceptable and unacceptable courses of action to take in the light of their own interpretation of the agency's role and purpose. The norms and attitudes of officials may thus affect their interpretation of the substantive legal framework. Officials may be rational actors motivated by their own self-interest which may be manifested in a variety of ways.¹⁶⁷ This may be a desire for subsequent appointment in the industry being regulated (the "revolving door" phenomenon), a desire to expand the remit and area of the regulatory agency, and other forms of private gains. These may include the satisfaction of individual ideals as well as more direct gains.¹⁶⁸ Officials may have their own values, expectations, agendas and morals. Indeed, Hawkins argues that "assessments of moral character made by legal decision makers are one of the most pervasive and persistent features in shaping the exercise of discretion."¹⁶⁹ Officials may also be influenced by the perceptions of others within the agency on what particular courses of action should be taken in certain circumstances. Alternatively, different groups of officials may have different norms depending on their backgrounds, views or positions within the agency which may impact on the activities of the agency. Katzmann, for example, has shown the impact of the different approaches and

¹⁶⁶ See P.H. Scuck, "Organization Theory and the Teaching of Administrative Law", 1983 *Journal of Legal Education* 13.

¹⁶⁷ A. Downs, *Inside Bureaucracy* (Boston 1967); W.A. Niskanen, *Bureaucracy and Representative Government* (Chicago, 1971).

¹⁶⁸ Downs, *op.cit.*

¹⁶⁹ Hawkins, (1992) *op.cit.*

priorities of lawyers and economists on the operation of the Federal Trade Commission.¹⁷⁰

The rule making decision specifically may be affected by the agency's perception of the function of the rule being made. The function of a rule may be to control officials within that agency, or control the behaviour and ordering of affairs of persons external to the agency: the regulated community. Who is the principal addressee of the rule, or the rule's audience, may affect the rule making decision. The rule's primary function may not be the control or influence of behaviour at all. It could be to distribute power within a system of authorities, or to send messages to third parties as to the legitimacy of enforcers' actions. Alternatively, the purpose of the rule could be to indicate to the regulated and wider community a change in the agency's approach to its task. Finally, there may be a recognition by the agency of the limits of rules in performing the desired function: it may not be possible to formulate a rule detailed enough to deal with the situation satisfactorily.

The community's perceptions of the agency may also affect its decision making. The community includes both the regulated and the wider community who may observe the agency's activities. The perceptions of different sectors of the community may differ, both as to the nature of the agency's role and in their assessment of its actions. These differences may arise between the regulated and the outside community, and/or within each and may be related to the agency's legitimacy, the nature of its role, and judgements as to the approach it should be taking and the means it should be using. These may be made known to the agency in direct or indirect ways: the views of the regulated may be made known directly to the agency through a formal or informal consultation process and the attitude of the wider community may be communicated through the media. How they affect the agency's decisions may depend on a complex interaction of factors, including the agency's own perceptions of their significance and importance, and its assessment of their impact on the agency's status and legitimacy.

¹⁷⁰ R.A. Katzmann, *Regulatory Bureaucracy* (Harvard, 1980).

Conclusion

The thesis seeks to explain and analyse the formation of the conduct of business rules by the financial services regulators. This chapter provides a framework in which the empirical material contained in the subsequent chapters can be analysed and assessed. The chapter has explored the nature of the decisions involved in rule making and some of the factors which may influence that decision process. Through this discussion it indicates the complexity of rule making and trade-offs which have to be made between the various implications of different rule types. Decisions on a range of different aspects of rules need to be made and some aspects may be of greater concern for an agency and its rule makers than others at different times. Similarly, different factors may affect decisions to a greater or lesser extent depending on a wide range of variables. Some may exert an influence which is strong and continuing, others may be significant in some decisions but not in others.

This chapter has also explored the implications of using rules of different structure on the discretion of the rule's applier, the rule's interpretation, the issue of providing predictability, and the compliance effects and enforcement implications of different types of rules. It has also talked in general terms about the types of factors which may influence the rule making process. These should be viewed together with the discussion in the next chapter of the rationales for regulation and the type of regulation provided, which indicates some of the issues involved in determining the substance of rules in the financial services area.

Chapter 2: The Substantive and Institutional Framework

The substantive framework comprises the terms and objectives of the enabling legislation and the area of social or economic activity at which regulation is addressed; the institutional framework is the relationship between agencies involved in regulating the same area. These were suggested in Chapter 1 to be two of the factors influencing rule making, and the aim of this chapter is to indicate what these consist of in the financial services context. The chapter briefly describes the nature of the financial services markets and the individual SROs which are responsible for its regulation. It then indicates the scope of the regulation, the powers and relationships of the regulators, and the main provisions of the Act and regulatory rules. First, however, the chapter considers the rationales for regulation of financial services and the principal regulatory techniques which may be employed.

Rationales for Regulation

The most common justifications for regulation lie in the theories of social welfare economics. They are based on a belief that the state is capable of remedying market inefficiencies and securing socially desirable economic distributions, and can also protect the public from abuses of economic power. Regulation is thus prescribed, and justified, when there is market failure or abuse of market power, or economic redistribution is required. The identification of market failures and the appropriate remedies are disputed by economists, and the idea that regulation is promoted with the public interest of correcting these market failures as its main rationale is rejected by those who argue that regulation is in fact a good supplied by the state to (or withheld from) the highest

bidder (interest group or public choice theorists).¹ It is not the purpose of the thesis to test the empirical accuracy of the interest group theories. The economic, and more paternalistic, justifications will instead be highlighted. Even if they may not be explicitly taken into account by regulators, or policy may not be articulated in these terms, they indicate the nature of the issues which rule makers may encounter in forming the substance of the rules and may recognise that they have to address.

In the financial services markets, negative externalities, or costs borne by those other than the producer of the good, provide a key rationale for regulation.² Financial markets rely on confidence; if a firm either becomes insolvent, or is the cause of a loss of a large amount of investor's money through fraud or simply incompetence, confidence in the market as a whole is lost and other market participants suffer. The argument is particularly apposite in relation to banks. Banks are worth more as going concerns than they are in liquidation. A large scale withdrawal of funds from a bank may lead even a healthy bank to collapse. Loss of confidence may result in loss of business, or on a larger scale, a collapse of the whole system: systemic risk. Regulation is therefore necessary to prevent loss of confidence in the whole sector arising from the actions of one participant. Further, market confidence can be characterised as a public good: consumption by one does not reduce consumption by another, and if supplied to one, cannot be excluded from another. Because of these two attributes it is difficult to devise a way of charging the costs of public goods to their users; hence there is an argument for intervention and regulation. The form of intervention varies. Systemic risk is guarded against by requiring an institution to retain a prescribed amount of capital in proportion to its risk exposure, financial resources or

¹ See G. Stigler, "The Theory of Economic Regulation" (1971) 2 *Bell J Econ and Man Sci* 1, R.A. Posner, "Theories of Economic Regulation", (1974) 5 *Bell J Econ and Man Sci* 335, S. Peltzman, "Towards a More General Theory of Regulation", (1976) 19 *J Law and Econ* 211, and for an application in politics, J.Q. Wilson, *The Politics of Regulation* (Basic Books, New York, 1980).

² For a fuller account of the rationales of regulation and the UK's regulatory response, see D.T. Llewellyn, *The Regulation and Supervision of Financial Institutions* (London, 1986) and "The Changing Structure of Regulation in the British Financial System" in K. Button and D. Swann (eds), *The Age of Regulatory Reform* (Oxford, 1989), D. Gowland, *Regulation of Financial Markets* (London, 1990) and C. Mayer, *The Changing Structure of Financial Markets* (Amex Bank Review, Special Paper, 1987).

capital adequacy rules, by providing deposit protection which covers all deposits, or through the existence of a lender of last resort.³ The low levels of systemic risk in non-banking activities, particularly fund management, has prompted some to argue that the capital adequacy requirements should be correspondingly low.⁴ On an individual scale, client money regulation, limited deposit protection with a co-insurance element (as under the Banking Act 1987) and compensation schemes (the FSA Investor Compensation Scheme) have a consumer protection rationale and guard against individual financial loss.⁵

The second key rationale for much of financial regulation is information failure. In other words, the consumer, or buyer of the service, does not have sufficient information to make a rational decision. There are three specific problems: failures in markets for information, problems arising from imperfect price information and asymmetric information about product quality.⁶ The market for information will result in an under provision of information principally because information has the properties of a public good.⁷ Information is costly to produce, but it is difficult for the producer to restrict it to those who will buy the good, so the information will benefit both those who buy the good and those who do not. Others making similar products may also free ride on the information produced. There is therefore little incentive for producers to disseminate information. Even if information is provided, investors may be under informed as they face a number of costs in acquiring the information: of deciding what type of information is needed, searching for it, understanding it and testing it.⁸

The consequences of information failure are a failure in the price mechanism and a

³ C. Goodhart and D. Schoenmaker, *Institutional Separation between Supervisory and Monetary Agencies* (Special Paper No.25, LSE Financial Markets Group, 1993).

⁴ J. Franks and C. Mayer, *Risk, Regulation and Investor Protection* (Oxford, 1989).

⁵ Llewellyn, (1986) op.cit.

⁶ J. Kay and R. Vickers, "Regulatory Reform: An Appraisal", in G. Majone (ed), *Deregulation or Reregulation?* (London, 1990).

⁷ See above, and I. Ramsay, *Consumer Protection: Text and Materials* (Weidenfeld and Nicolson, 1989), Chapter 2 and *Rationales for Intervention in the Consumer Marketplace* (London, 1984).

⁸ Ramsay (1989), *ibid.*

depreciation of product quality. Markets need adequate information on prices, quality and terms to function efficiently.⁹ In the absence of information about a product, a consumer may make inefficient choices. Experience of a product may not be sufficient to inform a consumer, either because it is difficult to detect the benefits or defects of a particular product, or because the product is a one-off purchase. A consumer may find it difficult to assess the quality of a product, leading to competition between producers on other attributes, for example, price. This may lead to a general depression of quality in the market as the bad, but lower priced, products, drive out those which are of better quality but more expensive.¹⁰ Poor consumer information on the relative quality of goods may also result in consumers drawing the incorrect inference that a product has some unique quality which differentiates it from other, identical, brands.

These issues arise particularly in the financial services sector. In purchasing investment products or services, investors are relying on another to manage that investment and cause it to increase in value. The problem is exacerbated by the principal/agent problem, itself one of information and incentives. The principal/agent problem is taken from micro economics, where it is assumed that the two have differing objectives. The principal wants to induce the agent to act in the principal's interests but does not have full information about the agent's circumstances and behaviour. The principal therefore has a problem of controlling the agent's acts. The principal cannot successfully tell the agent what to do as he or she cannot fully observe whether the agent is complying. Presuming the principal cannot structure the agent's incentives so as to ensure he or she acts in the principal's interests, some form of external regulation and monitoring may therefore be required.¹¹

Monitoring problems arise particularly in fund management. Inadequate information

⁹ Ibid.

¹⁰ G. Akerlof, "The Market for "Lemons": Qualitative Uncertainty and the Market Mechanism" (1970) 84 *Quarterly Journal of Economics* 488. See J. Stiglitz and A. Weiss, "Credit Rationing in Market with Imperfect Information", (1981) 71 *American Economic Review* 393 for an application of the model to financial markets.

¹¹ See Kay and Vickers, op.cit.

means that investors cannot monitor a firms' handling of transactions, be they on a long or short term basis.¹² The incentives of an investor to monitor a firm are inadequate as others may benefit, and so free ride on that investor's efforts. The problem becomes more acute as the number of investors increases. As a result, an investor will have inadequate information about his or her exposure to risk of financial loss through dealing with that firm. The primary risk that the investor faces is fraud. Fraud causes the investor financial loss, but cannot easily be detected by him or her unless it results in the firm's default. However in this situation the investor probably will not be able to regain moneys lost. Monitoring problems also leave the investor open to less extreme causes of financial loss: firms dealing purely for the purpose of earning profits for themselves rather than the investor, or even simply failing to compensate the investor for loss caused by errors in executing transactions or delays in settlement, which may have resulted from a poor choice of counterparty by the investment management firm. Even if the investor is aware that he or she may not have received full performance from the firm under a contract, the cost of enforcing the contract may be prohibitive and so the loss will go unremedied.

The nature of the product also contributes to information failure. The products bought are highly complex and their quality is difficult to assess. Inter-product comparison is difficult both due to the complexity of the product bought, and particularly because the ultimate return on the investment is based on the future performance of the funds. The investor is therefore having to make a judgement on the investment skill of the producer or service provider. The investor may be able to assess this skill quite quickly, for example if he or she has a contract with a discretionary fund manager which provides him or her with frequent reports as to the value of the funds, and allows him or her to terminate the contract with no penalties. In relation to long term investment vehicles, however, the investor has to wait ten or twenty years before he or she will know what his or her ultimate return will be. Even then the investor may not be able to recognise the quality of return and assess whether another product would have been better. Reliance on the

¹² See Franks and Mayer, *op.cit.*, *passim*.

investment skill is therefore greater, yet it is very difficult for the investor to tell where the investment skill lies. Performance can vary widely between and within the different product types, and funds managed by the same institution can vary widely in their performance.¹³

As indicated above, these market failures may be greater in relation to some investors than others. There may be strong rationales for providing clear and detailed information to some investors but not to others who due perhaps to their position in the market have greater information as to the nature of the product or investment and are more aware of the risks involved. This is particularly pertinent in the financial services markets for, as the brief description of the markets below indicates, the investors in the financial services markets vary considerably in their knowledge and understanding. Certain types of regulation or different regulatory provisions may therefore be justified in, for example, the retail sector which have no economic justification in the wholesale sector.

Types of Regulation

There are a number of different regulatory techniques which may be employed to correct some of these market failures. Information provision is seen by some writers as the most appropriate form of regulation where information failure is the problem.¹⁴ Investors are left free to make their own decisions and the market is free to respond to consumer preferences. It also poses a less serious risk of harm if the regulators turn out to be wrong, as an information remedy will not force the market to make an inefficient change, as would a mandatory product change, for example.¹⁵

Disclosure alone may be inadequate for three reasons, however. First, the investor may

¹³ See for example, J. Mitchell, *Savings and Investments* (London, 1992), p.24.

¹⁴ See H. Beales, R. Craswell and S. Salop, "The efficient regulation of consumer information", (1981) 24 *Journal of Law and Economics* 491, and on the principle of matching regulation to market failure, see S. Breyer, *Regulation and its Reform* (Harvard, 1982).

¹⁵ Beales et al., *ibid.*

not be able to comprehend the information, and so is still reliant on the advice of another. Secondly, in the financial services area, similar rationales exist for regulating the types of investment an investor can invest in or otherwise providing protection against risk of loss as for providing product safety regulation: the consumer's under-estimation of risk. Here the rationales take on a more paternalistic hue and the criteria for regulation is what is an acceptable social risk.¹⁶ In financial services, the particular structure of the market makes it particularly susceptible to risk, however, providing an additional economic justification for regulation. Thirdly, the problem of monitoring still remains: the consumer cannot ensure that the firm is acting in accordance with the contract or the information it provided.

Requiring firms to have adequate capital resources against risk has a rationale in banking regulation, where the risks of systemic collapse are greater,¹⁷ but less rationale in other sectors of the financial markets where the collapse of one firm will not lead to a complete loss of confidence and threaten a collapse of the system.¹⁸ The provision of compensation has the disadvantage, for economists, of moral hazard. In other words, if consumers know that their money will be protected regardless of the fate of the firm to whom they entrusted it, they will not bother to assess the risks of the investment or firm before they enter into the transaction. Risk averse firms who produce lower investment returns may therefore suffer, and so will increase the riskiness of their investments, raising the level of risk of the market as a whole. This can be minimised if the compensation is provided by those responsible for monitoring a firm, however, as it will provide them with an incentive to pursue active monitoring to prevent a firm's failure, or if the consumer is not fully protected, and/or is required to pay an insurance element in the

¹⁶ See Ramsay (1989), *op.cit.*, pp.470-2.

¹⁷ Though economists have doubts as to the real possibilities of systemic risk due to the prevalence of central banks acting as lenders of last resort or otherwise arranging a rescue. See Goodhart and Schoenmaker, *op.cit.*

¹⁸ Franks and Mayer, *op.cit.*, p.161, suggest that the separation of a firm's own positions from clients' is a more appropriate regulatory response to investment management firms.

scheme.¹⁹ Deposit protection schemes with a minimum insurance element thus have a stronger consumer protection rationale than they do an economic one.

Other forms of regulation may focus on the structure of the market, the conduct of its participants or the nature of the product being sold.²⁰ Structural regulation involves a determination of which firms are allowed to engage in which activities, usually through a functional separation of activities, for example between jobbers and brokers or banks and securities firms. Kay and Vickers argue that this form of regulation is preferable where there is an asymmetry of information between the regulator and the regulated, for example where a regulator cannot say whether a broker is acting in his own or his client's interests.²¹ It is preferable there to ensure that no conflict is permitted to arise. Other examples of structural regulation are licensing requirements, which require a professional qualification for the provision of services or otherwise pose restrictions on market entry.

Whilst structural regulation aims to create a situation in which the incentives or opportunities for undesirable behaviour are removed, conduct regulation addresses not the undesirable underlying incentives, but the behaviour that they would otherwise induce. It may involve price control, or rules against advertising and other restrictions on competitive activity. The weakness of conduct regulation is that to be effective it must be concerned with aspects of service provision which are readily measured; and these may be only loosely related to the issues of underlying concern. The final form of regulation is product regulation. This is necessary where consumers are poorly informed about product quality, and has the obvious effect of minimising adverse selection. However, it may be almost as difficult for the regulator as the consumer to judge product quality and could lead to more inefficiencies than it may prevent.

¹⁹ See generally Mayer, op.cit and M. Berlin, A. Saunders and G. Udell, "Deposit Insurance Reform: What are the issues and what needs to be fixed?", (1991) 15 *Journal of Banking and Finance* 735.

²⁰ See Kay and Vickers, op.cit., passim.

²¹ Ibid.

The Nature of the Markets and their Regulators

The discussion of the rationales for regulation has given some indication of the complexity of the substantive area in which regulation is considered. The market context in which rule making under the Financial Services Act 1986 occurs is heterogeneous and complex, and modes of business operation and investment products change rapidly. The financial services market is in reality several markets, often grouped into two sectors: the "retail" and the "wholesale" or "the City". The latter refers to the securities, gilts and derivative markets, in which professionals interact largely between themselves and undertake such activities such as fund management, broker/dealing, market making, raising capital and underwriting. The retail sector broadly covers the sale of investment products to individual investors, or "transactions with or on behalf of private individuals in investment products of all kinds."²²

The Retail Market

Defined broadly, the retail market covers all dealings with private investors, including those of banks and building societies, and products such as National Savings certificates and mortgages. The Act does not regulate these institutions except to the extent that they undertake investment business, and investments do not include National Savings certificates, deposits or mortgages, or interests in occupational pension schemes. The difference in scope between the Act and the range of the financial products and services used by private investors can lead to anomalies. "Investment business" covers the management of pension schemes, for example, though not the interests in those schemes. So although the trustees of a pension fund may be in breach of the rules, beneficiaries of the fund cannot claim under the statutory compensation

²² *Retail Regulation Review: Report of a study by Sir Kenneth Clucas on a new SRO for the Retail Sector*, SIB, March 1992, para 1 (hereafter Clucas Report).

scheme.²³ The frequent combination of mortgages with regulated products also leads to complications when loss occurs, as the recent home income plans affair illustrated,²⁴ and suggestions have been made that deposits and repayment mortgages should at least receive comparable regulation if not be brought within the FSA remit.²⁵

The regulated part of the retail sector comprises life assurance, personal pensions, unit trusts, gilt-edged stocks and equity shares acquired principally through packaged product providers and their agents, insurance and unit trust brokers, independent financial advisers, private portfolio managers and stockbrokers.²⁶ With the exception of regulated collective investment schemes the regulation does not focus on the product structure, but regulates only the giving of advice and dealing in these products.²⁷ The regulation separates three types of products for particular regulatory treatment: life policies, units in regulated collective investment schemes, and investment trust savings schemes.²⁸ The formation of the rules regulating the retailing of these products is the subject of Chapter 7.

Of these products it is life policies which are most heavily invested in by private investors, mainly through mortgage related endowment policies. The number of products on the market is enormous, as banks and building societies have developed their own products alongside those of the life and unit trust companies. The structure of the products varies. Unit trusts are the most

²³ S.191. In relation to the Maxwell pensions affair, see Social Security Select Committee, *Report on the Operation of Pension Funds*, 1991/2 HC paper no. 61-I and IMRO, *Submission to the House of Commons Social Security Committee*, February 1992.

²⁴ Products were designed by life assurance companies and sold by intermediaries which involved advising usually elderly people to re-mortgage their houses and invest the money. The returns, they were promised, would cover their mortgage payments and provide them with money left over to spend. Many of these collapsed, and although the two aspects of the transaction, mortgages and investment, were inextricably linked in the investor's mind, these are regulated by different rules and there were consequent wrangles over who should provide compensation and in what proportion: the banks or the FSA compensation scheme. The ICS has agreed to pay £15.1 million in compensation to date, SIB, *Annual Report 1992/93*.

²⁵ These are also noted by Clucas, and while suggesting that it may be appropriate to consider these issues in the longer term, he does not comment on them further. Clucas Report, para 7.12.

²⁶ See Clucas Report, para 1.

²⁷ See the definition of "investment business" below.

²⁸ See the Glossary of Terms.

transparent as the price of the units is linked to the underlying fund and details are published in the daily broadsheet newspapers. The investor may therefore track the performance of the investment. Life policies have been increasingly used for investment purposes and are more opaque. On most types of policy the investor may not know how much the investment will be worth, and in the most frequently purchased type (with profits policies) the amount which is returned is at the discretion of the life company.

The distribution of these products is usually through the direct sales forces of the life offices, banks or building societies, their agents or independent advisers. All the major banks and building societies act as agents of a life office as well as sell their own products.²⁹ The market for investment advice has become increasingly competitive over the last ten years due to the deregulation of banks and building societies,³⁰ and competition for distribution outlets is severe. All sellers are paid by commission by the product provider. Due to the opacity of the products and the difficulties investors have in distinguishing products on the ground of quality, competition between product providers is centred on distribution, which is seen by companies as the key to market share. Product providers thus compete on the level of commission paid for a sale, which vary between companies, and between the products of one company. Average commission levels have risen over the last three years and in 1993 endowment policies were 124% of the original stipulated levels for independent advisers and 144% for tied agents.³¹

Investors who purchase these retail products are usually unsophisticated with a low level of understanding of the financial products. Over the last thirty years, individual investors have invested increasingly in these types of investment products, rather than directly in shares. In 1963,

²⁹ See Chapter 7.

³⁰ The removal of controls on bank lending in 1980 (the Corset) enabled banks to enter the mortgage market, and the 1986 Building Societies Act enabled the Societies to compete effectively with banks in offering personal banking services, offer insurance and investment advice and to recapture the mortgage market by enabling them to go to the money markets to raise capital.

³¹ *Fair Trading and Life Assurance Savings Products*, (OFT, March 1993), para 2.9. Commission payments were stipulated by Lautro until 1.1.90. See further Chapter 7.

54 per cent of shares listed on the Stock Exchange were held by individuals. In 1990 individuals held only 18-20 per cent, with institutions holding approximately 65-70 per cent.³² For most individuals, therefore, their involvement with the financial services market is through the indirect investment packages of these institutions. In 1991 research commissioned by SIB and Lautro found that consumers had a low level of confidence in understanding insurance and "most consumers regard insurance with little interest and little curiosity and therefore are not inclined to spend much time in "shopping around" or even in improving their knowledge of what products are available",³³ a finding confirmed by a survey by the Office of Fair Trading. When asked how competent consumers felt in their general financial affairs, however, 89 per cent claimed they were confident about handling their own finances. OFT report concluded "[t]his dissonant combination of confidence and lack of sophistication suggests that consumers are especially vulnerable on savings and investment issues."³⁴ The implications for the rule makers of the combination of opaque products, ignorant consumers and a highly competitive market where focus is on sales rather than product quality are the subject of Chapter 7.

The Regulators

The two principal regulators in this area are the Life Assurance and Unit Trust Regulatory Organisation (Lautro), which regulates the marketing and sales of life assurance and unit trusts through the direct salesforces and company representatives of life offices, unit trust companies and a small number of friendly societies, and the Financial Intermediaries, Managers and Brokers Regulatory Association (Fimbra), which regulates independent financial advisers, and managers and brokers who act principally for individual investors. A recognised professional body, the Insurance Brokers Registration Council (IBRC), also regulates insurance brokers for whom life

³² H. McRae and F. Cairncross, *Capital City* (London, 1992), p.107-8.

³³ *Review of Retail Regulation: Consumer Research by Taylor Nelson Financial*, SIB Disclosures Research Report, January 1992, commissioned by SIB and Lautro, pp.6-7.

³⁴ *Ibid.*, p.15.

assurance is up to 45% of their total business. The other main operators in the area are the banks and building societies, who sought direct authorisation from SIB.³⁵

The division of the regulatory function can be explained historically. The organisation and number of the SROs is not prescribed in the Act, but the understanding has been since the inception of the regulation that they should be organised on a functional basis.³⁶ An association for licensed dealers and investment managers, NASDIM, had been formed and recognised in 1983 under the predecessor to the FSA 1986, the 1958 Prevention of Fraud (Investments) Act, after persuasion by the Bank of England and was seen as a prototype SRO.³⁷ Its members were generally small firms advising private investors and managing only small portfolios. A second group of intermediaries, essentially those regulated under the Insurance Broker's Registration Act 1977, formed an organisation called Lutiro in 1985, with a view to becoming an SRO. In April 1986 the two joined to become what is now Fimbra.³⁸

Lautro members are principally life offices, friendly societies and unit trust companies. Although most of its members are automatically authorised under the Act,³⁹ Lautro was formed as the result of an initiative of the main life and unit trust trade associations to regulate the direct selling of these companies, who did not want to join NASDIM as they felt they were of a different nature and scale to the intermediaries which comprised its membership. Although the banks and building societies have their own retail products and act as both direct sellers and representatives for life offices, they preferred to seek direct regulation through SIB rather than Lautro for two reasons. The first was the dominance of Lautro by the life offices; the second was the disadvantageous effects of Lautro's initial rules on their operation.⁴⁰

³⁵ See below.

³⁶ See L.C.B. Gower, *Review of Investor Protection, Discussion Document* (HMSO, London, 1982).

³⁷ L.C.B. Gower, *Review of Investor Protection, Report, Part I*, Cmnd. 9125, (HMSO, London, 1984), para 6.05.

³⁸ It was initially called IBRO, the Regulatory Organisation for Intermediaries, Managers and Dealers.

³⁹ See below.

⁴⁰ See Chapter 7.

There is currently a proposal that all firms engaged in investment business with private investors should be regulated by one SRO, the Personal Investor Authority. This re-organisation of the structure is proposed with two aims in mind, the need to create a viable tax base for the compensation scheme (see below) and to improve regulatory coherence, reducing the possibilities for regulatory arbitrage which exist mainly between Fimbra and the IBRC. Clucas recommended that the Board should be two thirds practitioners, with product providers as the main financial contributors having the majority, and one third public interest members. The number of the latter should be such that together with either the product providers or independent practitioner groups they would constitute an overall majority.⁴¹ Progress in forming the new regulator has been slow, however, although it was anticipated that it would be in operation by July 1993.⁴²

The Wholesale Market

The Act does not cover listed money market institutions and Lloyds, but it does cover the stock and Eurobond markets, and the activities of dealing, managing, advising, arranging to deal and underwriting.⁴³ Dealings on the derivatives and futures markets (for example, the London Futures and Options Exchange, LIFFE⁴⁴ and the Eurobond markets) are confined almost exclusively to professionals, as is the bulk of dealing on and off the exchanges. The Eurobond and equities' markets are telephone markets, and so are not dependent on any geographical location, a fact which has had a significant impact on policy and rule formation. London is the principal Eurobond market, and in equities second to New York. Turnover on the Stock Exchange in UK equities in 1992 was £433 billion, with an average daily turnover of £1.7 billion. In overseas equities turnover in 1992 was £329 billion, of which nearly 70% was in European

⁴¹ Clucas Report, para 5.47.

⁴² See further The Formation Committee, *The Personal Investor Authority, A Consultative Paper*, September 1992.

⁴³ See below.

⁴⁴ London International Financial Futures Exchange.

equities, principally French and German.⁴⁵

In the mid-eighties the securities markets underwent a radical structural change as a consequence of changes in the membership and dealing rules of the Stock Exchange, and the range of financial instruments increased in scope and diversity.⁴⁶ In the securities markets, the abolition of single capacity (the rule that persons had to either buy or sell shares as principal, a jobber, or act as an agent for others, a broker) led to the formation of "integrated houses" which combine market making, broking and fund management activities: "triple capacity". The implications of the integrated houses for conflicts of interest is discussed below.

Fund management involves the management of a portfolio of investment on behalf of a private client or institutions, either on a discretionary basis (in which the manager acts on his or her own discretion without referring to the client) or on a non-discretionary basis (in which the manager recommends investment sales and purchases to the client and await the client's approval).⁴⁷ Larger managers usually act only on a discretionary basis. The manager's decisions and advice are based on research provided either in-house, or by brokers. When acting on a discretionary basis the managers are required to initiate transactions by placing orders with brokers or dealers for the sale or purchase of securities.

Fund managers will pay brokers a commission to buy or sell the securities (and sometimes derivatives) for them, and the formation of rules regulating the arrangements for payment which exist between fund managers and brokers or market makers is the subject of Chapter 6. The subsequent execution and settlement is then under the control of the broker/dealer. The broker/dealer is a member of the Stock Exchange, but is not obliged to deal when offers are made. Since the abolition of single capacity in 1986, brokers dealing on the Stock Exchange execute the transaction by acting as principal and deal off their own book or act as agent. They may deal with

⁴⁵ Winter 1992, *Stock Exchange Quarterly*, Statistical Appendix.

⁴⁶ See Chapter 3.

⁴⁷ See Franks and Mayer, *op.cit.*, Chapter 2 for a full account of the fund manager's business.

one another, or alternatively approach a market maker. Market makers literally "make a market" in an investment, buying and selling for their own account regardless of what market conditions prevail. They are obliged continuously to quote and deal at the price quoted in normal marketable quantities. Their buy and sell prices are displayed through the Stock Exchange Automatic Quotation system (SEAQ), and vary with the size of the order: the price for 10,000 shares is different than for 100,000. The market is quote-driven: the market maker is obliged to deal at the displayed price.

The focus of the majority of the conduct of business rules is the operation of these integrated houses and the relationships between the principal actors in the market. The investors in these markets are of a very different nature to those involved in the retail sector, and the nature of products and services is far more complex. The direct involvement of private investors is minimal. The direct holding of shares, as we have seen, has declined considerably over the last twenty years and the majority of shares are held by institutional investors. The activity of advising and acting as discretionary portfolio manager straddles the professional and non-professional investor groups: because of their large holdings in securities, institutional fund managers and trustees are the types of investor usually using and receiving these services. The involvement of companies in the markets to raise capital or simply to invest money on a short term basis also confuses the clear division between private and professional customers. The regulation has so far focused on the dealing practices of those involved and not so much on the actual operation of the markets, though both fall under SIB's responsibilities. SIB is now starting to turn its attention to market regulation, however.⁴⁸

The Regulators

The wholesale market is regulated by the Securities and Futures Authority (SFA), which

⁴⁸ A. Large, *Financial Services Regulation: Making the Two Tier System Work* (SIB, May 1993), para 16.6 stated that SIB was preparing a discussion paper on market regulation policy for publication.

regulates brokers, dealers and market makers in securities and those operating on the futures and derivatives markets, including the Eurobond market, and the Investment Management Regulatory Organisation (IMRO), which regulates investment managers acting for institutional clients, and the management activities of life and unit trust companies and pension fund managers. Again, the division of the regulators can be explained historically. IMRO was a creature of the accepting houses, formed in the spate of SRO formation which occurred in the autumn of 1985. The accepting houses felt themselves to be of a different status to the small managers and advisers of NASDIM, and the scale of their fund management was far larger. They also wanted to disassociate themselves from the conflicts of interests involved in large conglomerates and emphasise their independence from the integrated houses through a separate regulatory organisation. Their membership base widened as Lautro members joined them for authorisation of their fund management activities, and although SIB urged their merger in December 1985, this was resisted.

SFA was formed in 1991 as a result of a merger between the Association of Futures and Bond Dealers (AFBD) and the Securities Association (TSA). TSA was itself formed in December 1986 as a result of a merger between the Stock Exchange and the International Securities Regulatory Organisation (ISRO). The Stock Exchange had been hostile to any erosion in its position, and had initially resisted a take over by ISRO. ISRO represented international securities dealers, including members of the Association of International Bond Dealers, and was formed mainly because of their concerns at the omission of consideration of international operators in the UK in the White Paper. They feared that the blanket introduction of rules designed to protect small investors would be too costly for firms trying to compete in the professional investor market, and stressed the importance of the Eurobond market. ISRO turned itself into a highly effective lobby group, and during the passage of the legislation headed the campaign for SRO immunity, and was responsible for stabilisation of securities being permitted under the Act (see below). The Exchange finally agreed to merge with it in 1986.

The Scope of the Regulation

The Act introduced a system of regulation which had a wider scope than its predecessor, the Prevention of Fraud (Investments) Act 1958, encompassing the sale of unit trusts and life assurance, and bringing large parts of the City under a system of formal regulation for the first time. The concept of investment used in the Act is based on a "touch and see" principle,⁴⁹ covering intangible rather than tangible items such as land and collectibles. Investments include company shares,⁵⁰ debentures, government or public securities, warrants and certificates representing securities, derivatives, contracts for differences,⁵¹ options, futures,⁵² units in collective investment schemes, life assurance contracts used as savings vehicles, personal pensions and "rights to and interests in" any of these. The financial markets, as we have seen, are in fact wider than the FSA's ambit of regulation and are regulated under separate statutes or codes.

The Act requires all those carrying on investment business from a UK base to be authorised or exempted under the Act.⁵³ In contrast to the Act's predecessor, the Prevention of Fraud (Investments) Act 1958, exemptions are given to defined bodies, including the Bank of England, Lloyds, members of listed money market institutions, recognised investment exchanges and clearing houses and appointed representatives of member firms: persons for whom another, authorised person has accepted responsibility (authorised representatives).⁵⁴ In 1992/3 there were nearly 28,000 authorised firms.⁵⁵ Investment business covers dealing and arranging deals in investments, managing investments, (including portfolios which have included, do or may include

⁴⁹ Gower, *Discussion Document*, para 2.02.

⁵⁰ Excluding Building Society shares, unless permanent interest bearing shares, SI 1991/1104.

⁵¹ *City Index v. Leslie* [1991] BCLC 643 (CA) held that this included bets taken on the movement of market indices.

⁵² Unless made for commercial and not investment purposes.

⁵³ S.3.

⁵⁴ Ss. 42-45. This list may only be extended by the Secretary of State with Parliamentary approval, s.46(1).

⁵⁵ SIB, *Annual Report 1992/3*, p.48.

investments) giving investment advice and establishing, operating or winding up collective investment schemes. Persons who engage in the activity of managing the assets of an occupational pension scheme are deemed to be carrying on investment business.⁵⁶ The Act excludes those dealing on their own account unless they are market makers or persons who regularly solicit members of the public to buy or sell investments,⁵⁷ also employee share schemes which do not involve the giving of advice, the transfer of control of a company,⁵⁸ giving general or generic advice,⁵⁹ and advice in publications whose principal purpose is not to lead persons to invest in a particular investment. All these do not need authorisation.⁶⁰

These activities must constitute a business: this is not defined in the Act, but formal guidance and debates in the House indicate that there must be a commercial motivation coupled with repetition and continuity.⁶¹ General exclusions are given, *inter alia*, for trustees and their personal representatives who are not carrying on investment business, employee share schemes, advice given in the media, and for the normal commercial activities of firms which may involve an investment element, for example participators in a joint enterprise embarked upon for commercial reasons in a relation to a non-investment business, the supplier of goods and services where the main purpose is commercial, and where one company in a group acts on behalf of another in that group.⁶²

Authorisation may be obtained through membership of the umbrella regulator, the Securities and Investments Board (SIB), or one of the four self regulatory organisations (SROs).⁶³

⁵⁶ S.191.

⁵⁷ Schedule 1, para 17. SIB may also give permission to an applicant whose main business is not investment business but who would fall under the provisions, if it would be inappropriate to require them to be authorised. Schedule 1, para 23. SIB has stated that permission is held to be appropriate only where private investors are not involved: SIB, *Permitted Persons* (December 1987) para 11.

⁵⁸ Schedule 1, paras 20 and 21.

⁵⁹ SIB, *The Financial Services Act and the Press* (March 1988).

⁶⁰ Schedule 1, para 25.

⁶¹ A.C. Page and R.B. Ferguson, *Investor Protection* (London, 1992), p.240.

⁶² Schedule 1, Part II.

⁶³ See below.

These bodies form the core of the regulatory system in the sense the majority of investment business is conducted by the members of these bodies. SIB directly regulates few firms, principally banks and building societies;⁶⁴ its direct regulatory power was provided mainly for constitutional reasons, to provide an alternative to the private SROs and to ensure that they did not restrict the ability of a person to conduct investment business; it was never intended that SIB should have a direct regulatory role on a par with the SROs.⁶⁵ The SROs together regulate approximately 9,600 firms, and it is through them that the bulk of the day to day regulation is carried out.

Authorisation is also conferred through membership of a recognised professional body (RPB). This was provided to enable principally solicitors and accountants to perform some of their traditional advisory, management and other activities which would now require authorisation under the Act. There are currently nine RPBs, defined in the Act as a body which regulates the practices of a profession, which do not include carrying on a business which is wholly or mainly investment business.⁶⁶ With the exception of the Insurance Brokers Registration Council, most RPB firms have obtained authorisation in order to continue offering investment advice ancillary to their main area of business.⁶⁷ Insurers and friendly societies authorised under the Insurance Companies Acts and the Friendly Societies Act are automatically authorised.⁶⁸

⁶⁴ In April 1993 there were 77 directly authorised businesses, of which 16 are building societies, 14 building society subsidiaries, 11 clearing bank subsidiaries, 2 life insurance companies and 5 intermediaries: SIB, *Annual Report 1992/3*, p.38.

⁶⁵ 1985/6 HC Standing Committee E, cc.305-5 (Michael Howard).

⁶⁶ S.16(1). The RPBs are: the Institute of Chartered Accountants of England and Wales; the Institute of Chartered Accountants of Scotland; the Institute of Chartered Accountants of Ireland; the Law Society; the Law Society of Scotland; The Law Society of Northern Ireland; the Chartered Association of Certified Accountants; the Institute of Actuaries and the Insurance Brokers Registration Council.

⁶⁷ Up to 49% of IBRC members' business can be investment business, raised from 25% by agreement from SIB in March 1991. Many IBRC members could therefore be members of Fimbra. This raises problems of regulatory arbitrage (gaining authorisation through a route which involves lower costs and regulatory requirements), and it has been recommended that recognition be withdrawn from the IBRC if a new SRO for private investors is established. Clucas Report, para 7.8.

⁶⁸ S.22 confers automatic authorisation as respects any business which is also investment business (this includes life policies with investment elements and pension fund management) for insurance companies authorised by the DTI under the Insurance Companies Act 1982. The products are not regulated; the rules made by SIB or Lautro apply only to their marketing: Sch.10, para.4(2). A parallel regime was introduced

Authorisation is also conferred on persons who are a national of an EC member state if they are not carrying on business from UK base, are authorised in that member state, and the member state has law equivalent to the UK or has implemented a relevant harmonisation directive.⁶⁹ This facilitates the implementation of the Second Banking Co-ordination Directive⁷⁰ and the Investment Services Directive.⁷¹ The ISD incorporates the concept of a single licence for investment business, closely following the Second Banking Co-ordination Directive which introduces the same concept for credit institutions.⁷² Firms registered in one member state in which the firm is registered or has its head office (the home country) may establish a branch or provide services in any other member state (the host country) without needing further authorisation from that host country. The home country is responsible for prudential and financial rules and for monitoring compliance of these by the firm throughout the EC. The host country is responsible for regulating the conduct of business.⁷³ Automatic authorisation is also given to operators of recognised UCITS carrying on business in the UK with respect to the operation of the scheme and connected purposes pursuant to the UCITS Directive.⁷⁴ There have been no authorisations under this provision yet.⁷⁵

The Institutional Structure

A diagram of the regulatory structure is given at the end of this chapter (Diagram 1). The

in s.23 for friendly societies, supervised by the Chief Registrar of Friendly Societies under the Friendly Societies Act 1974: Sch.11.

⁶⁹ S.31.

⁷⁰ 89/646/EEC, OJ [1989] L 386/1.

⁷¹ OJ [1990] C 42/7. Common position reached on 23 November 1992, likely to be implemented 1995.

⁷² Implemented 1.1.93.

⁷³ See the Financial Services (European Institutions) Instrument 1993.

⁷⁴ Commission Directive of 20 November 1985 on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, 85/611/EEC (as amended by Commission Directive of 22 March 1988, 88/220/EEC).

⁷⁵ Ferguson and Page, *op.cit.*, p.251.

structure comprises three tiers, with only two of the tiers acting as rule makers. At the top are the Chancellor, the Office of Fair Trading, the Bank of England and the Secretary of State for Trade and Industry (who exercises some enforcement powers jointly with SIB). Under these is the Securities and Investments Board (SIB), to whom the legislative, investigative and enforcement powers conferred in the Act have been delegated. SIB is responsible for recognising and supervising the regulatory activities of professional bodies, exchanges, clearing houses and self-regulatory organisations.

The Chancellor, the OFT and SIB

The Act gave legislative, investigative and enforcement powers to the Secretary of State, and enabled the majority of these powers to be delegated to a "designated agency"⁷⁶ subject, until 1989, to Parliamentary approval.⁷⁷ The agency was named in the Act as the Securities and Investments Board.⁷⁸ The powers could be delegated only if the body satisfied statutory conditions as to structure, Board membership, monitoring and enforcement, complaints and disciplinary procedures, and its rules complied with the principles set out in the Act.⁷⁹ SIB achieved designated agency status in May 1987, and the majority of the statutory powers, including all of the legislative powers, have been delegated to it.⁸⁰

The Bank of England and the Chancellor jointly appoint the chairman and Board of SIB, although the initial Board appointments were made by the Bank.⁸¹ The composition of the Board must be such as to "secure a proper balance between the interests of persons carrying on

⁷⁶ S.114. Responsibility for the Act was transferred to the Treasury in 1992.

⁷⁷ Via the affirmative resolution procedure (s.114(11)).

⁷⁸ S.114(2).

⁷⁹ S.114. The requirements are contained in Schedules 7 and 8.

⁸⁰ Financial Services Act 1986 (Delegation) Order 1987. Powers were transferred which included several not then in force. Powers relating to authorised unit trust schemes were delegated by the Financial Services Act 1986 (Delegation) (No 2) Order 1988. The system came into operation on 29th April 1988, "A Day".

⁸¹ Sch.7 para 1(2).

investment business and the interests of the public".⁸² The Bank's role in these appointments reflects the influence which it exerted in the process leading up to the Act, and that which it wished to continue to exert over the development of the regulation. There was cross-party support for the removal of the Bank's role which it was argued was there simply to enable the Bank to exert a continuing influence over SIB,⁸³ but it was justified on the grounds that it would limit rivalry between the bodies and reflected the "special authority" and "established preeminence" of the Bank.⁸⁴

SIB must report annually to the Chancellor and a copy of the report must be laid before Parliament. The Chancellor may make directions relating to SIB's accounts and their audit, with which SIB must comply,⁸⁵ although SIB is funded by the authorised firms and receives no public finance.

The Chancellor must ensure that SIB's rules do not restrict or distort competition to a significant extent, and can direct that its rules be amended if they do.⁸⁶ This power applies across the range of regulatory bodies: SIB, the SROs, recognised professional bodies, (RPBs) recognised investment exchanges (RIEs) and clearing houses (RCHs).⁸⁷ In exercising this function he must consult the Director General of Fair Trading, who is under a continuing duty to review the rules for their competitive effects.⁸⁸ In addition, SIB has to have leave from the Chancellor that the competition provisions have been complied with before it can recognise a body.⁸⁹ These powers of the Chancellor and OFT replace the general competition legislation, from which the rules and practices of these bodies are exempt.⁹⁰ The exemption, and the

⁸² Sch.7 para 1(3).

⁸³ See for example, 1985-6 HC Standing Committee E, c.719 (Anthony Nelson).

⁸⁴ Ibid., c.714 (Alan Howarth).

⁸⁵ S.117.

⁸⁶ S.119.

⁸⁷ S.119.

⁸⁸ S.122.

⁸⁹ Ss.119-121.

⁹⁰ Ss.124-126 (Fair Trading Act 1973, Restrictive Trade Practices Act 1976, Competition Act 1980).

competition review, stems from the case against the Stock Exchange brought by the OFT under the Restrictive Trade Practices Act 1956, which was settled in 1983.⁹¹

It is only in relation to the competitive effects of the rules that the Chancellor has any power to order SIB to alter or revoke its rules.⁹² If SIB's rules are failing to provide adequate investor protection or it is not otherwise meeting the required conditions, then the Chancellor has only the power to resume any of the transferred functions in whole or in relation to any aspect of investment business.⁹³ As this would involve a radical restructuring of the present regulatory edifice it has been more aptly described as a "nuclear deterrent" than an effective continuing control mechanism.

SIB and the SROs

The current chairman of SIB is Andrew Large, who was the first chairman of the SRO TSA (the Securities Association) and subsequently the chairman of the London Futures and Options Exchange, a recognised exchange under the Act. SIB is funded by the recognised bodies, directly authorised firms and collective investment schemes, although it does not regard this factor as making it accountable to them.⁹⁴ Initially it operated on an advance facility from the Bank of England, which by 1988 was nearly £9 million,⁹⁵ and its net costs for the year ending March 1993 were just over £14 million.⁹⁶

SIB has two roles within the system, which many are beginning to suggest conflict. It is a direct regulator, and a supervisor of the other regulatory bodies. SIB is responsible for

⁹¹ See Gower Report, Part I, paras 5.02-5.07 and 6.17-6.34.

⁹² The same provisions and powers lie in relation to RIEs, RCHs, RPBs and SROs.

⁹³ S.115. If done at the request or with the consent of SIB, the order is subject to a negative resolution procedure, otherwise the affirmative resolution procedure applies: s.115(6).

⁹⁴ See comments of Sir David Walker (SIB's chairman 1985-88), 1990/1 Trade and Industry Select Committee, Securities and Investments Board, Minutes of Evidence, HC Paper no.131, para 6.

⁹⁵ SIB, *Annual Report 1987/8*, p.79.

⁹⁶ SIB, *Annual Report 1992/3*, p.47.

recognising the SROs, professional bodies, exchanges and clearing houses.⁹⁷ The Act requires that each must have adequate arrangements and resources for monitoring and enforcement, the investigation of complaints and the promotion and maintenance of high standards of integrity and fair dealing.⁹⁸ The requirement that members be "fit and proper persons to carry on investment business of the kind with which the organisation is concerned" applies only to SROs.⁹⁹ The Act also requires that the governing bodies of the SROs must be such as to secure a proper balance between the interests of different members of the organisation and between the interests of the organisation and the interests of the public.¹⁰⁰

SIB has a discretion whether or not to recognise professional bodies, exchanges and clearing houses which meet the criteria, although it must give reasons for refusal,¹⁰¹ but it must recognise SRO applicants which meet the statutory criteria unless it considers that is no need for such an SRO as one already exists which regulates that area of business.¹⁰² The rationale for this provision was that otherwise an unhealthy competition could develop between regulators, competing on the basis of minimum standards.¹⁰³ An amendment to permit SIB to refuse to recognise eligible exchanges on the same grounds was rejected on the basis that this would amount to restricting markets, antithetical to the Government's competition policy.¹⁰⁴

SIB monitors the rules and practices of the SROs. The rules of the SRO must, together with those principles, rules or codes of practice of SIB to which its members are subject, provide

⁹⁷ It is also responsible for the Recognised Investment Exchanges (RIEs) and Recognised Clearing Houses (RCHs), but these are not considered here.

⁹⁸ They are set out in Sch 2 (SROs), Sch 3 (RPBs), Sch 4 (RIEs) and s.39 (RCHs).

⁹⁹ Sch.2 para 1. This does not apply to insurance companies and friendly societies, and others who are members of the organisation but do not gain their authorisation through that membership (Sch.2 para 1(4). It is presumed that RPBs will have similar requirements in their own membership rules.

¹⁰⁰ Sch.5 para 5. In relation to RPBs the Act requires that the arrangements for enforcement must be such as to secure a proper balance between the interests of persons certified by the body and the interests of the public. Sch.3 para 4(5).

¹⁰¹ Ss. 18, 37 and 39.

¹⁰² S.10.

¹⁰³ 1985/6 HC Standing Committee E, c.335.

¹⁰⁴ Ibid., c.334-6.

adequate protection for investors. In judging adequacy, regard is to be had to the nature of the investment business carried on by members, the nature of investors and the effectiveness of the organisation's enforcement arrangements.¹⁰⁵ Monitoring of compliance used to be through a series of "self-assessment" exercises undertaken by the SROs and then sent to SIB, who would then consider the report and discuss its contents with the SRO. Since the activities of the Maxwell pension fund managers came to light, throwing into question IMRO's regulatory activities, there are proposals that SIB's monitoring activities will become more formalised.¹⁰⁶

SIB has no "system management" powers beyond its ability to refuse recognition to an SRO on the basis of need. It cannot require those who sought membership through it to apply to an SRO,¹⁰⁷ nor can it force SROs to disband or restrict their area of regulation in the absence of a breach of the recognition requirements, a power which would have been viewed in 1986 as encroaching too deeply into the autonomy of the SROs. However the relationship between the rule making bodies has evolved to a point where in 1992 Sir Kenneth Cluca's report on the regulatory structure recommended that SIB be given the power to make these changes in the interests of the regulatory system as a whole.¹⁰⁸ SIB's power to direct its members to move to an SRO, or even to cease its role as a direct regulator was also recommended in the same report. SIB has declined to seek these statutory powers immediately, but has indicated that should persuasion fail, it may ask for an amendment in its powers to this effect.¹⁰⁹

SIB's enforcement powers

SIB has powers to require such information as it may reasonably need for the performance

¹⁰⁵ Sch.2 para 3 and Sch.3 para 3, as amended by s.203 CA 1989.

¹⁰⁶ See Large Report, Chapter 4.

¹⁰⁷ 1985/6 HC Standing Committee E, cc.303-6.

¹⁰⁸ Clucas Report, op.cit.

¹⁰⁹ Large Report, Foreward, para 22.

of its functions¹¹⁰ and has extensive investigation powers akin to those of the DTI which enable it to call for persons and documents, and information given by a person may be used in evidence against him.¹¹¹ These powers must be exercised concurrently with the Secretary of State for Trade and Industry¹¹² are not exercisable in relation to RPB or SRO members unless, in relation to the investigation powers, that body so requests, or appears to SIB to be incapable or unwilling to investigate them in a satisfactory manner. They are, however, exercisable in relation to appointed representatives.¹¹³

SIB has power to apply to the court for an injunction if there is a likelihood that any person will contravene SIB's rules or those of an SRO or RPB and apply for the payment into court a sum representing profits earned as a result of the contravention and/or loss or damage suffered by investors.¹¹⁴ These injunction powers are not extended to members of SROs or RPBs unless that body appears unwilling to restrain the contravention,¹¹⁵ but the power to order restitution is not so limited.¹¹⁶ SIB's powers to issue disqualification directions prohibiting the employment of a particular person¹¹⁷ and issue public statements as to a person's misconduct¹¹⁸ also apply to all authorised persons.

SIB's and the SROs' rule making powers

The legislative powers granted to the Secretary of State have been delegated to SIB.¹¹⁹

¹¹⁰ S.104.

¹¹¹ Ss 95, 105 and 106.

¹¹² S.114.

¹¹³ S.105(2).

¹¹⁴ S.61.

¹¹⁵ S.61(2).

¹¹⁶ S.61(3).

¹¹⁷ S.59.

¹¹⁸ S.60.

¹¹⁹ Powers delegated under s.114. See below.

These comprise powers to make rules relating to a firm's financial resources,¹²⁰ protection of clients' money,¹²¹ cancellation¹²² and cold calling rules,¹²³ and conduct of business rules.¹²⁴ Also notification regulations,¹²⁵ indemnity rules,¹²⁶ and rules concerning the compensation fund.¹²⁷ Cancellation rules, client's money and unsolicited call rules apply to all authorised persons. The indemnity rules apply to members of SROs and RPBs only if those bodies have requested that they do;¹²⁸ the compensation fund applies to members of SROs only after consultation with those bodies.¹²⁹

In exercising its rulemaking powers, SIB is required, as a result of amendments made to the Bill, to publish its proposed rules and regulations, together with a statement that representations can be made within a specified period, and SIB must have regard to any representations made.¹³⁰ The provision did not apply to the initial rules which SIB made in order to have the powers transferred to it under the Act,¹³¹ nor does it apply where SIB considers that the delay in complying would be prejudicial to the interests of investors.¹³² The latter exclusion has not yet been used. There is no requirement, following the underlying philosophy of the Act, that the Chancellor should be consulted on the rules. The constitutions of the SROs require them to undertake a similar consultation exercise with their own members. The 1989 amendments also

¹²⁰ S.49.

¹²¹ S.55.

¹²² S.51.

¹²³ S.56.

¹²⁴ S.48.

¹²⁵ S.52.

¹²⁶ S.53.

¹²⁷ S.54.

¹²⁸ S.53(2).

¹²⁹ S.54(3). RPBs must request to join.

¹³⁰ Sch 9, para 12(1).

¹³¹ Sch 9, para 12(3).

¹³² Sch 9, para 13(2).

required SIB and the SROs to consider the costs of compliance when forming its rules.¹³³

SIB was initially given the powers to make rules and issue guidance which would apply only to firms directly authorised by it. In 1989 the Act was amended to permit SIB to issue statements of principle which would apply to all authorised persons, and rules and codes of practice which apply directly to members of SROs, none of which may be amended by SROs without permission from SIB.¹³⁴ Breach of these rules is to be treated as a breach of the rules of the organisation itself,¹³⁵ and SROs are therefore responsible for enforcing the principles, core rules (and codes of practice, if issued) in relation to their members,¹³⁶ although SIB may still seek injunctions to prevent a breach of its or an SRO's rules.¹³⁷ Section 62 of the 1986 Act gave any person who suffered loss as the result of contravention of the rules of SIB or an SRO an action for damages.¹³⁸ In 1989 this right was restricted to private investors,¹³⁹ and does not apply to the statements of principle.¹⁴⁰

The Main Provisions of the Rules

The discussion of the rationales for regulation highlighted four main regulatory concerns: the need for confidence in financial markets, information failure, problems of monitoring and reliance, and differences between investors. To these has been added a legal concern: the requirements of fiduciary law. As the above account of the regulation indicates, the Act provides regulation in a wide range of areas. The next section will briefly consider the nature in which the

¹³³ Sch 2, para 3A (SROs) and Sch 7, para 2A (SIB), inserted by s.204 Companies Act 1989.

¹³⁴ S.47A and B, inserted by s.192 Companies Act 1989; s.63A and B, inserted by s.194 Companies Act 1989 and s.63C, inserted by s.195 Companies Act 1989.

¹³⁵ S.63A FSA 1986, inserted by s.194 CA 1989.

¹³⁶ Sch 2, para 4(1), as amended by s.206 Companies Act 1989.

¹³⁷ S.61.

¹³⁸ S.62.

¹³⁹ S.62A, inserted by s.193(1) Companies Act 1989.

¹⁴⁰ S.47A(3), inserted by s.192 Companies Act 1989.

regulation protects investors' money. There is now only one set of client money and financial resources rules, in contrast to the rule system of Principles, Core Rules and SRO third tier rules which exists for conduct of business rules. The provisions of the latter rules will be the main focus of this final section of the chapter.

Protection of investors' money

The Investors' Compensation Scheme (ICS), financial resources rules and client money rules are the three principal areas of regulation which concern the protection of the money that the investor entrusts to a person to invest. The rule making power relating to financial resources rules are very general: SIB may make rules requiring authorised persons "to have and maintain such financial resources as are required by the rules..".¹⁴¹ These are designed to ensure that all firms maintain a minimum level of capital to cover general business risks; their aim is thus very different from banking capital adequacy rules which aim to prevent a business failing for reasons of systemic risk.¹⁴² Since 1989 SIB's rules apply to all authorised persons, and for reasons of coherency and consistency, SIB has issued one single set of rules.¹⁴³ The powers under s.55 to make client money rules are more detailed, and in its study of the relationship between the regulatory rules and the common law, the Law Commission has concluded that the section authorises the modification of private rights and duties of authorised persons.¹⁴⁴ Again, SIB has

¹⁴¹ S.49.

¹⁴² It is likely that the implementation of the EC Capital Adequacy Directive (OJ [1992] C 50/5) will require a considerable change in the financial resources rules of the Bank of England, SIB and SFA. The Directive accompanies the Investment Services Directive and provides for capital against risks involved in investment business and complements the Own Funds Directive (89/299/EEC) and the Solvency Ratio Directive (89/647/EEC) which sets capital adequacy levels for credit institutions covered by the Second Banking Co-ordination Directive. See SIB, *EC Second Banking Co-ordination Directive*, CP 68, December 1992.

¹⁴³ The Financial Supervision Rules 1990, and the draft Financial Supervision (Amendment) Rules, CP 57, December 1991. Implementation of the Capital Adequacy Directive will also require a uniform set of provisions.

¹⁴⁴ Law Commission, *Fiduciary Duties and Regulatory Rules, A Consultation Paper*, CP No.124 (HMSO, London, 1992), para 5.3.5.

used its powers to issue rules which will be the only rules applying to authorised firms,¹⁴⁵ formed in negotiation with the SROs for similar reasons of coherency and consistency, but with the added reason that only SIB can use the statutory powers.¹⁴⁶

The Investors Compensation Scheme is also a central scheme, however its operation illustrates the tensions which exist within the structure and the differences between the market areas, and it is the search for a more stable system of funding which has prompted a re-organisation of the institutional structure and the formation of a single SRO for the retail sector (the PIA). The Act provides the Secretary of State with powers (delegated to SIB) to form an Investors Compensation Scheme to compensate investors where authorised persons cannot satisfy claims in respect of any civil liability incurred by them in connection with their investment business.¹⁴⁷ The Scheme is run by the ICS Management Company, whose directors comprise representatives of SRO members, SIB regulated firms and one public interest representative.¹⁴⁸

The principle of the scheme is to provide an industry wide safety net to compensate investors if a participant firm goes into default. To claim from the scheme, an investor has to show that it relates to business done with the investor or on his behalf¹⁴⁹ after its participation date¹⁵⁰ or property held by the firm before its participation date,¹⁵¹ and that it is a compensatable claim, i.e. based on theft or embezzlement or arising from uncompleted transactions.¹⁵² Other claims, for example, based on negligence or breach of a conduct of business rule are only compensatable where the ICS Management Company considers it "essential in order to provide fair compensation to the investor".¹⁵³ There is no compensation available

¹⁴⁵ The Financial Services (Client Money) Regulations 1991, and Supplementary Regulations 1991.

¹⁴⁶ SIB, *Proposals for amended Client Money Regulations*, CP 53, April 1991, paras 6-12.

¹⁴⁷ S.54.

¹⁴⁸ Financial Services (Compensation of Investors) Rules 1990.

¹⁴⁹ A scheme business claim.

¹⁵⁰ I.e., after it became an SRO or SIB member, or from 28.8.88, whichever is the later.

¹⁵¹ But not before 18.12.86 when the Act came into force, *SIB v. Fimbra* [1991] 1 All ER 398.

¹⁵² See Financial Services (Compensation for Investors) Rules 1990.

¹⁵³ FS(CI)R r.2.04.1.

if the claim relates to or depends upon a failure of investment performance to match a guarantee given or representation made.¹⁵⁴ The rules under the scheme are unclear and there have been several cases to date concerning their interpretation, including three applications for judicial review.¹⁵⁵ The scheme is limited and involves a co-insurance element, providing a maximum cover of £48,000 in the event of the firm's default,¹⁵⁶ up to an annual limit of £100 million. Its availability was restricted to private investors in 1989.¹⁵⁷

The scheme is funded by a levy on authorised firms, imposed on the SRO when claims relating to one of its members arise. The maximum contribution of each SRO is currently calculated on the basis of the aggregate revenue of FSA regulated business of the firms belonging to that SRO. If claims are made in excess of that SRO's maximum contribution limit then a cross-contribution is collected from the other SROs, the rationale being that all firms benefit from the added confidence provided to investors by the provision of such a protection. However, claims on the ICS arise principally from the default of Fimbra members.¹⁵⁸ Fimbra's aggregate revenue is the lowest of all the SROs, and so its maximum contribution threshold has been crossed since 1990/1. Lautro members, whose products Fimbra members sell, have been subsidising Fimbra's contribution so reducing the amount the other regulators need contribute,¹⁵⁹ but this experience of funding and operating the ICS prompted a review to examine whether the structure of the

¹⁵⁴ Ibid., r.2.04.3a.

¹⁵⁵ *R v. ICS ex p. Bowden and others*, *The Times* 22.1.93 (two applications combined), the others are not yet reported. For details see SIB, *Annual Report 1992/3* p.33.

¹⁵⁶ 100% of the first £30,000 and 90% of the next £20,000. The level of compensation has not increased since 1988, much to the disappointment of the Consumer's Association.

¹⁵⁷ As a consequence, business conducted with professional and business customers is "non-compensatable". The revenue of members who deal principally with non-private business is still included in the calculation, however, following the rationale that all investment business benefits through the confidence effects of the scheme, though the revenue attributed to their business is abated by 50%.

¹⁵⁸ In 1992/3 the cost of the Scheme was £17 million, of which £15.6 million was due to the failure of Fimbra members; in 1991/2 the total cost was £37 million, of which £32 million arose from Fimbra members. SIB, *Annual Reports 1991/2 & 1992/3*.

¹⁵⁹ In 1990 Fimbra's share was capped at £5 million; the Lautro contribution was £4,446,000 for 1990/1. SIB, *Annual Report 1991/2*. Lautro members agreed to meet Fimbra's liabilities above £5 million up to the £19 million threshold for 1991/2.

system should be reformed, partly to provide a broader levy base.¹⁶⁰

Provision of Information

(i) False and Misleading Claims and Advertising

The disclosure requirements under the Act and rules accord with the rationale of information failure, discussed above. The FSA not only requires provision of information, it also prohibits the giving of false information. The Act provides that it is a criminal offence for any person knowingly or recklessly to make a statement, promise or forecast which s/he knows to be misleading, false or deceptive, or dishonestly conceal material facts if such a statement/concealment is made for the purpose of inducing (or is reckless as to whether it may induce) any other person to enter/refrain from entering an investment agreement or exercising any rights conferred by an investment.¹⁶¹ The person induced need not be the person to whom the statement was made or from whom the fact was concealed. It is also an offence for any person to create a false or misleading impression as to the market in or price or value of any investments if he does so for the purpose of creating that impression and with purpose of inducing some action in relation to those investments by another.¹⁶² An exception is granted for the stabilisation of investments.¹⁶³

The Act and Core Rules also regulate advertisements, implementing the EC Misleading and Unfair Advertising Directive.¹⁶⁴ All investment advertisements must be either issued or approved by an authorised person, otherwise the contract is unenforceable at the instance of the

¹⁶⁰ Clucas Report, op.cit.

¹⁶¹ S.47(1), based on s.13(1) PFIA 1958. Injunction and restitution orders apply. For Chinese walls, see below.

¹⁶² S.47(2). Stabilisation, the maintenance of a price of a newly issued security or bond which does not necessarily reflect its true market price, is allowed by the Act in certain circumstances. There is also a provision for SIB to provide an exemption from s.47 if a chinese wall exists, but SIB has not exercised this power.

¹⁶³ S.48(2)(i).

¹⁶⁴ Council Directive on the approximation of the laws, regulations and administrative provisions of the member states concerning misleading advertising, 84/432/EEC.

issuer.¹⁶⁵ The Core Rules require the advertisement to be fair and not misleading in its overall effect,¹⁶⁶ with the burden of proof falling on the firm. Communications designed to promote the provision of investment services, do not need to be approved or issued by an authorised person but must still be shown to be fair and not misleading.¹⁶⁷ There is no requirement that either the advertisement or communication should affect, intentionally or otherwise, the conduct of any person.¹⁶⁸

(ii) *Information about the investment/service*

The Act requires that SIB's rules make "proper provision" for disclosure of a firm's interests in a transaction or other material fact, including the disclosure of commissions or other remunerations received from a third party; whether the firm is acting as principal or agent, and a firm advising a customer must give him sufficient information about the investment and its financial implications as to enable him to make an informed investment decision.¹⁶⁹ In addition, under s.48 the Act provides that the Secretary of State may make rules regulating the manner in which a person holds himself out as carrying on investment business,¹⁷⁰ and requiring the disclosure of the amount or value or arrangement for the provision of commission.¹⁷¹ There is a separate disclosure regime for advertising.¹⁷² SIB has confined the application of most of the

¹⁶⁵ S.57(8). The court may uphold the contract if the advertisement was not materially influential or was not misleading as to the nature of the investment or terms of the agreement. The issue remains a criminal offence, s.57(3).

¹⁶⁶ CR 9.

¹⁶⁷ CR 9(1), implementing the EC Misleading Advertisements Directive, the scope of which is wider than the FSA definition of investment advertisement.

¹⁶⁸ The authorised person has an added duty in relation to advertisements for derivatives and warrants to private customers to ensure that the advertisement will be distributed to private customers for whom the investment would be suitable. (CR 5(4)(b)). In relation to overseas business advertising for UK private customers the authorised person must ensure that the firm will treat them in honest and reliable manner. CR 6.

¹⁶⁹ Schedule 8, paras 4-7.

¹⁷⁰ S.48(2)(c).

¹⁷¹ S.48(2)(g).

¹⁷² CR 5.

disclosure provisions to private and advisory customers, and a more detailed disclosure regime accompanies the sale of unit trusts and life assurance products, the formation of which is discussed in Chapter 7.

(iii) *Information during the course of the investment/service*

SIB's conduct of business rules expand on the Act's requirements in this respect in a number of ways. Whether information is required to be given during the period of the investment depends on the type of investment involved. The rules aim to assist the consumer in monitoring the performance of the firm, so addressing in part the principal/agent problem discussed earlier in the chapter. They require, for example, the provision of details of transactions executed for the customer (contract notes),¹⁷³ and for investment managers to provide periodic valuations of his or her portfolio and if the firm is acting on a discretionary basis, any changes in it.¹⁷⁴ Life offices need give no information as to the current value of the investment, as it is only the value on maturity which is relevant to the consumer. Instead, they are required to give information on penalties for early surrender of the policy.¹⁷⁵ The formation of these rules is considered in Chapter 7.

Quality of Service

Product regulation is confined to unit trusts.¹⁷⁶ SIB's rules otherwise rely strongly on regulating the quality of service provided to the customer. In this the regulation is recognising the problem of reliance of the customer on the service provider in a situation not just of an information failure, but an inability on the part of the investor to judge product and service quality,

¹⁷³ CR 19(1).

¹⁷⁴ CR 19(2).

¹⁷⁵ See Chapter 6.

¹⁷⁶ Financial Services (Regulated Schemes) Regulations 1991. See Linklaters and Paines, *Unit Trusts: Law and Practice* (London, 1989); J. Vaughan, *The Regulation of Unit Trusts* (London, 1990), and Ferguson and Page, *op.cit.* chapter 12.

which is enhanced when the products involved are non-repeat or infrequently purchased.¹⁷⁷ Disclosure may not be sufficient, and so other forms of regulation, conduct or structural regulation, may be required.

The Act provides that SIB's rules must promote "high standards of integrity and fair dealing" and must make proper provision for requiring authorised persons to act with due skill, care and diligence, to subordinate his own interests to that of his client and act fairly between them, and to ensure that due regard is had to the customer's circumstances. One of the main planks of the regulation which is aimed at ensuring quality of service, however, is the licensing regime.

The licensing standards for investment businesses obtaining authorisation through membership of an SRO require only that the person be "fit and proper" to conduct investment business.¹⁷⁸ Some SROs have indicated what this means: financial integrity, absence of convictions or civil liabilities, competence, good reputation and character and efficiency and honesty,¹⁷⁹ others, beyond requiring compliance with the Principles, SRO rules and Takeover Panel, have not indicated how the requirement would be interpreted.¹⁸⁰ The licensing requirements are now being bolstered by the requirements for professional training and competence imposed by the SROs. The authorisation of firms controlled by Robert Maxwell has called into question the effectiveness of the SROs' "gatekeeping" activities, but they themselves argue that they feel constrained by the prospect of judicial review from refusing membership except on strong, admissible evidence. The "fit and proper" requirements do not apply to exempted persons, of whom the most significant group for these purposes are appointed representatives. All intermediaries acting for a single life company are appointed representatives. The company is responsible for their actions, but their regulation and control has been a considerable source of

¹⁷⁷ See above.

¹⁷⁸ Schedule 2, para 1.

¹⁷⁹ SFA rule 2-3.

¹⁸⁰ IMRO Rules, Chapter 1, Section 1.

difficulty for the regulators, particularly Lautro, as it has to regulate them via the life office.

The rules on standards of advice require firms advising customers or offering discretionary services to inquire into a customer's financial position and requirements and to recommend only investments which are suitable. SIB's rules also extend the statutory provisions significantly in the area of marketing of retail products, and their formation is discussed in Chapter 7. SIB felt that the dangers of advisers disguising their true status from investors was so great that structural regulation was necessary. Firms are therefore required to sell the products of either one company or all companies, the polarisation rules. This is accompanied by particular requirements as to the standards of advice each type of seller must give.

The dangers at which polarisation is directed are not confined to the retail sector. However it is in this sector where the most unsophisticated customers will be involved, and such extensive use of structural regulation is not paralleled elsewhere in the regulatory provisions. Other forms of dealing are regulated by rules aimed at protecting the customer from "behind-the-scenes sharp practice".¹⁸¹ Again they address the problem of monitoring, and apply to private, discretionary and advisory customers. Not all aspects of the process of dealing are regulated. The exercise of discretion by a manager in relation to the allocation of investment opportunities between portfolios is not covered, for example.

The central dealing rule is that requiring best execution, one of the most significant, and problematic subjects in the securities markets.¹⁸² The requirement applies across the industry, with the exception of life policies and unit trusts. Best execution, in SIB's Core Rules, requires that a firm must take reasonable care to ascertain the best available price for the customer on that market, and must then deal at a price which is no less advantageous to the customer, unless to do so would be in the interests of the customer.¹⁸³ It is accompanied by further provisions which

¹⁸¹ SIB, *The SIB Rulebook: An Overview*, October 1987, para 28.

¹⁸² See Chapter 6.

¹⁸³ See Chapter 5.

require firms to effect or arrange execution of an order as soon as reasonably practicable,¹⁸⁴ to allocate the transaction promptly,¹⁸⁵ and not to deal for a customer excessively (churning) in other words not to deal to earn commission for the firm without additional benefit to the investor.¹⁸⁶

Managing Conflicts

The issue at which many of the rules relating to quality of service are addressed ensuring that an agent acts in the principal's interests. This was discussed earlier in terms of micro-economic theory: the principal/agent model. The issue is also recognised in common law, and addressed by the law of fiduciary duties. This is one of the most intractable areas of the regulation, and the relationship between SIB's rules and the common law of fiduciaries is the subject of a Law Commission referral.¹⁸⁷ Fiduciary law essentially provides that a person in a fiduciary relationship with another owes four principal duties: not to place himself in a position where his own interest conflicts with the beneficiary; not to profit from his position; not to place himself in a position where his duty to one beneficiary conflicts with his duty to another, and not to use information obtained in confidence from the beneficiary for his own or another's advantage.

Conflicts of interest have always existed in the financial services markets. However two factors which arose prior to the Act's formation significantly enhanced their nature and extent: the abolition of the requirement that a person deal on the Stock Exchange either as principal or as agent (single capacity), and the formation of integrated houses offering a full range of investment services including buying, selling, managing, advising, underwriting and raising capital through the issue of securities or debentures.¹⁸⁸ The types of conflicts which can arise are multifarious,

¹⁸⁴ CR 21.

¹⁸⁵ CR 23.

¹⁸⁶ CR 26.

¹⁸⁷ See Law Commission CP No.124, op.cit.

¹⁸⁸ See Chapter 2.

but may be attributed to three main factors: the range of products and services provided by the firm; the composition of its customer base; and the different capacities in which it conducts business.¹⁸⁹

Conflicts can arise within conglomerates in a multitude of ways.¹⁹⁰ When acting as a broker¹⁹¹ or discretionary fund manager, if the firm deals as principal it is breaking the "no conflict" and "no profit" rules. If a firm matches one sell order with another buy order, it is breaching the undivided loyalty rule. If a firm deals in shares purely to earn itself commission (churning), it is breaching the no profit rule. If a firm treats one customer more favourably than the other, for example executing the sell order of one prior to the other (when the price will have fallen), it is breaching the undivided loyalty rule. If one division learns information in confidence, for example that a client company is in financial difficulties, it faces an intractable conundrum. If it uses this information in its fund management activity, it is breaching the confidentiality laws, if it does not, it is acting in disregard of the undivided loyalty rules.

How these conflicts should be dealt with has been one of the more difficult areas of the regulation. The Core Rules provide that a firm must not offer or accept inducements which are likely significantly to conflict with any duties owed to a customer.¹⁹² The more difficult problems arise in situations where conflicts such as those illustrated above exist. The differences in opinion which surrounded the formation of the Principle which addresses this issue are considered in Chapter 5. Principle 6 provides that a firm should place a customer's interests above its own, and avoid a conflict of interest arising. If a conflict does arise it should ensure fair treatment to *all* its customers "by disclosure, internal rules of confidentiality, declining to act, or

¹⁸⁹ Law Commission, op.cit., para 2.2.1.

¹⁹⁰ For the purposes of this discussion it is necessary only to highlight some of the more obvious. Details can be found in R. Poser, *International Securities Regulation* (Boston, 1991) pp.186-7, and in R.M. Goode (ed), *Conflicts of Interest in the Changing Financial World* (London, 1986).

¹⁹¹ Assuming a fiduciary relationship.

¹⁹² CR 1. Inducements do not include soft commissions or commissions which have been disclosed to private investors under CR 18(2). The formation of the rule on soft commissions is discussed in Chapter 6.

otherwise." The Principle is echoed in a less detailed Core Rule.¹⁹³

The option is thereby given to a firm to "manage" its conflicts. The rationale is that the investor is protected if the existence of the interest does not result in him or her being unfairly treated. Examples of particular situations are the rules on fair allocation between a firm and a customer where own account and customer orders have been aggregated,¹⁹⁴ and dealing with own account and customer orders "fairly and in due turn".¹⁹⁵ The rules on dealing ahead of publication of research or analysis follow the same rationale.¹⁹⁶

Disclosure is the second principal tool used in the rules to manage conflicts of interest. Disclosure is required of the amount or basis of commission,¹⁹⁷ and of soft commission arrangements.¹⁹⁸ The former requirement, disclosure of the basis of commission, the Law Commission has concluded does not satisfy fiduciary law (unless taken to be usual practice, or the rules have a special status in relation to common law),¹⁹⁹ though ironically given the regulatory attention paid to it, commission disclosure by independent advisers who are paid commission by the product company is not necessary under fiduciary law.²⁰⁰ The soft commission rules, the Commission has concluded, also do not satisfy the common law provisions on secret profits.²⁰¹

The rules regulating conflicts of interest proceed on the basis that it is not the existence of a conflict which raises an issue, but its abuse. The common law, however, appears to provide that the existence of a "real and sensible possibility" of conflict²⁰² is itself sufficient to breach

¹⁹³ CR 2. Material interest does not include soft commissions or disclosable commissions (Core Rule Glossary).

¹⁹⁴ CR 24.

¹⁹⁵ CR 20.

¹⁹⁶ CR 25; SFA rule 5-36, IMRO 1991 Chapter II, rule 3.12. The SRO rules provide for post hoc disclosure in the publication itself that the firm may have/may effect an own account transaction in that investment.

¹⁹⁷ CR 18(2).

¹⁹⁸ CR 3.

¹⁹⁹ See Law Commission, CP No.124, para 5.3.15.

²⁰⁰ See Chapter 7.

²⁰¹ See Chapter 6.

²⁰² *Boardman v. Phipps* [1967] 2 AC 46 at 124 *per* Lord Upjohn.

a fiduciary duty, in the absence of consent.²⁰³ Although in a number of respects the rules require a standard of conduct which is higher than that required at common law, for example, the suitability rule, it may be that the blanket disclosure provisions which are used to obtain consent to conflicts of interest may not satisfy the common law requirements.

The Commission has provisionally concluded that "disclosure and consent are not a reliable means of avoiding conflicts between fiduciary law and what is required or permitted by regulatory rules."²⁰⁴ Thus the rules relating to commission disclosure (which do not require disclosure of the amount), the payment of dual commission in a matching transaction, soft commission arrangements, provisions in customer agreements that a firm may withhold material information, and a general disclosure of the fact that a broker may act as principal in a transaction do not satisfy the common law. The implications of this dissonance between the rules and common law depends on the conclusion the Commission comes to on the status that the rules have in relation to common law, and whether they may modify fiduciary law either as statutory rules, or as providing evidence of a trade custom.²⁰⁵

The third technique used in the rules for managing conflicts is the structural technique of the Chinese wall. This is defined as

"an established arrangement which requires information obtained by the firm in the course of carrying on one part of its business of any kind to be withheld in certain circumstances from persons with whom it deals in the course of carrying on another part of its business of any kind."²⁰⁶

The wall thus acts as a barrier to information flows, addressing the problem of attribution of knowledge and confidentiality of information as between different arms of integrated investment houses.²⁰⁷ It provides a defence to certain rules which imply or require knowledge,²⁰⁸

²⁰³ UK case law is equivocal, see *Anglo African Merchants Ltd. v. Bailey* [1970] 1 QB 311, *North South Trust Co. v. Berkely* [1971] 1 WLR 470. Australian case law seems to require abuse: *Jones v. Canavan* [1972] 2 NSWLR 236. See generally Finn, *op.cit.* and Law Commission *op.cit.*

²⁰⁴ Law Commission, *op.cit.*, para 3.4.39.

²⁰⁵ See *ibid.*, Parts 2 and 5.

²⁰⁶ CR 36, shadowing the wording of s.48(2)(h).

²⁰⁷ Blair, *op.cit.*, p.137.

including the misleading statements rule,²⁰⁹ but no disclosure of the existence of the wall is required.

The protection that a Chinese wall provides in common law is by no means certain,²¹⁰ and the Commission has concluded that as a matter of private law the wall "does not afford the type of protection that is needed for a firm to carry on its functions with the degree of assurance that the wall is designed to provide [under the Rules]".²¹¹ Section 48(2)(h) provides however that the rules may make provision "enabling or requiring information" to be withheld in this manner,²¹² a provision which the Law Commission has provisionally concluded authorises the modification of rights and duties at common law.²¹³

Considerations for rule makers

The substantive context is thus complex and heterogenous, with the several market areas encompassed by the Act raising slightly different regulatory issues, with quite distinct patterns of business and investment products. In forming rules, regulators have several choices over the substantive technique of regulation to adopt: disclosure, structural, product, conduct or price regulation. The rules employ all the techniques of regulation: financial resources, deposit protection (the compensation scheme) disclosure, structural (licensing and polarisation), conduct (for example the dealing rules) and product regulation (unit trusts). The regulatory problems posed by a major financial house operating in the City, however, may be quite different from those posed by life assurance salesmen or independent advisers, and not only because the size of the

²⁰⁸ CR 36(3). The rules where this would apply are Principle 6 (above), CR 2, material interests; CR 16(1), suitability; CR 25, dealing ahead of publication; and CR 28, insider dealing.

²⁰⁹ S.48(6)

²¹⁰ See *Re a Solicitor* (1987) 131 S.J. 1063, *Lee (David) & Co (Lincoln) Ltd v. Coward Chance* [1991] Ch 259 and *Re a Firm of Solicitors* [1992] 1 All ER 353.

²¹¹ *Ibid.*, para.4.5.25.

²¹² S.48(2)(h).

²¹³ CP No.124, paras 5.3.16 and 5.4.9.

organisation differs. It may not be possible to apply the same technique across the range of investment business. However, as Chapters 6 and 7 indicate, regulators face similar needs to balance objectives and consider the impact of the regulation on market operations even in quite different areas of market operation.

The discussion of the institutional structure suggests that the question regulators will have to ask is not just whether to make a rule, and what the rules should say, but who should make it. The structure is one of a network of regulators connected by fairly complicated lines of control and accountability. Determining the functions and roles of SIB and the SROs has been a source of considerable difficulty. The next chapter will consider how this system of regulation evolved, considering why the decision was made to regulate such a wide area of economic activity, and how the different rationales and objectives of those involved in that decision affected the structure, and expectations of rules, which were formed.

THE REGULATORY STRUCTURE

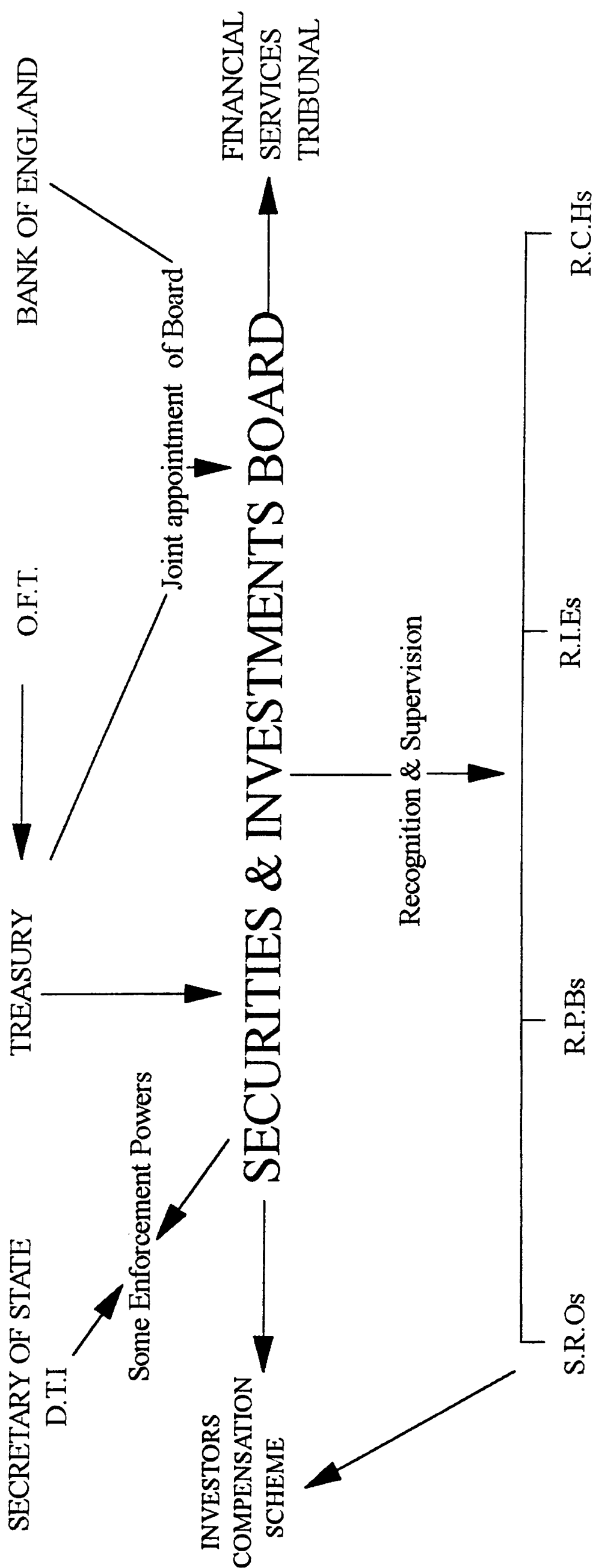


Diagram 1

Chapter 3: The Origins of the Regulation and the Rule Makers

Regulators do not exist in a historical vacuum: they are created with a particular set of powers, in a certain relationship with other regulatory and political actors, and with a certain mandate or remit. Less tangibly, they are also created with and are consequently surrounded by expectations as to what they should do and the objectives which they should achieve, expectations which may not always be free of contradictions. This chapter will examine the reasons why the new system of regulation was established, focusing in particular on two questions. Why did the Act establish this set of rulemakers, and what aims were their rules to achieve? The answers to these questions will in part be the answers to two subsequent questions addressed in the following chapters: what rules have the rule makers formed, and why did they form them?

Two themes characterised the history of financial services regulation which have had a significant and continuing impact on the rule making process: whether the system of regulation should be "self regulatory" or statutory, and whether the primary purpose was to provide investor protection or to regulate the market to facilitate efficiency and innovation. In the debates surrounding the formation of the Act there was a tension between a desire for responsive and flexible regulation to meet the demands of a transformed securities industry and for firm regulation with strong policing powers attached to combat fraud. Those in favour of "self regulation" argued that flexibility could only come from regulation of practitioners by practitioners, where experts not bureaucrats would formulate rules and be responsible for their implementation. Those against self regulation distrusted it, fearing that it could lead to cartels and stagnation. Those on both sides of the debate questioned the granting of the strong policing powers necessary to combat fraud to self regulatory bodies, either due to feelings of unease about the constitutional legitimacy of such a move, or arguing that self regulation would be ineffective in preventing fraud, and may even foster it.

The tension between investor protection and market regulation was reflected in competing

demands of the rules. As a system of market regulation rules were demanded which would be sufficiently flexible to permit financial innovation and market efficiency, yet provide sufficient certainty to permit firms to do business. As a system of investor protection, a more formal system was demanded with more detailed and onerous requirements than may be necessary for regulation of business between professionals.

Types of rules were equated in the debate with types of regulation. The debate over the regulatory structure was in essence a debate about who should be the rule maker and what type of rules should be used. There was a certain amount of confusion surrounding the issue, but it was generally presumed that a statutory body could only act either through legislation spelling out the substantive requirements or through statutory instruments, as under the FSA's predecessor the Prevention of Fraud (Investments) Act 1958. Self regulatory bodies, on the other hand, it was presumed would have rules which would be sensitive in their content and application to market practices, would be applied by understanding practitioners who would not worry about "technical" breaches, whilst providing sufficient certainty to enable business to continue. The system would be less legalistic, providing the benefits of rules but none of their drawbacks.

The issues of regulatory structure and substance were to a large extent intertwined, but in so far as they may be separated, it was the former which dominated the debate. The initial proposals for the organisation of regulators, the different reactions to them and the resulting structure can be explained by the complex substantive and regulatory situation which existed prior to the Act, the changes in the market area which the regulation had to accommodate, and the differing objectives and perceptions of what type of rules were necessary. The decision to regulate was not made on a clean slate, and although an entirely new regulatory edifice was established, the formation of the regulatory structure under the Financial Services Act was piecemeal and incremental. This was due to two main factors: the complete upheaval which overtook the securities industry in the early to mid-1980s and the different objectives of those responsible for forming the structure. The objectives of the regulation began as rationalisation and investor

protection, were joined by the desire to combat fraud, and finally became embroiled with the issue of market regulation and the competitiveness and efficiency of the City.

The chapter will outline the regulatory situation which faced Gower in 1981 and his proposals for reform. These were received with a certain amount of hostility and resistance, which turned to reluctant acceptance as it became clear that regulation was necessary. The impetus for the adoption of a new regulatory system arose from the changes which were taking place in the City independently from Gower's proposals. The nature of these, and the reasons why existing institutions and law were not felt to be sufficient are explored in the second part of the chapter. The chapter then examines the different answers given to the question, who should be the rule makers, looking at the varying views of Gower, the Bank of England and the Government, the answer which was given in the White Paper and the changes which were made during the passage of the legislation. Finally it summarises the objectives attributed to the regulation, the impact they had on the institutional structure and the continuing influence on rule making which we can expect them to exert.

Background to Gower

Gower was appointed following the collapse of several intermediaries which had revealed significant frauds on private investors and called into question the efficacy of the existing regulation, and regulators. The largest, and the catalyst of the review, was the collapse of Norton Warburg in 1981. The firm's licence had recently been renewed by the Department of Trade, and the Bank of England had advised its ex-employees to invest their redundancy payments with the firm. The issue of revising the Prevention Frauds (Investments) Act 1958, the FSA's predecessor, was not new: there had been a series of consultative documents from the Department of Trade

(DoT) on the matter, including a White Paper in 1977¹ and the Jenkins Committee had recommended its reform, but nothing had ever come of the recommendations.²

When Gower started to consider what reforms should be made to the regulation, he was faced with a market situation which was heterogenous and changing rapidly, and a system of regulation which was substantively uneven, regulating similar products and activities in different ways, and conducted in a complex institutional framework. In relation to the markets, competition in the retail sector had intensified, and although the deregulation of building societies had yet to occur, the shift in personal investment from direct to indirect investment had already begun with a consequent rise in significance of the investment adviser. In the wholesale markets, the removal of controls on bank lending and of exchange controls caused an increase in international business and prompted the formation of new, complex, financial products.

The system of regulation under the Prevention of Fraud (Investments) Act 1958 (PF(I)A) placed strong controls on the design and sale of unit trusts, exercised by the Department of Trade, but was otherwise narrow in its application, partly because it was limited essentially to offers to acquire or dispose of securities,³ and partly because of the large number of exemptions granted. The Licensed Dealers (Conduct of Business) Rules 1960, applied to only a few licensed dealers. The wide provision of exemptions by the DoT had led to what Gower described as a "fringe and an elite" where exemption was regarded as a status symbol.⁴ Members of the Stock Exchange and those regulated by the Bank of England were exempt, as were managers and trustees of unit trusts, anyone whose main business was not dealing, or who dealt only with exempted or licensed dealers, or acted as principal, or acted for or on behalf of a licensed dealer or recognised

¹ *Amendments to the Prevention of Frauds (Investments) Act 1958*, Cmnd 6893 (HMSO, London, July 1977).

² *Report of the Committee on Company Law*, Chaired by Lord Jenkins, Cmnd. 1749 (HMSO, London, 1962).

³ Its takeover provisions were largely superceded by those of the Panel on Takeovers and Mergers.

⁴ L.C.B. Gower, *Review of Investor Protection, Discussion Document* (HMSO, London, 1982), para 5.10. In 1981 over there were over four hundred exempted dealers, mainly merchant banks, licensed deposit takers or insurance companies.

association. Whole networks of dealing and business were thus exempt, and this exclusion was much relied on in dealings on, for example the Eurobond markets. Exemption was indeed almost self-perpetuating as it came simply from dealing with another who was exempt. Further, the Act left investment managers and advisers unregulated.

In contrast, the Act imposed regulation over unit trusts which was far more rigorous, and much greater than any regulation imposed on life assurance products, which were increasingly involving a unit trust component. The DoT was responsible for authorising unit trusts, and had an absolute discretion whether or not to grant approval. It effectively assumed complete control over the contents of the trust deeds. Their sale was heavily regulated, again in contrast to the absence of regulation for other intermediaries.

The regulation of life assurance was far lighter. The Policyholders Protection Act 1975 set up a statutory compensation scheme financed by a levy on industry, but there was no product regulation, and no effective regulation of intermediaries. The Insurance Brokers Registration Act 1977 (only brought into force in 1981) required intermediaries selling life assurance to register and be subject to certain levels of training and competence. However it only applied to those who called themselves "brokers" and so could easily be avoided by the use of a different title, "adviser", for example. There was an element of self regulation with the major trade associations drawing up their own codes of conduct,⁵ and the introduction of a "cooling off period" in 1980, following Government pressure. However, industry wide attempts at regulation were not particularly successful as they were subject to fragmentation. A central complaints structure was established in 1981, for example,⁶ but one third of companies refused to join and set up their own.⁷ It was the commissions agreement which provoked the greatest controversy. In an attempt to control rising commission levels and to ensure that an intermediary's advice was not driven by

⁵ The British Insurance Association, Life Insurance Association and Institute of Insurance Consultants.

⁶ Insurance Ombudsman Bureau.

⁷ The Personal Insurance Arbitration Service.

the commission level attached to a product, in 1981 the two principal trade associations⁸ introduced a commissions agreement to which all life companies had to comply which set maximum commission levels. However the agreement quickly broke down as members left the Associations in order to pay higher commissions, and it was formally abandoned in 1982. The Government refused to accede to life offices' demands for statutory controls, and a further agreement was introduced in 1984 in the midst of an escalating commissions war.⁹

Gower concluded that the main defects resulted from a combination of factors. He criticised the regulatory situation as complicated, uncertain and irrational, especially regarding the definition of "investment" under the PF(I)A, with a failure to treat like alike, overkill of regulation on unit trusts and "underkill" in relation to investment advisers and managers, an over concentration on honesty rather than competence and the development of a fringe and an elite. The regulation was complex and diverse, yet also failed to distinguish between the different activities, for example, investment management and stockbroking, which could require different regulation. In relation to the DoT's performance as regulator, the Act had permitted licenses to be granted too easily (licenses were granted on request), but the DoT had also been too inflexible in its regulation of unit trusts: approval of a deed could take months, there were no published guidelines giving the grounds on which approval would be granted and there had been ossification in the rules regulating the conduct of dealers and the distribution of circulars and unit trusts.¹⁰

Finally, the range of regulatory bodies involved was too diverse and enforcement of the regulation difficult. The DoT regulated licensed dealers and unit trusts under the PF(I)A and life insurance companies under the Insurance Acts. The Stock Exchange regulated its members, some of whom were also members of the Council for the Securities Industry. The CSI had been set up by the Bank of England to co-ordinate self regulation among all users and practitioners in the

⁸ Life Offices Association and Association of Scottish Life Offices.

⁹ Register of Life Associations Commissions.

¹⁰ Gower, *Discussion Document*, para 8.

securities markets, essentially Exchange members and those exempted under the PF(I)A.¹¹ It had formed a Code of Conduct for Dealers in Securities in 1980¹² but it had decided not to introduce a similar code for investment managers in 1979, having found "no evidence of abuse".¹³ It had no formal powers, no enforcement powers and no permanent staff. Gower concluded that the distinction between Governmental and self-regulation had become blurred, with no apparent rationale for the choice of one method of regulation over another.¹⁴

Gower's Proposals

Faced with this fragmented and complex regulation, Gower made three main proposals. First, that the definition of investments be widened. Secondly, that all those conducting business in these investments be authorised: there should be no repeat of the wholesale exemptions under the PF(I)A, and that conditions for authorisation should be imposed. These two proposals meant that market areas and participants which had always regarded themselves as entirely separate, and as having a different status within the markets, should be subject to the same system of regulation. Finally, that a new institutional structure should be imposed to formulate and carry out this regulation. It was not sufficient, Gower argued, to alter only one part of the regulation, either the substantive or the institutional framework. Both had to change if the new regulation was to be effective.¹⁵ In order for this to occur, the collaboration of the City, particularly the Stock Exchange, was crucial.¹⁶

¹¹ CSI, *Annual Report*, 1979, para 2.

¹² Following the recommendation of the Directorate for Financial Institutions that member states implement a Code of Conduct relating to transactions in transferable securities for investors. See CSI, *Annual Report* 1979, Code contained in CSI, *Annual Report* 1980.

¹³ Ibid., para 36.7.

¹⁴ Gower, *Discussion Document*, para 3.44.

¹⁵ Ibid., para 8.01.

¹⁶ Ibid., paras 7.11, 7.16-18.

In relation to the substantive provisions of the new Act, Gower proposed that the definition of investments be widened to include long term life assurance and futures, following the involvement of small investors in these markets and police reports that the incidence of fraud had increased by over forty per cent in 1981.¹⁷ He recommended that the scope of activities which should be covered be extended to include investment advisers and managers, including pension fund managers. Gower also recommended that the Act set up a coherent system of regulation of public offerings and update the prospectus provisions,¹⁸ and include provisions for the recognition and operation of exchanges, on which all business would have to be conducted.¹⁹ Following the experience of the Stock Exchange under the competition regulation, (see below), he recommended that the rules of the agencies be exempt from the competition statutes, but be reviewed by an independent Governmental authority to ensure that the rules did not restrain competition to an extent greater than was necessary for the protection of investors.²⁰

Gower's main concentration otherwise was on the institutional structure. He argued that governmental and self regulation should be seen not as antithetical but complementary.²¹ The Government should decide major questions of public policy, but its role should be "residual and supervisory"; it should not be involved in the day to day business of regulation as the likely result would be

"junior staff acting in accordance with rules derived from past precedents which would destroy flexibility, prevent desirable initiatives and constitute a code of esoteric law and lore largely unknown to those it affects."²²

His proposed structure mirrored in form that of the US Securities and Exchange Commission (SEC), and was in a sense an institutionalisation of what could have partly evolved

¹⁷ Gower, *Report, Part I*, paras 2.11-2.12. Gower quoted extensively from the Metropolitan Police Commissioner's Annual Report 1981 which had criticised the inadequacy of the existing legislation, para 1.12.

¹⁸ *Ibid.*, para 2.11.

¹⁹ *Ibid.*, para 6.04.

²⁰ *Ibid.*, para 5.03.

²¹ Gower, *Discussion Document*, para 6.02.

²² *Ibid.*

under the PF(I)A, but which due to the wide granting of exemptions, had not. The PF(I)A had permitted members of recognised associations to be exempt from the statutory rules if the association had rules which were equivalent to the LD(CB)Rs. Gower proposed that under the new system the Act should lay down the basic requirements which those conducting investment business would have to observe, and prohibit certain activities, and should empower a Department or self-standing Commission²³ to make rules which would cover the whole range of investment business and apply directly to firms regulated by it.²⁴ The day to day regulation should be administered by self-regulating associations (SRAs), who would not be recognised unless they satisfied certain conditions. These should be stated in the Act and not left to the discretion of the Secretary of State.²⁵ They should include the demonstration of a need for an SRA, that the agency had rules relating to the admission, suspension, expulsion and discipline of members, investigation of complaints, procedures for monitoring and enforcement, requirements that members be "fit and proper" in terms of their character, training and experience and financial resources, and their constitution such that it would secure "adequate independence of its governing body from the sectional interests of its members".²⁶ Their rules should provide protection at least equivalent to that provided by the rules of the Commission.²⁷ Following criticism of his original proposal that the Commission should have the power to revoke or amend the SRAs' rules,²⁸ he suggested that this power should reside with the Secretary of State.²⁹

The Impetus for Change

²³ This question he left open, Gower, *Report, Part I*, Chapter 3, and see below.

²⁴ Ibid., paras 7.07-7.15.

²⁵ Ibid., para 6.15.

²⁶ Ibid., para 6.17.

²⁷ Ibid., para 6.29.

²⁸ Gower, *Discussion Document*, para 8.04.

²⁹ Ibid., para 6.36.

Following the publication of his proposals it quickly became clear that the formation of the SRAs would not be a simple matter as each group of market actors sought to preserve their existing positions. Gower had initially suggested that there should be four SRAs, but the City had reacted against this, as it would involve parts of the market joining together with other sectors which they saw as alien from them. The merchant banks, clearing banks and acceptance houses, for example, stated that they had no interest joining a multi member agency, or being used "to bolster the business of [their] less credible competitors."³⁰ These hostilities, Gower feared, would merely serve to perpetuate the divisions between the fringe and the elite. The existing regulatory bodies resisted any change in their roles. The Stock Exchange refused to contemplate that its regulatory role over its members could be limited in any way, a view it maintained throughout the debate leading up to the Act.³¹ The CSI, which had been the subject of much criticism by respondents to the Discussion Document, one of whom had described it as "the fifth wheel on the chariot", objected to the fact that Gower had anticipated no role for it in the Discussion Document and started fighting for a prominent overseeing role in which it would identify areas of concern and suggest changes to SRAs, who would be represented on it.³² As the debate continued, the CSI fought harder to be a central element in the new system, and in 1984 contemplated seeking statutory recognition of its role.

Given the lack of interest in the issue shown by Governments to date, the Conservative Government's unveiled hostility to any extension of Departments or creation of quangos, the wide-ranging and radical nature of his recommendations and the unwelcoming reception his proposals received from the City, Gower was sceptical about their prospects.³³ The decision to pursue with

³⁰ Responses reported in the *Economist* 3.7.82.

³¹ In 1985, the Chairman stated that it did not need any Board to supervise changes in its rules, and that any suggestion that the Exchange would cease to play a regulatory role could be due only to "malice or ignorance": Sir Nicholas Goodison, "The Regulation of Financial Services in the UK", speech to the Insurance Institute, 4.2.85, (March 1985) *SEQ*.

³² CSI, *Annual Report 1983*, Appendix A.

³³ Gower, *Discussion Document*, para 7.02.

regulation along the lines suggested by him was due to three principal factors: changes in the market structure of the City, the attitude of the Government, and crucially the Bank of England to regulation, and the publicised increase in the incidence of fraud, including the experience of Lloyds. As Gower later commented, "[e]vents ... achieved what arguments and persuasion would not have done."³⁴ Whilst these factors gave the impetus to the formation of the regulation, however, each emphasised a different rationale for regulation, and thus made different demands on its structure and objectives.

Changes in the City

The market structure of the City had been characterised by the Stock Exchange's restrictions firstly, on outside control of members, and secondly on the capacity in which firms could act. The Exchange had imposed structural regulation on firms requiring them either to act as principals (jobbers) or agents (brokers) when dealing on the Exchange (single capacity) and set the commission levels to be paid to jobbers. The rules of the Exchange had been since 1979 the subject of an action by the OFT for breach of the Restrictive Trade Practices Act 1956.³⁵ The Exchange had been demanding a withdrawal of the action since 1979, arguing that it was paralysing it and preventing it from making any changes to its rules whilst it prepared its defence,³⁶ but the Government had refused to comply.³⁷ In 1980 the Wilson Committee also noted the strain on the single capacity requirements and the harm which they were doing to London's competitive position, and had doubted the wisdom of the resolution of the issue through the Restrictive Practices Court,³⁸ and Wilson had appealed to Thatcher to intervene.

³⁴ L.C.B. Gower, "Big Bang and City Regulation", 1988 *MLR* 1 at 10.

³⁵ Which applied to services under the Restrictive Trade Practices (Services) Order 1976.

³⁶ See, for example, Goodison, *op.cit.*

³⁷ The fullest accounts of the OFT's case and the Stock Exchange agreement can be found in M. Reid, *All Change in the City* (London, 1988), and M. Moran, *The Politics of the Financial Services Revolution* (London, 1991).

³⁸ *Report of a Committee to Review the Functioning of Financial Institutions*, chaired by Harold Wilson, Cmnd. 7934 (HMSO, 1980), paras 365-66.

Both politicians and the Bank of England were also concerned at the impact of the Stock Exchange's rules on London's competitive position in the international securities markets. In the Bank's view, it was mainly due to fixed commissions and the limitations on membership that "the British securities industry had been slow to recognise and respond to the trends and pressures of international competition". Fixed commissions were undermining the very system they had been designed to protect.³⁹ The abolition of exchange controls in 1979 had led to an outflow of portfolio investment, most of which was handled by London or foreign offices of overseas securities houses, which were not bound by the fixed commission rules. The high commission rates meant that major UK shares were being traded more cheaply and hence more heavily on the New York Stock Exchange than in London. Further, single capacity had meant that firms did not need to be heavily capitalised, but this meant that they were under resourced and unable to compete in an international context.

The Bank was therefore in favour of a change in the Exchange's rules, but did not want this to come through a ruling of the Restrictive Practices Court, for two reasons. Firstly, if the Exchange lost there would be a damaging void in the rules as the Court had no power to revise them, it could only render them void. Matters might be worse, however, if the Exchange won, as there would be little impetus to change. The issue went beyond this, however, into the politics of influence: the OFT would have a role in the formation of new rules, and the susceptibility of the Exchange to future actions would be ensured.⁴⁰ The Bank therefore entered into negotiations with Whitehall, and together with interventions from Gower and an increasing amenability of Ministers to a negotiated solution,⁴¹ in July 1983 the Government declared that the Exchange

³⁹ E. George, "Changes in the structure of Financial Markets: A View from London", (March 1985) *BEQB* 76. A similar sentiment was expressed by the Governor in May 1984: R. Leigh Pemberton, "The Future of the Securities Market", (June 1984) *BEQB* 189.

⁴⁰ See Moran, *op.cit.*, pp.76, and L. Jones, "The Changing Securities Market, A Stock Exchange View", 1984 *Company Lawyer* 97-100.

⁴¹ See Reid, *op.cit.*, p.47.

would be exempt from the 1956 Act.⁴² In return the Exchange agreed to abolish fixed commissions by the end of December 1986, to introduce lay members into the Council, amend internal appeal procedures and to have substantive rule changes. The Bank, with the DTI, was to monitor the implementation of these measures "and [the Exchange's] evolution and development as an efficient, competitive and suitably regulated central market affording proper protection to investors."⁴³

"Big Bang"

The implications of the abolition of fixed commissions and the relaxation in membership rules were not immediately realised. When making the announcement the Secretary of State, Cecil Parkinson, had stated that single capacity would remain in place for some time, a view shared by the Bank,⁴⁴ even though it had always been a central plank of the Exchange's argument that single capacity and fixed commissions were inextricably linked. The nature of the market was changing rapidly, however, and this rather sanguine view did not last long. The institutional structure of the City would undergo a radical change, and as it became clear that this would not be a gradual process, the term "Big Bang" entered the vocabulary. Strictly speaking it referred to the date when the new dealing system would come into operation in October 1986, but it became a shorthand expression for the fundamental changes which were taking place in the market structure.

Single capacity had not required large capitalisation, and so the under-resourced jobbers and brokers were forced to merge with institutions, principally banks, who could provide the necessary capital. This, combined with the growing trend for creating "one stop shopping" in financial markets, led the rush of takeovers of brokers and jobbers and formation of financial

⁴² HC Debs 27.7.83 cc. 1194, 1195.

⁴³ Ibid.

⁴⁴ See for example, E. George, op.cit. and R. Leigh Pemberton, op.cit.

conglomerates. Between 1984 and 1985 there were sixty mergers and acquisitions between brokers, accepting houses and banks to a value of £0.75 billion.⁴⁵ The ability, and perceived need, to form such conglomerates would however lead to a series of conflicts of interest, previously prohibited by the structural division between jobbers and brokers and the limitations on outside membership of the Exchange, which would have to be regulated.⁴⁶ The structural changes did not introduce conflicts of interest to the conduct of financial business, but they exacerbated them significantly, raising them onto the political and regulatory agenda in an unprecedented manner.

However, the increasing internationalisation and competition meant for many that the regulation should not hamper, indeed should facilitate, London's position as a financial centre. Financial markets were becoming much more international and fragmented, with a growth of commodity and financial futures exchanges which catered for quite small investors and an expansion in non-Stock Exchange dealing in domestic and international securities, including the nascent unlisted securities market.⁴⁷ Progress in technological innovation had facilitated this process, as developments in telecommunications meant that all that became necessary to do business was a computer screen and telephone line. This enabled dealing to occur off the Exchange, threatening its monopoly. Dealers not operating on the Stock Exchange were not bound by single capacity, which began to pose an increasing competitive threat to the Exchange whilst it was evolving a new dealing system.⁴⁸ Technological development also greatly increased the mobility of the industry and fuelled the fears that over-regulation could lead to business leaving

⁴⁵ Ibid.

⁴⁶ Both the Stock Exchange and the CSI produced their own codes for dealing with conflicts of interest in 1984 and 1985.

⁴⁷ Created in 1980 it was a market for shares and convertible loan stocks of companies whose share capital was lower than that necessary for listing on the Stock Exchange. The listing requirements were also not as rigorous.

⁴⁸ The Exchange appealed to the Government to prevent such off-exchange dealing until its dealing system was in place, but its requests were greeted unsympathetically by both the Bank and the Government. *FT*, 9.4.85.

London.

The financial products were also becoming increasingly complicated as companies moved from traditional bank loans as a means of raising finance. Dealings on the Eurobond market trebled between 1983 and 1986.⁴⁹ The volatility of interest rates had led to the innovation of products to mitigate these fluctuations in prices, principally hedging options and futures and swaps. The financial futures market had opened in London in 1982, and the value of swaps, for example, increased from £3 billion in 1982 to over £100 billion in 1985. The exact nature of the risks attaching to these new products was uncertain, however, given their novelty, which raised serious questions about the appropriate capital adequacy levels of firms dealing in them.

Why not use existing institutions and law?

The Goodison/Parkinson agreement opened the way for changes to occur in City practices which ensured that the issue of regulation became much larger, and more pressing, than merely revamping the PF(I)A 1958 in the light of some scandals in the fringe licensed dealer and commodity markets. Priorities shifted from the predominantly investor protection concerns which had prompted the appointment of Gower to a more market-orientated approach. The need for change, its degree and the speed at which it was set to occur had four consequences: the regulatory structure envisaged by Gower had to be adapted to meet a far larger structural change within the industry than was initially anticipated, the agenda for reform was not simply investor protection but the promotion of the City as an international centre of finance, the substantive regulation would have to provide for the conflicts of interest which were inevitably to intensify, and the new regulation had to be implemented with all possible speed. In an uncertain business climate, the form that the post Big Bang regulation would take needed to be established quickly if foreign firms were to enter the market.

⁴⁹ C. Mayer, *The Changing Structure of Financial Markets* (Amex Bank Review, Special Paper, 1987), *passim*.

Conflicts of interest were seen to require regulation for two reasons. The first related to levels of confidence investors would have in the City. Regulation was necessary, it was argued by the Bank, Exchange and Government, to prove that London was a safe place to do business.⁵⁰ If business abused positions of trust, this caused loss to individual clients and a loss of confidence in the market, which drove out trade. The second stemmed from the private law of agency and fiduciary duties.⁵¹ Many of these conflicts were not new, and some had been dealt with in the Stock Exchange rules, for example churning.⁵² The no conflict rule had been avoided by the "elegant solution"⁵³ of the functional division between brokers and jobbers, however. In the absence of this, firms would be able to act in the dual capacity of brokers and market makers. A more worrying prospect was the combination of dual capacity with fund management, so called "triple capacity". There was never a suggestion that the issue of regulating conflicts be left to private law. Instead the approach, of Gower, the DTI, the Exchange, the CSI and the Bank, was that regulatory rules based on agency law needed to be formed. The reasons for this were never fully articulated, but they appear to be based on a practical business approach that firms needed to be certain of their duties and obligations in order to function efficiently, and that common law could not provide this certainty. Regulatory rules had to be formed.⁵⁴

The CSI and Stock Exchange introduced their own codes for conflicts of interest in 1984, partly as a bid to indicate their credibility as regulators and ensure a place in the new regulatory framework. The CSI's Code for the Management of Conflicts of Interest⁵⁵ made provisions for

⁵⁰ See, for example, R. Leigh Pemberton, "Changing Boundaries in Financial Services", Governor's speech to the Finance and Investment Seminar at the University of Edinburgh, March 1984, 1984 *BEQB* 40 and Stock Exchange, *Conflicts of Interest and their Regulation, Discussion Document*, 1984 *SEQ* 18.

⁵¹ See Chapter 2, and generally, P.D. Finn, *Fiduciary Obligations* (Sydney, 1977).

⁵² Permanent Notice C-101.

⁵³ E. George, *op.cit.*

⁵⁴ Specific exemption from private law was sought by some of the major firms, but refused. The nature of the relationship between the rules and private law is currently the subject of a Law Commission review: see Law Commission, *Fiduciary Duties and Regulatory Rules: A Consultative Paper*, CP No.124 (HMSO, 1992).

⁵⁵ Published in *CSI Annual Report 1985*.

material interest disclosure, and introduced the best advantage rule for fiduciary customers which required a practitioner to protect and secure a client's interest before his own, ensure that the terms of the transaction were the best apparently available to the client and act generally at all times in good faith in what he reasonably believed to be the best interest of the client, as if acting as agent. The Stock Exchange proposed a best execution rule which required the broker to deal at the best price available, to prevent potential abuse of firm's dual capacity as broker and market maker. It also provided rules on disclosure of capacity, material interest, excessive dealing (churning), client order priority and restrictions on dealing as principal on behalf of managed funds or discretionary customers.⁵⁶

These Codes were felt to be insufficient, however, not because of their substance, but because of the nature of the body issuing them. The Bank made it quite clear that the Exchange could not be the sole, or even principle, regulator for conflicts of interest. Although conflicts may have been of direct concern to the Exchange, they "[did] not lie totally within its competence to resolve."⁵⁷ The jurisdiction of the Exchange was far too narrow to permit it to be the sole, or even principle, regulator of conflicts of interest, the Bank argued. Conflicts could arise between the member firm and its parent or sibling companies, and the Exchange would only have direct regulation over one part and conflicts could arise where there was no member involvement at all.⁵⁸ In the case of the CSI, it had no powers and little authority in the City and it was never proposed that it should continue in its present form. However, the CSI represented the umbrella self regulatory body that those in favour of self regulation wanted to preserve. Both the City Capital Markets Committee and the Bank of England envisaged that the CSI would become a high level investor protection council, supervising the body which would be supervising the self regulating agencies,⁵⁹ and wanted the Secretary of State to have to seek its approval before

⁵⁶ *Conflicts of Interest and their Regulation*, op.cit.

⁵⁷ R. Leigh Pemberton, op.cit.

⁵⁸ Ibid.

⁵⁹ *FT*, 17.2.84 and 4.4.84.

recognising SRAs or subsequently intervening in its affairs.⁶⁰

The acceptance of a need to overhaul the institutional structure of the regulation was surprising, given the resistance of the City itself to change. The attitude of the Bank, however, was crucial in this respect. There had been calls for a stronger system than the traditional City style self regulation, prompted by two factors. The first was the increase in the incidence in fraud. In 1984 nearly fifty firms in the commodities markets were under investigation in relation to over £100 million of losses, and fraud had increased by 42% since 1982.⁶¹ This prompted the establishment of the Fraud Investigation Group in 1984⁶² and the commissioning of Lord Roskill to consider changes in the conduct of fraud trials.⁶³ Secondly, the change in nature of the markets lead many to believe that the style of regulation would have to change. The fragmentation of the markets and their internationalisation meant that the old City club was disintegrating. The increasing heterogeneity of the industry would reduce the effectiveness of self regulation, which it was argued worked best in relation to narrow areas of business concerning homogenous groups. Many questioned the ability of the "Governor's eyebrows" to maintain discipline in the way they had before: large foreign banks, especially American banks used to more litigious atmospheres, would not be impressed. The financial press in particular urged strongly that statutory backing was necessary for the regulation to be effective.⁶⁴

Who Should be the Rule Makers?

In the debate leading up to the passage of the Bill, the issue of what the rules should say

⁶⁰ Barry Riley, "Gower, After the City Upheaval", *FT*, 30.4.84.

⁶¹ *Report, Part I*, para 1.12.

⁶² This followed a pilot scheme set up in 1981 of an ad hoc group drawn from the DoT, Director of Public Prosecutions and the Metropolitan Police to investigate two major fraud cases.

⁶³ *Report of the Committee on Fraud Trials*, Chaired by Lord Roskill (HMSO, 1986).

⁶⁴ Both the *Financial Times* and the *Economist* argued strongly for a statutory commission throughout 1984. See, for example, *FT Leaders* for 1.5.84, 16.7.84, 4.9.84, 10.10.84, *Economist*, 12.5.84, 14.7.84.

was overshadowed by the debate over who should make them: what structure the regulation should take. There was a strong feeling on the part of those involved in the policy process, from the Bank, to the Government, City and press, that if the structure was right, then the right kind of regulation would follow. What "right" meant was, of course, the issue in dispute. In general, there was agreement over the core aims of the regulation: it should be effective and provide investor protection whilst permitting the markets to function in an efficient manner, and should therefore have a large practitioner input in the formation of the rules, and provide for the maximum amount of flexibility. A large part of the differences lay in relation to the means. Some felt effectiveness could only come from strong statutory regulation, which would indicate to participants, consumers and observers that the Government was serious about cracking down on fraud, ensuring investors were protected and London was a safe place to do business. Others argued that effectiveness came through allowing those with the most knowledge about the markets the power to form rules that would be sensitive to market practice. This would then prevent insensitive and excessive regulation which would drive business from London.

What was striking was the extent to which certain types of institutional structure were presumed to lead inexorably to particular regulatory consequences, and to particular types of rules. Statutory regulation was held to stand for everything that was bad about regulation. Staff would be civil servants, or on civil servants' pay scales, which would guarantee low quality staff with a lack of sensitivity and expertise in the financial services sector. Regulation would be by legislation, cumbersome and inflexible, and rules would be rigidly applied. The result would be ossification, and a flight of business from London. Regulation by an independent statutory commission was seen by members of the Government, the Bank and initially the City as the worst possible scenario; there was a complete aversion to instituting an equivalent of the US Securities and Exchange Commission, although the City became increasingly resigned to a statutory commission. Self regulation, on the other hand, was felt to offer expertise, flexibility and sensitivity which would foster efficiency whilst ensuring investor protection and the commitment

of those it regulated to high standards of conduct.

Gower felt that the investor had not been well served by self regulation. That self regulatory agencies should play a prominent role in the regulation was one of the central tenets of his recommendations, however, although he did stress that self regulation should amount to more than the current propensity to trust people to behave themselves.⁶⁵ Self regulation and statutory regulation should be welded into a coherent statutory framework "in which each would perform what it does best working harmoniously together."⁶⁶ He criticised the ineptitude of the Department of Trade in administering the PF(I)A, a view shared by many. The Department revoked more licenses in the period 1982-4 than it had since 1958. His criticisms were shared by all who had to operate under the system, and the Department was the focus of blame for the new system of regulation by those who resisted it most strongly.⁶⁷

Self regulation had benefits and advantages which should be used, he argued, but it should be subject to surveillance otherwise it could degenerate into nothing more than a system of cartels with rules which were seldom reviewed and ineffectively enforced.⁶⁸ Gower did not doubt that the supervisory body should be statutory. The question he deliberately left open was whether it should be the Department or a statutory Commission, though he favoured the latter. The factors in consideration were the advantages of regulation being formed and enforced by persons with knowledge of the industry, which could provide more flexible regulation and operate in a more harmonious relationship with the City, weighed against the disadvantages of capture, and the complexity of the institutional structure of the regulation between the Department, Commission and SRAs, and the rest of the Department's regulatory functions.⁶⁹

The Government's position illustrated the prevailing confusion over what statutory and self

⁶⁵ *Discussion Document* para 8.27.

⁶⁶ *Ibid.*, para 6.04.

⁶⁷ The Stock Exchange argued that "[t]he State has let the investor down, and in the ironic way in which these things occur, has by its inaction caused a dent in the high reputation of the City." Goodison, *op.cit.*

⁶⁸ *Report, Part I*, para 2.03.

⁶⁹ *Ibid.*, paras 3.01-3.14.

regulation actually involved, and which was preferable. Whilst the Secretary of State for Trade and Industry responsible for the White Paper, Norman Tebbit, gave a speech stating that "self regulation will provide everything we want",⁷⁰ the Chancellor, Nigel Lawson stated that the regulation needed a free standing commission with umbrella responsibilities and statutory backing.⁷¹ The DTI's view remained that a statutory commission was undesirable: significantly, the disadvantages of remoteness, ossification and bureaucratisation which Gower had listed in relation to regulation by a Government department were echoed by the Secretary of State for Trade and Industry when talking about a statutory commission, and his advantages for an independent commission were Brittan's stated advantages for self regulation.⁷² The Government was involved in a wider process of privatisation and deregulation, and its ideology was one of non-intervention. It was opposed to the creation of more quangos or an extension of the public sector, and though recognising that some statutory framework was necessary to deal with the issue of fraud, was in favour of self regulation.⁷³

The Bank of England remained strongly committed to self regulation. The Bank's prime concern was the desire to develop London as the key European financial centre, and efficiency, integrity and financial innovation were watchwords of the Bank's policy. The attempt to balance financial innovation and market prosperity with formal regulation had already been encountered by the Bank in its role as banking supervisor.⁷⁴ It now faced a similar tension in the area of non-banking business. Its preferred solution was self regulation. This would enable practitioners to retain control of the regulation, determine its intensity and application and combine formal regulation with a flexibility and sensitivity that would foster confidence and not impede financial

⁷⁰ *FT* 28.6.84.

⁷¹ *FT* 4.7.84.

⁷² See *Report, Part I*, Chapter 3; 1986 HC Debs vol.89 c.941 (Mr Leon Brittan).

⁷³ N. Lawson, *The View from No.11, Memoirs of a Tory Radical* (London, 1992).

⁷⁴ For an account of the Bank's approach to regulation in the 1970s, see M. Moran, *The Politics of Banking* 2nd ed. (London, 1986).

innovation.⁷⁵

In the midst of the confusion and debate of early 1984, the Bank took the initiative. The Governor established the Governor's Advisory Group (GAG) to advise him "as a matter of some urgency on the structure and operation of *self regulatory* groupings that would most appropriately cover all types of securities activity (including investment management) together with commodity and financial futures, and which could in practice be formed in the near future."⁷⁶ Subsequent to its report in August 1984⁷⁷ (which was never published), the Bank entered discussions with the DTI.

*The White Paper*⁷⁸

The resulting White Paper proposed a balance between government and self regulation which was struck slightly differently to Gower's proposals.⁷⁹ Crucially, the umbrella body would be neither a Department nor a statutory Commission, but two practitioner bodies whose powers would be delegated to them by the Secretary of State if they satisfied specified criteria, and who would be funded by the investment industry. Their rules and constitution had to provide adequate investor protection and comply with the principles set out in the Act, which echoed those which Gower had set down for the recognition of the self-regulating associations. Two bodies were proposed: the Securities and Investments Board (SIB) and the Marketing of Investments Board

⁷⁵ See, for example, R. Leigh Pemberton, "The UK Approach to Financial Regulation", (1986) *BEQB* 48.

⁷⁶ R. Leigh Pemberton (1984) *op.cit.* p.193-4. The members of the group (described in the *Economist* 26.5.84 as a "roll call of the great and the good") were: Martin Jacomb, Chairman of VC Kleinwort Benson and Deputy Chairman of CSI; Sir Nicholas Goodison, Chairman of the Stock Exchange; John Barkshire, Chairman of Mercantile House; Brian Corby, Chief Executive of Prudential; David Hopkinson, Chairman of M&G Investment; Bill Mackworth Young, Chairman of Morgan Grenfell; Sir Jeremy Morse, Chairman of Lloyds Bank; David Scholey, Chairman of S.G. Warburg; Mark Weinberg, Chairman of Hambro LA and Richard Westmacott, senior partner of Hoare Gavett.

⁷⁷ And that of the parallel group for the life assurance industry which was appointed by the DTI, chaired by Marshall Fields.

⁷⁸ DTI, *Financial Services in the UK - A New Framework for Investor Protection*, Cmnd. 9432 (HMSO, 1985), published in January 1985.

⁷⁹ *Ibid.*, chapter 5.

(MIB), later formed as the Marketing of Investments Board Organising Committee (MIBOC). These bodies would recognise SRAs, and ensure that they had the ability to regulate the admission and conduct of their members and that their rules provided a standard of investor protection equivalent to those of the Boards. The SRAs, as Gower had suggested, would be organised on a functional basis, but there was no provision as to their number.

In order for the system to work, the Paper stated, there had to be minimum of government or parliamentary interference: rule changes could not be the subject of their approval. Instead, the body would report to the Secretary of State annually, who would lay the report before Parliament, he would be able to revoke or amend rules where in conflict with international obligations, special provisions would be made regarding competition, and he could withdraw delegated authority from the body if it did not conform to the Act. The Secretary of State and the Bank of England would appoint the Board of SIB, the Secretary of State alone would appoint the Board of MIBOC, in consultation with the industry. In addition the Secretary of State would retain certain powers in relation to competition and international obligations, to ensure that the rules did not conflict with these, or were more restrictive than necessary for the purpose of protecting investors or maintaining proper standards in the industry.

The proposals aimed to strike a careful balance between the different institutions, and the Paper was disarming in its presentation of their nature. Crucially, the government itself retained no control over the day to day operation of the regulation or formation of the rules, save on international and competition issues. It was clear that SIB⁸⁰ would in fact have the position of a self standing commission, but its status as a private company, and more importantly the granting of powers to the Secretary of State rather than to SIB, disguised its nature.⁸¹ The voluntary nature of the SROs was strongly emphasised. The Paper stated that the Board may want to use

⁸⁰ It was quickly realised that MIBOC would be merged with SIB once the rules had been formulated.

⁸¹ The powers were only exercisable by SIB once the Secretary of State had issued the necessary delegation order.

them, SROs could come forward if they wanted to and that there were no restrictions on their number or scope. In terms of the relative positions of the bodies and their accountability, SIB had control over the granting and revocation of authorisation of the SROs, but no further powers. It could apply to court for injunction and restitution orders, and prohibit persons from engaging in investment business. It had no general investigative powers, although the Government indicated a willingness to provide these.⁸² The SROs governed their own membership, and SIB could not alter their rules.

In appearance, therefore, the SROs seemed to have retained the autonomy to regulate themselves that the Stock Exchange was used to, and there were no specific requirements as to their constitution. The Paper made no parallel provision to that made for SIB and MIB's constitutions: to ensure that the governing councils had adequate independence from sectional interests. The equivalency requirement echoed the provision in the PF(I)A, but so few had been subject to its requirements its impact had not been felt. Finally, there were certain areas of vagueness in the Paper, principally concerning the relative rule making roles of the bodies, which were open to interpretation.

Changing Priorities: From Bill to Act

The balance proposed in the White Paper was described by Gower as "an ingenious one - and presented in a way so ingenious as to amount almost to a confidence trick."⁸³ The reasons for its presentation were political; concerns when striking this balance had not solely centred on the most effective way to regulate. The government was aware of the City's unveiled hostility to a statutory body, and equally aware of the need for the City's co-operation if the system was to work at all. It depended on it for the quality staff which it sought, and the City were clear in their statements that such staff would not be forthcoming if the system were made statutory and if the

⁸² Cmnd. 9432, para 5.10.

⁸³ Gower (1988) op.cit., p.11.

SROs were not given real responsibility.⁸⁴ Yet there had been further scandals in the commodities markets and an increase of concern over the levels of fraud in the securities markets.⁸⁵ These, combined with the drive to increase private share ownership through privatisation, meant the Government also had to reassure Parliament and the public that it was strengthening statutory responsibility for investor protection and was determined to prevent fraud.

The pressure for a strong statutory element in the regulation increased subsequent to the White Paper. Three events significantly affected the political climate in which the Bill was debated. The first was the resignation of the chief executive of Lloyds, whose inquiries into a previous misappropriation of members' funds had been curtailed by the Chairman of Lloyds. An enquiry into whether the 1982 Lloyds Act provided protection for members' interests comparable to that proposed under the Financial Services Bill, chaired by Sir Patrick Neill, was ordered in January 1986 following Tory and Opposition pressure.⁸⁶ The perceived failings of the Lloyds Act 1982 had a strong influence on MPs' attitudes towards self regulation in the City, and it was Lloyd's not the Takeover Panel which was the model of self-regulation in their minds.⁸⁷ The second was the failure of Johnson Matthey Bank, which called into question the conduct of the

⁸⁴ Such warnings, prominent in the passage of the Act, are still made: see, for example, IMRO's *Modification Note*, December 1989, in relation to SIB's working paper, *A Forward Look*, October 1989, which envisaged a more central policy role for SIB.

⁸⁵ Not abated by the purchase by the bank Singer and Friedlander of British Telecom privatisation shares intended for institutional investors but in fact allocated to its executives and private clients (an internal inquiry concluded there had been no bad faith), and the allegations of multiple share applications investigated by the DPP.

⁸⁶ In November 1985 the chief executive of Lloyds, Ian Hay Davidson, had resigned when attempts were made by Lloyds to change his terms of reference, which were not defined in the 1982 Act. Davidson had been brought into Lloyds by the Bank in 1983 to reform the market after a series of scandals in which millions of pounds of underwriting members' funds had been misappropriated.

⁸⁷ See, for example, in relation to SIB's powers and the composition of its Board, 1985/6 Standing Committee E c.207 (Brian Sedgemore). The inadequacies of the 1982 Act were used in arguments by Tory backbenchers in favour of making SIB a statutory commission (eg, 1985/6 Standing Committee E c.757-8, Tim Smith). Gould argued that "at Lloyds the regulators themselves became tarnished by the very practices they should have been outlawing. It is from this basis that the House should approach the whole question of regulating the City." HC Debs vol.96 c.979. The Opposition wanted Lloyds brought within the ambit of the Act.

Bank of England's supervisory responsibilities.⁸⁸ The third was the increasing concern over fraud in the City, recognised in the Government's creation in 1984 of the Fraud Investigation Group and highlighted by the publication in January 1986 of the Roskill report on the conduct of fraud trials.⁸⁹

These factors had a direct impact on the light in which strong statutory regulation was viewed by the Government as well as backbench and Opposition MPs. Prior to the introduction of the Bill the DTI indicated that it was considering strengthening the investigative powers of SIB in relation to fraud.⁹⁰ The issue of fraud and the need to secure prosecutions was climbing ever higher on the political agenda, and in a letter to David Steel the Prime Minister pledged measures to strengthen and extend the regulation.⁹¹ There was also growing support amongst some Tory backbenchers for a stronger statutory framework, and for SIB to be a fully statutory, independent commission. The collapse in the autumn of 1986 of a licensed dealer firm with the loss of millions of pounds of investors' money heightened this pressure.⁹² These events gave rise to a lack of faith in ability of some organisations to regulate themselves and many MPs on both sides of the House doubted whether the regulatory structure proposed in 1984-5 could really survive the structural upheavals of Big Bang. There was a high degree of cross party support for many of the proposals which tightened the regulation: half of the amendments which significantly strengthened the position of SIB were tabled by Tory backbench MPs.

Some MPs and Lords were also concerned to control through the legislation the nature and

⁸⁸ JMB was bought by the Bank for £1 in rescue operation in October 1984. Following an investigation by the Bank it found that JMB had made some suspicious loans for which it had made no specific provision in the accounts and which it could not cover; after failing to find private companies to support JMB, it was nationalised. The Bank's action had been prompted by JMB's position in the bullion markets and the fears of the loss of confidence that could result from its failure in that market and the linked silver and foreign exchange markets, which would affect London's position as a financial centre.

⁸⁹ Roskill Report, *op.cit.*

⁹⁰ *FT*, 22.11.84, 26.11.84.

⁹¹ *FT*, 4.12.85.

⁹² The firm, McDonald Wheeler, collapsed in October 1986. Although the Bill was by this stage in the Lords, it strengthened the case of SIB and those anxious to see a strengthening of the Bill, and was much cited in debates.

powers of the regulatory bodies due to the uncertainty of what form the SROs, in particular, would take. It was unclear as the Bill went through the Commons how many SROs there would be, or what areas of the market they would regulate. One MP commented that the Bill was "legislating for a mirage".⁹³ The feeling of both Houses was summed up by Lord Tyron who stated "the whole debate has seemed something like Hamlet without the Prince because the whole time we have been trying to guess what SIB might do, what their rules might be."⁹⁴

The unease which this uncertainty gave rise to was exacerbated by the absence of subsequent accountability of the SROs and of control over SIB's rules, and by the "private" nature of the bodies and the fear that they would regulate only in the interests of the industry. MPs therefore wanted to impose more detailed legislation to ensure greater control over the future operation of the structure. Amendments were sought to increase the specificity of the substantive provisions of the legislation, for example the fit and proper requirement, and to provide that the Secretary of State "shall" make rules instead of "may".⁹⁵ Also to incorporate into the Bill as many as possible of the regulations and guidelines, particularly relating to disclosure of charges and commissions, "which we do not want to leave to be drawn up after with a more lax and accomodating approach".⁹⁶ The Government replied that only broad rule making powers would provide the flexibility needed,⁹⁷ and that it would ensure that the rules were satisfactory before it delegated powers to SIB.⁹⁸ The Standing Committee was told "to think very carefully before taking upon itself a rule drafting role."⁹⁹

Changes were made to the institutional structure as a result of amendments proposed by Tory backbench MPs and the Opposition. These included powers sought by SIB to increase its

⁹³ 1985/6 HC Standing Committee E, c.233, Austin Mitchell.

⁹⁴ HL Debs vol.481, c.102.

⁹⁵ 1985/6 HC Standing Committee E c.439 (Tim Smith); HL Debs vol.480 c.768.

⁹⁶ Ibid., c.167 (Austin Mitchell).

⁹⁷ Ibid., c.440 (Michael Howard); HL Debs vol.480, c.1013 (Lord Lucas).

⁹⁸ Ibid., cc.425 and 439 (Michael Howard).

⁹⁹ Ibid., c.425 (Michael Howard).

power over the SROs, which were resisted by the nascent SROs, particularly the Stock Exchange. In particular, an amendment proposed by SIB and tabled by the Opposition removed the need for SIB to seek a court order before being able to require SROs to alter their rules if they failed to provide equivalent investor protection.¹⁰⁰ SIB also sought that it be clearly established that its rules would have precedence over the SROs',¹⁰¹ and the power to alter the practices of the SROs, but both were refused.¹⁰² The role of SIB was also significantly enhanced by the provision for a central compensation scheme, again lobbied for by SIB and fiercely resisted by the nascent SROs.¹⁰³ Certain powers SIB made it clear that it did not want: as a result of an amendment by a Tory backbench MP it was given the power to investigate unauthorised businesses,¹⁰⁴ but it stated that it did not want its enforcement powers to extend to the members of SROs without the SROs' request.¹⁰⁵ Finally, SIB made it clear that it did not want to be a statutory commission. This was lobbied for by Tory and Opposition MPs, but SIB stated that if it was statutory it would be tied to civil service pay scales, which would seriously reduce the quality of staff which it could attract. However, an amendment tabled by a Tory backbench MP ensured that SIB was named in the Act as the body to which powers would be delegated.¹⁰⁶

Successive amendments also affected the liabilities and constitution of the SROs. An Opposition amendment that the SROs be immune from liability to its members except for acts in bad faith was initially refused by the Government on the grounds that statutory immunity should only rarely be given to private bodies and SROs should include it in their membership rules if they wanted it.¹⁰⁷ However following warnings from SROs that lack of immunity would discourage

¹⁰⁰ Ibid., c.235-42.

¹⁰¹ Letter from Sir Kenneth Berrill to Mr Campbell Savours, HC Debs vol 89 c.987.

¹⁰² HC Debs vol.99, c.431-2.

¹⁰³ See the debate at HL Debs vol.479 c.784-797.

¹⁰⁴ 1985/6 HC Standing Committee E, c.513 (Anthony Nelson), later amended to be exercised in conjunction with the Secretary of State.

¹⁰⁵ Ibid., c.489-90.

¹⁰⁶ Ibid., c.519-30 (tabled by Anthony Nelson).

¹⁰⁷ Ibid., cc.172-188.

their formation and that as SIB had now been given the power to amend their rules the SROs should not be liable for acting according to rules over which they had little choice,¹⁰⁸ the Government agreed to amend the Act to grant immunity from action in respect of all persons, except for acts in bad faith.¹⁰⁹ In a counter move to increase the SRO's accountability, Opposition amendments to require the governing bodies of SROs to be such as to secure a proper balance between interests of the different members of the organisation and between the interests of the organisation and the public, which had failed in the Commons,¹¹⁰ were passed in the Lords.

By the end of the legislative process, therefore, the institutional structure had undergone a number of changes which had essentially added to the powers of the central body, SIB, and altered the balance created by the White Paper without introducing the coherency that the full scale adoption of Gower's proposals might have afforded. The debates reflected a constant concern over the appropriate balance between SIB and the SROs, and an increasing feeling as the amendments piled up that the balance had shifted so far from that created in the White Paper that it was incoherent to leave SIB as a non-statutory body when it had all the powers associated with a statutory one.¹¹¹ They reveal the piecemeal addition of powers to SIB and alteration in the structure of the regulation. The amendments prompted comments that the legislation was now firmly pulling in two directions with the centralising element of, for example, the compensation scheme being at odds with the autonomy of the SROs on other areas, and by the end of the process, it was being argued that it would have been more coherent to start with a statutory body and concentrate on increasing its flexibility, rather than on a self regulatory one and constantly adding powers to it.¹¹²

¹⁰⁸ HC Debs vol.96, c.416-7.

¹⁰⁹ HC Debs vol.96, c.402-4.

¹¹⁰ 1985/6 HC Standing Committee E, c.227.

¹¹¹ "The risk is that the SIB will resemble that ugly and awkward animal the camel, or a horse designed by a committee." (Vct Chaldane) HL Debs vol.478 c.602.

¹¹² See, for example, HL Debs vol. 479 c.795 (Vct Chandos); HL Debs vol.481 c.19 (Lord Ezra).

The Implications for Rule Making

The genesis of the regulatory system shows that the demands for a system which was accountable and free of the dangers of capture, yet which was flexible, knowledgeable and responsive led to a polarised debate. The options, at least as regards the supervisory regulator SIB, became characterised in terms only of statutory versus self regulation. Moreover, each was perceived as meaning a particular type of institution with particular types of rules. The institutions which were formed are the embodiment of compromise between the two positions. But they do not represent a compromise which was negotiated at one point in time. After the Gower Reports, and certainly after the publication of the White Paper, the policy process was piecemeal and incremental, with different demands giving different dimensions to this compromise.

The result was an institutional structure in which the different roles of the regulators and the relationship between them was left ambiguous. The tension has so far proved to be greatest in the issue of what rules, and what type of rules, each body should make. The tensions in the structure arise from the confused objectives attributed to the legislation, and the fact that the means of achieving those objectives was felt to lie in constructing a certain institutional structure.

Gower's proposals proceeded on the basis that all regulation should aim to do was "prevent reasonable people from being made fools of..".¹¹³ He referred to the tension between investor protection and market efficiency, and stressed that the regulation should aim to ensure that investors had confidence in the market.¹¹⁴ Although Gower stated that "it would not be in the national interest"¹¹⁵ for London to be over-regulated, his primary concern was with rationalising the existing system of regulation into a more coherent whole in the interests of, principally, investor protection.

¹¹³ Gower, *Report, Part I*, para 1.16.

¹¹⁴ Ibid.

¹¹⁵ Ibid., para 1.15.

The Bank of England and the Government also accepted that *caveat emptor* was not a realistic option, but placed greater emphasis on regulation to promote the position of London as a financial centre. This had two aspects, the avoidance of restrictive practices and the facilitation of an efficient market, and the provision of markets in which investors could have confidence. This confidence, it was felt, could be provided by well regulated and orderly markets. This feeling was enhanced by the fears that the conflicts of interest consequent on the abolition of single capacity could lead to firms abusing their position. If investors were to be assured that this would not happen, regulation was necessary. Moreover, regulation was from a practical business point of view needed to address the problems posed for the conduct of business by fiduciary law.

The White Paper stated the objectives of the Act to be fourfold: efficiency, competition, confidence and flexibility.¹¹⁶ In setting out the principles underlying the new system, the White Paper placed great emphasis on market forces and the advantages of disclosure and competition in ensuring that the industry met the needs of its customers.¹¹⁷ It stated that the law should provide a clearly understood set of general principles and rules which facilitated the raising of capital, investments and savings and buying and selling of investments. The focus of the future regulation to prevent fraud and malpractice through vigorous enforcement of a "simplified, clear investment law" and a commitment to high standards as a matter of integrity and principle which would come through self-regulation. However, the investor should not be relieved of the responsibility for exercising judgement and care in deciding how to invest his or her money.

The market orientated approach of the White Paper contrasted with Gower's more consumerist concerns. In the period between the drafting of the White Paper and the passing of the Act, the issue of fraud prevention also joined the agenda. These different motivations were associated with different perceptions of the effectiveness and implications of different types of regulation, which were seen to be synonymous with different types of rules. Statutory regulation

¹¹⁶ Cmnd. 9432, Chapter 3.

¹¹⁷ Ibid.

meant tough regulation which would stamp out fraud, but would have rigid, detailed and legalistic rules. Self regulation meant flexible, principled rules, sensitive to the operation of the industry and which would facilitate market operations, but also cartels, lack of competition and self-interest rather than public interest regulation.

In reconciling these objectives a structure emerged in which SIB, a non-statutory body, was given quite extensive powers of investigation and enforcement and the responsibility for the establishment and administration of the central compensation fund. It has the task of recognising and monitoring other regulatory bodies: the SROs, professional bodies (RPBs), investment exchanges and clearing houses, and had to measure the suitability of SROs and RPBs to become regulators against its own investor protection provisions. It was given the power to amend the rules of the SROs directly and though it had to consult, could amend without their consent. It also acts as a direct regulator for those investment businesses who do not wish to join an SRO.

Against these centralising elements lie the powers and role of the SROs. The role envisioned for the SROs was that they would be the regulators of the majority of investment businesses, and would be responsible for writing rules tailored to their respective areas of the market. It was anticipated that they would have a considerable amount of flexibility in forming their rules, and be the engines of policy change. It was through them that the regulation was to achieve the benefits of effectiveness and flexibility which it was argued a large state commission could not provide.

This role is not apparent on the face of the Act, however, due to the combination of the equivalency requirement and the power of SIB to alter SRO rules directly, favoured by those concerned about the legitimacy and effectiveness of extensive self regulation. The relationship between SIB and the SROs remained ambiguous in one vital respect, the relationship between their rule making functions. Was SIB to form rules which were general standards, or was it to form detailed rules which would comprehensively regulate the entire area? Were the SROs to write their own rules to suit their own area of business in the form and substance that they wished, or

were they to follow the lead set by SIB? How was any rule maker to discern and implement the different objectives of the Act? The two subsequent chapters explore the impact the tensions in the institutional structure, itself an attempt to achieve the conflicting objectives of the Act, have had on the rule making functions of the regulators.

Chapter 4: Forming the Rule Books

Gower had proposed an institutional structure of a central body with self regulating bodies under it. This structure would be mirrored in the rule making system through a requirement that the rules of the agencies had to provide investor protection equivalent to that provided by the Commission's rules.¹ The equivalency requirement was there to provide a measure of control over the substance of the SRO rules, and was adopted in the Act. As we have noted in the previous chapter, concerns over the nature of the structure, and the nature of the rules, had dominated the debates. Rules were a significant part of the qualifications necessary for recognition of both SIB and the SROs, and in practice it was to them that the recognising body paid most attention.

SIB's initial rule making powers had enabled it to make rules and issue guidance which would apply to those firms which sought authorisation from it. In 1989 the FSA was amended to extend SIB's rule making powers and alter the basis of assessment of the SRO's rules. SIB was given the power to make statements of principle, rules and codes of practice as well as issue guidance, and the scope of these rules was extended.² Principles apply to members of RPBs and SROs, and the rules and codes of practice to SRO members. The SROs' rules now have to ensure that, taken together with the principles and rules of SIB to which their members are subject, the rules provide adequate investor protection.³

This chapter explores the formation of the initial 1987 Rules of SIB, indicating the scale of the task which faced the regulators and analysing the factors which influenced their formation. Some of these had affected the formation of the substantive provisions of the Act itself, others were a product of it. Particularly, the provision of a private right of action under s.62 for a person

¹ L.C.B. Gower, *Review of Investor Protection, Report Part I*, Cmnd. 9125 (HMSO, London, 1982), para 6.17.

² Ss.47A, 63A-C, inserted by ss.192, 194 and 195 Companies Act 1989.

³ Sch 3, para 3, amended by s.203(1) Companies Act 1989.

who suffered loss as a result of a firm breaching a rule enhanced demands by the firms themselves for increasingly specific rules. It then examines the reasons for the change in the rule system, exploring why it was felt that SIB needed a greater rule making flexibility and increased control over authorised firms.

Forming the 1987 SIB Rules

Statutory Principles

Provisions on SIB's powers for making conduct of business rules are found in two places in the Act. The first is the section enabling the Secretary of State to make "rules regulating the conduct of investment business",⁴ powers delegated to SIB under the delegation order.⁵ The Act gives a non-exhaustive list of particular provisions which the rules may make, which includes prohibiting a person from conducting investment business, regulating the manner in which a person may hold himself out as carrying on investment business, requiring disclosure of commissions and charges, regulating advertisements, arrangement for the settlement of disputes and regulating the manner in which a person makes a market in investments.⁶ The rules may also regulate business done in connection with investment business, or held out as being for the purposes of investment.⁷ The only limit imposed is that SIB may not make rules which place limits on the amount of commissions or other inducements paid in connection with investment business.⁸

SIB's conduct of business rules also have to comply with certain provisions as a condition for SIB receiving and retaining designated agency status. The rules have to provide an "adequate"

⁴ S.48.

⁵ Under s.114, by Financial Services Act 1986 (Delegation) Order 1987, SI 1987/942.

⁶ S.48(2).

⁷ S.48(4).

⁸ S.48(3).

level of protection for investors,⁹ "promote high standards of integrity and fair dealing" and "make proper provision" for the following:

- (a) authorised persons to act with due skill, care and diligence;
- (b) firms to subordinate their interests to those of their customers;
- (c) firms to act fairly between customers;
- (d) firms to have due regard to the circumstances of their customers;
- (e) the disclosure of material facts (including the firm's own interests, commissions and inducements);
- (f) the disclosure of capacity (eg. principal or agent) and terms of business by the firm;
- (g) the provision of sufficient information about the investment and its implications to enable the customer to make an informed decision;
- (h) the protection of property entrusted to a firm;
- (i) the keeping and inspection of records.¹⁰

In addition, following Gower's remit in 1981,¹¹ the rules were to make distinctions between different types of customer in their requirements, to recognise that provisions made for business with one type of customer "may not (by reason of their knowledge, experience or otherwise) be appropriate in relation to others."¹²

The Nature of the Task

Although much of SIB's attention was focused on the passage of the Bill, partly to address MPs' concerns with delegation, and partly because its rule book had to be formed before the whole system could get under way, SIB began the process of drafting its rules prior to the passing of the Act. The first draft of its rules was published in March 1986, the next in September.¹³ In February 1987 SIB produced a further draft of rules for submission for designated agency status. The DTI requested further amendments prior to the granting of the delegation order in May 1987, and SIB's rules were finally published in October 1987.¹⁴

⁹ S.114(9).

¹⁰ Schedule 8, paras 2-7 and 9-11.

¹¹ L.C.B. Gower, *Investor Protection: Discussion Paper* (HMSO, London, 1982) para 1.01.

¹² Schedule 8, para 12.

¹³ SIB, *Draft Rules and Regulations*, 1986.

¹⁴ SIB, *Rules and Regulations* October 1987.

SIB's rules had to be capable of regulating all types of investment business, because firstly, any person could apply to it for direct authorisation and hence regulation, and secondly, its rules were the benchmark for the SROs' rules, and the SROs would between them cover the whole range of investment business. SIB was responsible not just for conduct of business rules, but financial resources, client money and unsolicited call rules, as well as for the initial task of approval and recognition of SROs, RPBs, exchanges and clearing houses.

The sense of those involved was one of the enormity of their task: one initial Board member described the drafting of the rule books as "mapping a continent: you had to find out where the rivers and mountains were".¹⁵ The Act is a highly technical piece of legislation, and the legislative process groaned under its strain.¹⁶ The Bill was subject to a huge number of amendments, the majority of which were Government amendments tabled in the Lords as a result of last minute representations by firms who suddenly realised that they would be subject to the provisions of the Act. There were over 300 amendments on Report stage in the Commons, and over 750 in the Lords, over 400 on Report stage there. The bill ended the process fifty per cent longer, with three new schedules and forty six new sections. The result, as Gower stated, "is an Act of great complication and frequent obscurity".¹⁷

Many of the activities covered by the Act had not been subject to regulation, and because of the changes occurring in the City it was not clear what new activities would be emerging which would need regulation. The rules had to embrace the principles set out in s.48 and Schedule 8. Whilst these principles follow the more detailed statement as to the provisions of the conduct of business rules in the White Paper (which included a provision as to best execution),¹⁸ themselves

¹⁵ Interview with independent Board member of SIB, May 1992.

¹⁶ See, for example, comments made at HL Debs vol.479 cc.87-9 and 255-258, vol.480 c.684-6.

¹⁷ L.C.B Gower, "Big Bang and City Regulation" (1988) 51 *MLR* 1 at 29.

¹⁸ *Financial Services in the UK: A New Framework for Investor Protection*, Cmnd. 9432, (London, 1985), Chapter 7.

based on the draft codes of the CSI,¹⁹ the Stock Exchange²⁰ and a joint working paper of the DTI and Bank of England,²¹ none of these Codes had been implemented. The Licensed Dealers' (Conduct of Business) Rules had been revised in 1983, but the experience of their operation was limited due to factors of time and the relatively few numbers of persons subject to them. They were also not as extensive in their requirements. Much of the regulation was therefore being formed without a precedent in UK regulation. The rules of the SEC were relied upon, but as Gower stated, the UK was having to do in four years what the SEC had done in fifty.²²

Factors Influencing the Rules' Formation

SIB's rule book emerged as a more detailed and complex set of rules than had been anticipated by many of those involved in the drafting of the White Paper proposals, and by those to be subject to them. The rules were greeted by observers and the regulated as complex and confusing, threatening to stifle the business they were meant to be regulating. The structure of the rules was complex and precise, which reduced their clarity. The rules had a negative expression of scope (prohibition followed by exceptions), rather than a positive one, partly due to the absence of a private customer definition, which tended to obscure understanding of their scope.²³

As had been the case in the formation of the Act, due to reconsiderations or requests for change the rules were constantly subject to amendment. Many of these were drafting or technical amendments, but a substantial number were substantive changes to the rules, either their requirements or their scope. Between February 1987 and October 1987 there were two major sets

¹⁹ CSI, *Draft Code of Conduct on the Management of Conflicts of Interest*, CSI Annual Report 1985, Appendix B; see Chapter 3.

²⁰ Stock Exchange, *Conflicts of Interest and their Regulation: Discussion Document*, November 1984, in 1985 SEQ 18.

²¹ L.C.B. Gower, *Investor Protection in the UK, Report, Part II* (London 1984) Chapter 4.

²² Gower (1988), op.cit.

²³ See Chapter 4.

of amendments; in March and April 1988 (the rules came into effect on 29 April: "A Day"), SIB issued six rule releases containing over fifty amendments;²⁴ in the following two months it issued four releases containing nearly thirty amendments.²⁵ Over half of these amendments were substantive. The structure of the rules, requirement or prohibition followed by exceptions, was designed to accommodate the frequent requests for "carve outs" or exemptions from the rules, with cross-referencing providing an interdependence of the rules which meant changes in one part could be reflected throughout the rule book. The pressures of speed meant that there was little time to stand back and review the rule books as a whole, either by the regulated or by SIB, with the consequence that they were produced in a fairly raw form.

This section will explore the reasons for the complex and detailed structure of the rules, highlighting the principal factors which influenced SIB's rule making process. Of these, the institutional structure and the political context were significant influences in the formation of the initial rules. They do not by themselves, however, explain the complex rule books which emerged. The most important factors, determinative in their influence, were fourfold: the statutory provision of a private right of action for breach of the rules,²⁶ the nature of the consultation with the regulated and the SROs, SIB's approach to regulation, and the nascent and untested state of the regulatory system.

Political Context

The political context imposed a requirement for speed, arising from the impending date of Big Bang on 27 October 1986 when the new dealing system of the Exchange was to be

²⁴ The FS (Conduct of Business) (Amendment) Rules 1988 (No. 8) 17/03/88; The FS (Oil Markets) Rules and Regulations 1988 (No. 11) 31/03/88; The FS (Misc. Amendments) Rules and Regulations 1988 (No.13) 21/04/88; The FS (Transitional) Rules and Regulations 1988 (No.14) 12/04/88; The FS (Conduct of Business) (Amendment No.2) Rules 1988 (No.21) 28/04/88; The FS (Interim) Rules and Regulations 1988 (No.22) 28/04/88.

²⁵ The FS (Conduct of Business) (Amendment No.3) Rules 1988 (No.23) 03/05/88; The FS (Conduct of Business) (Amendment No.4) Rules 1988 (No.26) 27/05/88; The FS (Misc. Amendments) (No.2) Rules and Regulations 1988 (No.27) 16/06/88.

²⁶ S.62, see Chapter 2 (private and public enforcement mechanisms).

introduced. Firms would be dealing without restraint of rules other than the CSI's Code of Conduct and the Stock Exchange rules (for those who were members of either) until the Act and rules came into force. The Government was keen that this should be as short a time as possible, and the initial timetable for implementation was 1987. In the event, the system did not come into effect until April 1988 ("A-day"), eighteen months after Big Bang.

The political context also required an indication from the rules that SIB would be a tough regulator. This was for two reasons: concern about fraud and doubts about the effectiveness of self regulation. During the initial stages of the Act, the need for strong regulation to combat fraud and sharp practice had been at the forefront of debates. Although this had subsequently been subsumed by concerns to ensure that professional investors were not too constrained by the Act's requirements, prompted mainly by the professional investors themselves,²⁷ the desire for strong regulation was still great. This pressure was enhanced by the issue of SIB's legitimacy, raised above. Critics of self regulation argued that it was no more than a cartel system in which regulation was provided to meet the demands of the regulated rather than a wider public interest. Strong regulation would be a sign that the system would not be simply regulating in the interests of the regulated.

The Functions of SIB's Rules

More fundamental than these political demands for speed and strong regulation was SIB's position within the institutional structure. The length of the rule books was in large part due to the different functions SIB and its rule book played in the regulatory system. SIB's role as the designated agency meant that its rules had to incorporate the principles of the Act and serve as the main qualification for SIB to be recognised as the designated agency. Its rule book was regarded by the DTI as the key statutory test of SIB's ability to fulfil the role of designated agency, and it was also subject to review by the Director General of Fair Trading under the

²⁷ See above.

competition provisions before recognition could be granted. SIB's rule book was thus the first stage in, and the pre-requisite for the establishment of the entire system. This re-inforced the pressure of speed which contributed to the complexity of the rules, and as we will see, the recognition requirement allowed the DTI an important influence on the form and nature of the rules.

Further, SIB's rules acted as the benchmark for the rule books of the SROs for the purposes of their recognition by SIB. They therefore had to cover the entire range of investment business and set standards which the SROs' rules had to match. The ability of firms to seek direct authorisation from SIB meant that it was also a regulator as well as a standard setter, however, and its rules therefore had to be capable of regulating any firm which sought direct authorisation from it.

Consultation

The rule making process was heavily influenced by the attitudes and approaches of those involved in the formation of the rules, the DTI, SIB, the SROs and the regulated. Prior to its recognition SIB was not legally bound by the statutory consultation requirements but nevertheless engaged in consultation with those who would be subject to its substantive provisions, either directly or indirectly through membership of the SROs. The consultation process was less fruitful than might have been hoped, however, due largely to the scale of the changes occurring in the City and the regulatory structure.

The SROs were in the process of forming, recruiting staff, ensuring that their organisational structures, membership and disciplinary processes satisfied the statutory conditions and setting up procedures for handling the vast numbers of firms that would seek authorisation through them. With the exception of those who had worked in the Stock Exchange or been members, none had experience either in regulating or being regulated as much of the City had been unregulated, or subject to very general codes of practice. This inevitable process of

establishment, the novelty of regulation and the pressure for speed restricted fruitful consultation with the SROs on the rule books as a whole. The expertise which was meant to inform the rules was not forthcoming from practitioners in the City either. The City's attention was occupied by the restructuring of the industry and the bull market, which prevailed until the crash of October 1987. Responses to consultations tended to come at the end of, or after, the consultation process and were particular to each firm's or sector's problems, with fears of s.62 actions playing a large role in influencing their demands.

Section 62

Demands for exemptions or further detail as to the nature of the requirements were fuelled by the provision of a private right of action for breach of the rules under s.62 of the Act. Although not initially a major consideration for SIB in its drafting, it was a serious concern of practitioners and so one which SIB felt it had to accommodate. Actions in common law for breach of agency or fiduciary duties had not figured prominently in the history of investment business and there was little reason to suppose that the Act would alone cause the judiciary to abandon its customary approach of respecting "best market practice". The actual likelihood of actions did not matter, however, what was significant was the City's perception that there would be an increasingly litigious atmosphere in which firms would be suing each other almost as a matter of course. This fear was prompted by several factors, the "consciousness raising" of the Act and the rules generally, the changing nature and increased competitiveness of the City environment, and the entry of American firms into the market. Evidence used in support of these fears was the litigation against the Takeover Panel for the first time in 1987, when it was held that the Panel was susceptible to judicial review.²⁸ Firms were therefore concerned to ensure that their duties were clearly defined and their liability to other professional firms was limited. They demanded rules which were certain, but not too detailed. A policy director at SIB commented:

²⁸ *R. v. City Panel on Takeovers and Mergers, ex.p. Datafin* [1987] 1 All ER 524 (CA).

"[S.62] complicated the task of the rule drafters considerably - trying to draft rules which are simultaneously not too woolly to be meaningful and not too easy to break inadvertently to the benefit of litigious professional customers is difficult."²⁹

S.62 did not only fuel the demands of the regulated for certainty, it meant that it would not only be the regulators who would be involved in the enforcement of the rules. S.62 almost negated any possibility that the rules could have the "flexibility" which had formed such an important part of the rhetoric surrounding the genesis of the Act, as it meant that enforcement and application of the rules was not in the hands of the regulators alone. The rules had to be capable of application by the court. SIB used this consideration to counter criticisms that the rules should be more general. The private right of action, SIB argued, meant that the rules had to be drafted in "legal language" precise enough to enable both the regulators and the courts to establish whether they have been broken. "Rules of this sort cannot be as "user friendly" as the Highway Code or CSI codes."³⁰

The DTI

The demands of s.62, the need for speed and the effect of consultations all contributed to the length and complexity of the rules. It was the role of the DTI, however, which exerted one of the strongest pressures on SIB for detailed rules.³¹ The Secretary of State for Trade and Industry was responsible for making the delegation order if SIB satisfied the statutory conditions. In practice this meant the DTI was allowed enormous influence on the shape of the rules, which became the principal criteria for recognition. Responsibility for the growth of the rule book between the first drafts of 1986 and the final draft of 1987 is laid firmly at the feet of the DTI by those at SIB during that period: "[t]hey insisted that it be comprehensive, and told SIB that it

²⁹ K. Mortimer, "The Securities and Investments Board" in A. Seldon (ed) *Financial Regulation - or Over Regulation?* (London, 1988), at p.50. Mortimer was Policy Director at SIB, 1985-7.

³⁰ SIB, February 1987, para 5.

³¹ This section is based on interviews with Board members and senior staff at SIB, 1985-8. Interviews were conducted over the period May - July 1992.

would not have powers delegated to it unless they could see what it would do with them."³² In the words of one senior executive,

"[w]hen the Bill became an Act the DTI lawyers especially were very proprietorial over it - it was their baby...They were very insistent on a strict interpretation of the views of Parliament as expressed in the debates and text, and those views were very restrictive. The pressure was to be watertight, not user friendly. The DTI did not really care if the rules worked, they just had to be legally correct and precise."

SIB's approach

SIB's own approach to its statutory responsibilities also tended towards the formation of detailed rules imposing high standards of conduct rather than more general rules, however. Gower had urged against "moral exhortations" in his Report,³³ and SIB showed no inclination to use them. SIB's idea of what regulation should provide was expressed clearly in the overview to its rule book. SIB stated that when drafting the rules to implement the statutory principles "whilst fully appreciative of the appeal of simple relatively general rules", it had felt bound to give weight to three important considerations:

"certainty: the need for firms to know what they must do, can do or cannot do; for customers to know what to expect and to what they are entitled; for the rules to be capable of being monitored effectively and efficiently; and for the sanctions under the Act, whether discipline of firms or of individuals or redress by the courts for individuals who have suffered loss, to operate effectively;

consistency: the risk that rules drafted in general terms will be interpreted too diversely by different firms in a huge, competitive and diverse industry, penalising firms who take a strict interpretation and the customers of other firms;

standards: the difficulty, given a starting point of considerable variations in standards of competence and honesty, and given the highly competitive environment, of assuming that without specific guidance all firms will operate to the standards of the best."³⁴

SIB felt that the equivalency requirement particularly meant that its rules had to be the exemplar, providing a very high level of protection.³⁵

³² See further, K. Mortimer op.cit, pp.50-1.

³³ *Report, Part I*, para 8.52.

³⁴ SIB, *The SIB Rulebook: An Overview*, October 1987, para 10 (emphasis provided).

³⁵ *Ibid.*, para 5.

Uncertainty

Underlying these interrelated factors and considerations was one fundamental factor: uncertainty. Regulation, and the regulated agencies, were all unknown quantities. This imposed a desire at all stages of the formation of the Act and the initial rule books for the delegating body to control as much as possible the manner in which that authority would be used. As we have seen, some in Parliament were wary of what type of regulation would emerge, and so pressed (in vain) for more detailed enabling legislation on the substantive provisions.³⁶ The DTI was uncertain as to how SIB would carry out its statutory functions, and so demanded increasing detail in its rules. SIB was unsure about how many firms it would have to regulate, and what the SROs would prove to be like as regulators. It was also unsure of whether it could trust the practitioners to act as it wanted if only general requirements were made. SIB was therefore concerned to spell out in detail how it expected investment firms to act. In the chain of delegation, each delegator sought to influence through detailed prescription the manner in which the power would be used.

Pressures for Change

SIB's rule book was greeted with a barrage of criticism. It was argued that the rules were too complicated, too detailed and too difficult to understand, and as such, uncertain in their interpretation and inflexible in their application. It was also argued that in their substance the rules went beyond what was necessary to protect the ordinary investor and imposed too many duties on professionals dealing between themselves, which risked damaging the development of market innovation domestically and impairing the ability of UK and foreign firms to compete internationally from a UK base.³⁷

Some of the criticisms stemmed from the shock felt by many of being subject to regulation

³⁶ See Chapter 3.

³⁷ See Chapter 3.

for the first time. Underlying many of the complaints about the rules, however, was the more fundamental criticism directed at the role the rules demonstrated SIB was playing in the regulation. SIB was not laying down the minimum standards many had expected, rather it appeared to be setting out, in great detail, what best practice should be. This was a more dominating role than many had anticipated. The SROs could not ignore it, however; SIB's approach to regulation impacted directly on the rule books of the SROs through the equivalency requirement.³⁸ The provision was ambiguous: was it the overall protection provided which had to be equivalent, or the precise requirement of rules? SIB took the latter interpretation and required that the rules be "equivalent in each separate respect", so locking the SROs' rules into to SIB's rule book, and opening them to similar criticisms of over-complexity as those which had been directed at SIB's rules. The SROs felt they were being given insufficient opportunity to draft their own rules, whilst SIB protested that it was simply carrying out its statutory duties. Critics argued that the self regulatory ideals of the regulatory system were being betrayed as the practitioner input expected from the regulatory structure was not being allowed to be felt and SROs could not tailor the rules to suit their own market sector.

Paradoxically, the SROs' rules were also criticised on the basis that there was too much diversity between them. As the SROs are organised on a functional basis, one firm may be member of more than one SRO. The need for a firm to digest each rule book, and conform to the slightly different requirements, served only to exacerbate the complexity of each individual rule book. It was not so much that the rule books imposed contradictory requirements, more that provisions such as the advertising rules and requirements for customer and business documentation differed, causing significant difficulties and expense.

The hostility to the new regulation came primarily from the City, as opposed to the life assurance and unit trust markets, and was focused on the SIB chairman, Sir Kenneth Berrill. The City's attitude was not lost on the new Secretary of State, Lord Young, who publicly

³⁸ Schedule 2, para 3(1). See Chapter 2.

acknowledged the concern over reports of "excessive legalism" of SIB and some of the SROs³⁹ and as part of the "Releasing Enterprise" initiative,⁴⁰ expressed his intention to ensure that small businesses were not burdened with excessive demands under the Act. When in February 1988 it was announced that Sir Kenneth Berrill's term of office as chairman of SIB would not be renewed, despite his publicly stated wish to remain,⁴¹ many in the City were delighted. There had been reports of a growing discontentment with the SIB chairman in the City and Bank of England for many months prior to the announcement, and it emerged that the Bank and Lord Young had decided as far back as October 1987 that he would be replaced.⁴² That his successor was a Bank of England executive director, David Walker, was seen as a victory for the City establishment in the battle against the regulators: one commentator described "Sir Kenneth's scalp" as "the City's biggest prize",⁴³ another called it a "slap in the face for SIB".⁴⁴

Officials at the Bank of England also wanted changes, principally a repeal of s.62 and a re-writing of the rulebooks. The Bank also sought a revised approach by SIB to its regulatory role. The suggestion endorsed by leading Bank officials was that the SIB rule book should confine itself to stating general principles rather than detailed provisions, giving more discretion to the SROs.⁴⁵ In a speech at the Lord Mayor's Dinner some months after Walker's appointment the Governor of the Bank stated that the "practitioners' contribution had been overshadowed" and expressed the hope that "we are now moving into a phase of application and refinement in which practitioners can be allowed a greater part."⁴⁶

The SROs were also demanding greater flexibility to enable them to write their own rules.

³⁹ *FT*, 11.2.88.

⁴⁰ DTI, *Releasing Enterprise* (London, February 1988).

⁴¹ *FT*, 29.2.88, Leader.

⁴² Richard Waters, "Decision to appoint Walker", *FT*, 27.2.88.

⁴³ *Economist*, 10.4.88.

⁴⁴ Waters, *op.cit.*

⁴⁵ Clive Wolman, "Bank's hopes for SIB Chairman", *FT*, 31.5.88.

⁴⁶ R. Leigh Pemberton, "The Markets, the City and the Economy", (1988) *BEQB* 59.

IMRO publicly urged SIB to adopt a lower profile, threatening that self-regulation would otherwise come to an early end: "SROs must be allowed to develop personalities without being over-restricted by the school-marmish SIB... SIB should allow SROs scope to vary their rulebooks and apply flexible, practitioner based regulation."⁴⁷

Within weeks of taking office, Walker publicly agreed with the need for simplification of the rule books, later stating that they were "over-long, over-complicated and over-specific."⁴⁸ Although he resisted calls for substantive modifications of the regulation (principally of the polarisation regime and client agreement requirements), he did see a different role for regulation and rules from that manifested in the initial rulebooks. Instead of "detailed prescription of when and how things should be done", he argued, rules should merely "prescribe that they be done".⁴⁹ In July 1988 SIB announced that it was redrafting its rules in a more simplified form, and anticipated that the new rules would be complete by early 1989.

The New Approach

In November 1988 a revised version of SIB's rules was published, the New Approach.⁵⁰ Drafted entirely by SIB's chief legal adviser, Michael Blair, it was essentially a recasting of the rules, reorganising and simplifying them but essentially leaving their substantive content intact.⁵¹ The stated aim was to "re-fashion the...requirements so as to enable the principles underlying them to be more readily discerned."⁵² To this end, "principles of conduct" were introduced which had the detailed requirements set out beneath them. In total there were 93 principles, some of which were not followed by more detailed rules and which had to be observed according to their terms,

⁴⁷ Speech of John Morgan, Chief Executive of IMRO, to the National Association of Pension Funds, quoted in *FT*, 27.2.88.

⁴⁸ D. Walker, "Financial Services: The Principals Initiative", (February 1989) *BJIBFL* 51.

⁴⁹ *FT*, 6.7.88; *Economist*, 30.7.88.

⁵⁰ SIB, *The SIB Rulebook, The New Approach*, SIB, November 1987.

⁵¹ For details of the changes, see *ibid.*, Commentary, paras 11-42.

⁵² *Ibid.*, para 1.

the majority of which were followed by rules and which were an "indication of purpose and a general guide" for the interpretation and application of the rule.⁵³

In an attempt to mitigate the effects of the detail of the rules different levels of duty were to be owed to different types of customer. The customer's interests were to be paramount when dealing with private and experienced customers, to be balanced against those of the firm when dealing with other customers, and the firm's interests were to be the only consideration in relation to other persons.⁵⁴ The equivalency requirement remained intact, and both the rules and principles were to be subject to s.62 as changing either would require statutory amendment. The effect of s.62 was softened by a "best endeavours" provision: a professional was to be taken to have complied with a rule vis a vis another professional if he had taken all reasonable steps to comply.⁵⁵

The introduction of the principles was an attempt to inject more comprehensibility into the rules, and to "infuse a degree of willingness to comply with the rules, instead of mere literal observance of the detail."⁵⁶ It was hoped they would introduce a dynamic quality into the rules, encouraging a more purposive approach to interpretation and setting standards to guide conduct in specific areas not covered. There was little sense of what a "principle" should be, however. Some of the principles were more explanations than statements of fundamental obligation, some were quite general but others more detailed.

Certain aspects of the new rule book were welcomed, for example the introduction of tables setting out the requirements for customer documentation and advertisements and the new section on stabilisation which was immediately adopted, but on the whole the New Approach was not favourably received. The main criticisms focused on the incoherent use of the principles and

⁵³ Ibid., r.2.01.

⁵⁴ Ibid., Part 2.

⁵⁵ *A New Approach*, r.2.07.

⁵⁶ Ibid., para 10. See also A. Whittaker, "Financial Services, Developing the Regulatory Structure", (January 1989) *BJIBFL* 5.

their susceptibility to private action under s.62.⁵⁷ Many legal practitioners and firms argued that it was not appropriate for such imprecise principles to create obligations actionable in law. In addition, the imposition of absolute duties by some of the principles, rather than duties to take reasonable care, was resisted. On the whole, the Law Society's Committee on Company Law concluded that "the New Approach would not only create new problems but also do nothing to solve the fundamental problems in the old system."⁵⁸

The New Settlement

Although the particular use made of principles in the New Approach was criticised, the idea of principles was seen by SIB and the other SROs, principally IMRO and TSA,⁵⁹ as the key to a revision of the rule books. From the end of the consultation period in January 1989 debates centred on their appropriate role and status in a new system. The SROs were actively involved in this debate, and appeared to have a clearer conceptualisation of the problem than SIB. The model which was disclosed in mid April 1989 appeared to owe much to the initiatives, particularly, of IMRO.⁶⁰

The proposed structure would have three tiers, about a dozen principles, up to 50 core rules and finally SRO and RPB rules, with the SROs and RPBs having greater input at the more detailed level than hitherto. The principles would operate at the highest level of generality; at an intermediate level of generality would be a common core of rules which were to be included within SRO rulebooks as a backbone for the more detailed regulatory system; and detailed support in the form of rules, codes or guidance of the SROs. SROs which wished to adopt into their rulebooks the principles and common core rules issued by SIB could develop a third tier of

⁵⁷ See further Chapter 5.

⁵⁸ Law Society's Committee on Company Law, *Law Society Gazette*, 22.2.1989.

⁵⁹ The Securities Association, which merged in 1991 with the Association of Futures, Brokers and Dealers to become the Securities and Futures Authority (SFA).

⁶⁰ See Chapter 5.

detailed rules and guidance specific to their own sector. The SIB rule would be regarded as evidence of one method by which the principle could be adequately supported, and as evidence that the principle needed support.

The three tier rules required a change in the relationship of SIB's and the SROs' rule books. The equivalency requirement had caused such a degree of friction between SIB and the SROs that the simplest way of signalling this change in relationship was seen to be a change in the requirement itself. It was proposed that a new adequacy test would be substituted for that of equivalency for those SROs who decided to amend their rules. To prevent recurrence of the bitter disputes which had occurred over the appropriate interpretation of equivalency, adequacy would be defined and would be assessed on a wider basis than the rulebooks, taking into account the nature of investment business carried on by their members and the kinds of investor involved, the effectiveness of arrangements for securing compliance and other controls to which the members were subject.⁶¹ The change was primarily political in nature, and was viewed by many participants as the key change, facilitating the rest (see below).

The vehicle for change was the Companies Bill, which was at the time going through Parliament, and the amendments were tabled after the Bill's Second Reading. MPs criticised the speed with which the amendments were introduced, having had only two weeks' notice of them.⁶² Some of the proposed amendments had not been part of the previous consultative process, and were greeted with some surprise by MPs. In particular it was now proposed, contrary to the structure proposed in April, that the new regime of principles and core rules be compulsory for all SROs: the rules and principles would be designated to apply directly to their members, although only the principles would apply to members of RPBs.⁶³ SIB was now given the power

⁶¹ Schedule 2, paragraph 3(1) and (2) FSA, amended by s.203 Companies Act 1989 and s.128A, inserted by s.196 CA 1989.

⁶² 1988/9 Standing Committee D, 29.6.91, c. 598 (John Garrett) and c.602 (Tim Smith).

⁶³ S.47A, inserted by s.192 CA 1989 (principles) and S.63A, inserted by s.194 CA 1989 (conduct of business rules, financial resources rules, clients money regulations and unsolicited calls regulations).

to issue a single rule book which, if sufficiently detailed, could render the SROs' rules redundant. The power has in fact been used to this effect to create a single set of Unsolicited Call Regulations and Client Money Rules. The SROs were to be responsible for monitoring the compliance of their members with the Principles and Core Rules,⁶⁴ could modify or waive their application to individual members,⁶⁵ but had to ask SIB for derogations from designated rules in its own rules.⁶⁶ In addition, the provision requested by SIB for it to formulate codes of practice which would have the status of the Highway Code and to which members of the SROs would be subject gave rise to considerable concern and confusion.⁶⁷

Two further changes were introduced.⁶⁸ Firstly, SIB and the SROs were required to have "satisfactory arrangements" for taking into account the costs of compliance with the regulatory provisions.⁶⁹ Secondly, the scope of s.62 was amended. The principles were excluded from s.62,⁷⁰ so breach of a principle meant a firm was liable to disciplinary action only by the relevant SRO. In addition, in a separate but related move, the right of action was restricted to private investors only.⁷¹ The implementation of s.62 had been delayed until October 1988 to give firms a chance to become acquainted with the rules,⁷² and its limitation was a direct result of the strong criticisms it had received. The restriction of the right had been the subject of

⁶⁴ Sch.2, para.4(1), amended by Sch.23, para.20 CA 1989.

⁶⁵ S.47B, inserted by s.192 CA 1989 (principles) and s.63B, inserted by s.194 CA 1989 (rules). The Government has indicated that the power to waive the application of principles will not be introduced while the principles are expressed in general terms. Statement of the Minister of Corporate Affairs, HC Debs vol 139 c.1239.

⁶⁶ S.63A(2), inserted by s.194 CA 1989.

⁶⁷ S.63C, inserted by s.195 CA 1989. For the debates see, for example, 1988/9 Standing Committee D, 26.6.89, c.600-8.

⁶⁸ In addition the procedure for transferring powers to SIB changed, so functions can be transferred by the order bringing the transfer into force, avoiding the need for the Parliamentary affirmative resolution procedure: s.206 CA 1989.

⁶⁹ Sch.2, para.3A FSA (SROs) and Sch.7, para.2A (SIB), inserted by s.204 CA 1989.

⁷⁰ S.47A(3), inserted by s.192 CA.

⁷¹ S.62A, inserted by s.193 CA 1989.

⁷² Postponement made by Financial Services Act 1986 (Commencement) (No.6) Order 1987, SI 1987/1997.

consultation by the DTI since November 1988,⁷³ and the limitation took effect in November 1989.⁷⁴

Motivations for the New Settlement

The New Settlement has three key aspects: the limitation of the right of action to private investors, the new adequacy test and the three tier rule books. The remainder of the chapter will discuss the reasons for the change in the rule system, arguing that it was the result of two principal motivating factors: a desire to make the institutional structure work and a change in regulatory philosophy at SIB prompted by the change in chairman. International considerations also played a secondary role: the aim to promote London's position as the leading financial centre and the harmonisation of international regulatory requirements, which would reduce the possibility of regulatory arbitrage.

Institutional purpose

We have seen in Chapter 3 how the conflicting demands of the regulation led to a structure which is ambiguous and to an extent contradictory. The institutional structure embodies conflicting centrifugal and centripetal forces creating a tension which is greatest in the area of policy formation. The structure is a federal one, but there are no defined scopes of action. The 1986 Act envisioned a strong initial role for SIB in the establishment of the regulatory structure, and a continuing role of monitoring and oversight. In that SIB's rules set the standard for investor protection, a leading policy role was also envisaged. The extent to which SIB should become involved in the detail of policy formation was not defined, however, and indeed remains undefined

⁷³ DTI, *Releasing Enterprise*, November 1988. The proposal was also contained in the DTI's consultative paper, *Possible Changes to the FSA 1986*, 1 March 1989.

⁷⁴ CA 1989 s.193. "Private investor" was not defined until 1991: SI 1991 No. 489, which came into force in April 1991.

after the Company Act amendments. The appropriate division of roles between the two tiers of SIB and the SROs was thus left for them to work out. SIB's initial approach, detailed above, and its interpretation of the equivalency requirement, differed from the SROs' view of what the regulatory approach should be. This difference, and the dominant role SIB was felt to be playing, meant that this structural ambiguity became a source of severe friction between the two tiers, and relations between them were extremely strained.

The situation was such that the system could not continue to work without a redefinition of the respective roles of the two tiers. The tension is inherent in the institutional structure, but it was the interpretation of the equivalency requirement which became the focus of the SROs' frustration. Any change would have to involve a change in this provision. However, to maintain sufficient control over the standards of the SROs its substance could not be radically altered. The new adequacy provision was thus fundamentally an attitudinal and psychological move rather than a substantive change. Its purpose was to signal a change of approach, indicating the anticipation and form of a new relationship.

However, the two sets of regulators had different perceptions of what this new relationship would be. A working policy document release by SIB to the SROs aimed to set out SIB's view of its role and that of the SROs in the future of the regulatory structure.⁷⁵ It stated that the aim of the New Settlement was

"to create a more satisfactory set of relationships in which there is a greater sharing of responsibility for the successful operation of the FSA system, greater clarity of role as between SIB and the other bodies to develop their own style and approach."⁷⁶

However, the document criticised the SROs for acting more like trade associations than regulators: "[t]heir boards sometimes have to strike a delicate balance between investor interests and the health of the industry, and it is hardly surprising that, on occasion, SIB has felt that the balance might have been struck the other way." SIB proposed to take a closer role in monitoring the

⁷⁵ *A Forward Look*, op.cit.

⁷⁶ *Ibid.*, para. 5.1.

SROs, and suggested that SIB should be the centre of the policy making and rulemaking process.⁷⁷

The document drew sharp reaction from the SROs, who criticised its "centralist philosophy".⁷⁸ The AFBD, in a watered down version of the condemnation sent to SIB and the DTI said in a letter to its members that SIB was pushing more of its own rules on the SROs, rather than acting in what AFBD saw to be the spirit of the FSA, promoting a greater share of responsibility to the SROs.⁷⁹ It criticised the way the arguments in the document consistently resolved "in favour of a large and dominant SIB."⁸⁰

The exchange emphasised the unsatisfactory nature of the relations between the two sets of regulators. SIB thus issued a policy statement in April 1990 which reiterated this change.⁸¹ It emphasised that the new adequacy test was "a major step on the way to establishing more satisfactory and durable regulatory relationships", recognising that the equivalency requirement, despite its provenance and intention, "has involved an unsustainably intrusive role for SIB." The paper stressed the more flexible approach the adequacy test permitted, taking into account an SRO's monitoring and enforcement arrangements as well as its rules, although SIB would also take into account the consistency of the SRO's rules with those of other recognised bodies.⁸² It emphasised the responsibility SROs would take for their own rules, stating that "as a deliberate counterbalance to the diminution in the autonomy of recognised bodies inherent in [the designation]...SIB will stand back...from third tier rule-making."⁸³

Changing the equivalency requirement to one of adequacy may have been necessary but

⁷⁷ Ibid.

⁷⁸ See, for example, IMRO, *Modification Note*, January 1990.

⁷⁹ Quoted in *FT*, 12.1.90.

⁸⁰ *FT*, 14.1.90.

⁸¹ SIB, *Achieving and Judging Adequacy*, CP 39, April 1990.

⁸² SIB, *A Wider Basis for SIB's Principles of Conduct: The Next Stage of the New Approach*, March 1989, p.8, and SIB, *Regulation of the Conduct of Investment Business: A Proposal*, August 1989, paras 21 and 24.

⁸³ Ibid., echoing *A Forward Look*, para 4.11. Financial supervision rules would be an exception.

it was not felt to be sufficient, however, to redefine the respective roles of SIB and the SROs. In addition, the rule system would be changed to reflect a more appropriate division of functions. The relative roles of SIB and the SROs were defined by the different tiers of rules. The formation of the more general Principles and Core Rules enabled SIB to set out the central elements of regulatory policy and act as a high level regulator, whilst leaving the detailed working out of that policy to the SROs "in the confident expectation that the essential elements of investor protection can be fully safeguarded in the overall result."⁸⁴

The formation of principles required a statutory amendment, but SIB could have produced more general rules under the existing Act, setting the minimum requirement that many had hoped for initially. Control over the SROs' rules would then have been through the adequacy requirement. SIB wanted to retain greater control over the substantive provisions, however, and so sought in the proposed amendments the power to designate rules as directly applicable to the members of SROs.⁸⁵ Its view of the arrangement was summed up thus,

"The essence of the new settlement is that greater unanimity and cohesiveness at the level of principles and, where applicable, core rules, makes it possible for the SIB to be more flexible and less intrusive at the level of detailed support....its new power to write the essential elements of regulation in a clear and enforceable way by designation rules means that it can, without impairment to investor protection, properly stand back from the detail of an SRO's own rules."⁸⁶

The New Settlement thus represents an attempt to resolve the tensions between the role of SIB and that of the SROs arising from the institutional structure through the adoption of a particular rule structure. SIB could define its role as the body responsible for the high level policy by forming rules of a high and intermediate level of generality. The detailed application of this policy would be by practitioners, whose expertise and knowledge could thus be felt in the day to day operation of the rules. Deciding in abstract on a particular type of rule did not, indeed could

⁸⁴ SIB, *Regulation of the Conduct of Investment Business*, August 1989, para 11.

⁸⁵ Its power to amend the rules of SROs directly was therefore removed: s.206 and Schedule 23, Part I, para 1 CA 1989. Its power to amend the rules affecting the scope of investment business that an SRO may regulate if the statutory requirements are not satisfied was retained.

⁸⁶ D. Walker, "The New Settlement in Financial Services", *Law Society Gazette*, 26 July 1989.

not be expected to, resolve the deep rooted tensions which existed, however. As we will see in the following chapter these continued to have a considerable impact on the form and structure of the rules over the course of their formation.

Regulatory philosophy

Behind the idea of principles lay a philosophy held strongly by SIB's second chairman, Sir David Walker. It is a philosophy which sees regulation as a contract between the regulator and the regulated in which the former agrees not to interfere in the detailed operation of the latter, but in return expects compliance which goes beyond obedience to the mere letter of the law. The way to encourage such compliance, Walker argued, is through general rules which express fundamental duties.

"[I]n giving high level guidance to firms, [detailed rules] weaken the inducement to firms, often using their legal advisers, to explore the detail of complex subordinate rules to find ways around the letter. By making clear, as the 10 principles do, the spirit of regulation, high level compliance should be more readily achieved."⁸⁷

Walker's views contained many implicit assumptions about the consequences of different types of rules.⁸⁸ Walker recognised that detailed rules provided firms with certainty as to their legal position, but he was concerned that valuable practitioner support was at risk due to the excessive specificity of some of the rules,⁸⁹ and that they were encouraging non-compliance. The latter view was also held by TSA, whose chairman stated that "[w]e do not believe that complexity ensures better regulation, on the contrary it encourages loop-hole hunting and excessive reliance on legalistic interpretation rather than common, practical sense."⁹⁰ The case for principles, Walker argued, rested on a belief that both regulators and firms could develop a greater maturity

⁸⁷ D. Walker, "Some Issues in Regulation of Financial Services", Lecture at the Irish Centre for Commercial Studies, University College, Dublin, 14.11.91.

⁸⁸ See Chapter 1.

⁸⁹ D. Walker, "Financial Services Regulation, Mid-1988, and Some Elements in Prospect", Speech to the Financial Times/Deloittes Conference, 5.7.88.

⁹⁰ *FT*, 23.11.89.

of approach to conduct of their business. He recognised that they could therefore impose a larger burden on firms than more detailed rules as mere compliance with the detail of rules was not enough.⁹¹ However, general principles would aid firms in understanding the essence of the requirements, and so would aid compliance in a complex area of regulation by lifting the issue into the boardroom, and reminding a chief executive that there are basic principles that should govern the conduct of his business.⁹² Principles had the advantage of being readily assimilable and so capable of setting "a memorable and thus immediately accessible standard for reference or reminder."⁹³ Moreover, they would not be any less effective in deterring rule breakers than detailed rules.⁹⁴

His approach was an echo of the more traditional style of City regulation and was shared by the Bank of England.⁹⁵ Compliance with the spirit of the rule had been emphasised as one of the benefits of self-regulation when the structure was being formed. Practitioners would not be tempted, as under a statutory system, to adopt a formalistic and legal approach to the rules in an attempt to circumvent them.⁹⁶ Compliance with the spirit is an important feature of the Takeover Code,⁹⁷ and had also been introduced as a regulatory requirement by TSA subsequent to the 1989 statutory amendments.⁹⁸ Principles were introduced in an attempt to ensure that literal compliance with the rules did not become a substitute for management integrity. The need to maintain a high corporate ethos which could answer the question of "what is right and wrong" in a particular circumstance was one of the vital tasks of management. "This is an essential

⁹¹ D. Walker, Speech to the Foreign Banks Association Annual Dinner, 29.11.88.

⁹² Walker, Dublin lecture, *op.cit.*

⁹³ D. Walker, "The Development of Principles and Conduct of Business Rules for Financial Services in the UK", Speech to the Brussels Centre d'Etudes Financieres, 29.5.90.

⁹⁴ *Ibid.*

⁹⁵ See, for example, Governor's Speech to the Association of International Bond Dealers, 31.5.79, in 1979 *BEQB*.

⁹⁶ This is discussed further in the Conclusion.

⁹⁷ City Code on Take Overs and Mergers, General Principles, Introduction.

⁹⁸ R.1201. See Added Board Notice 35, 3.10.89.

foundation for the efforts of regulatory authorities, which provide systems and rules but cannot be a substitute for high standards in the firms themselves."⁹⁹

International Considerations

One of the key objectives of the FSA, as we have seen in the Introduction, was to promote London as a financial centre. The peripatetic nature of the wholesale industry particularly meant that business could easily re-locate if it found a particular environment inconducive to its operation. The need to promote London's securities markets had been the impetus for the Bank of England's insistence on the Goodison-Parkinson agreement and the Bank's and the Government's desire to make London the primary financial centre had informed much of the debates about the nature of the regulation which should be introduced.¹⁰⁰ When the rule books were published, therefore, one of the principal criticisms was that they would cause firms to re-locate to more favourable regulatory environments. The impact of conduct of business regulation on a firm's location is disputed, however, and it is not clear whether firms would actually move to more amenable regulatory environments. A survey by Price Waterhouse of banking and securities institutions in London found that, with the exception of the Japanese, "most respondents did not believe that "regulatory arbitrage" opportunities had seriously influenced decisions regarding the present and prospective location of their European operations."¹⁰¹ The City of London Research Project identified harmonisation of regulation at the EC level as a greater threat to London's position, indeed that of the EC itself.¹⁰²

⁹⁹ R. Leigh Pemberton, "Takeovers and Standards in the City", Speech to the Association of Corporate Trustees, (1989) *BEQB* 545.

¹⁰⁰ See Chapter 3.

¹⁰¹ Price Waterhouse World Regulatory Practice, *Banking and Securities Regulation in Europe: A Survey of Senior Management Views*", (Price Waterhouse, February 1990). Further research has been indicated that the direct costs of regulation in London are similar to those of France and New York: J. Franks and S. Schaefer, *The Costs and Effectiveness of the UK Financial Regulatory System* (City Research Project, London Business School, March 1993).

¹⁰² City Research Project, *Key Issues for the Square Mile: Interim Report* (Corporation of London and London Business School, July 1992), pp.46-49.

The call was nevertheless to amend the regulation in order not to deter, and hopefully to attract, financial business. One of the underlying considerations in the deregulatory aspect of the New Settlement, the reduction of the duties owed to professionals, was therefore to appeal to financial business to come to London rather than elsewhere. The re-casting of the rules also played a significant role: Walker argued that the best way to stop foreign firms leaving London was to attack their perceptions of the regulatory system. Formulating standards would indicate that what was demanded was simply good business practice.

In a parallel move, the UK was also involved in promoting harmonised standards at the level of principle on an international scale, which would reduce slightly the divergence between systems and so the possibilities for regulatory arbitrage. The formation of the Principles provided Walker with a useful springboard for suggesting the drawing up of international principles of business conduct under the auspices of IOSCO,¹⁰³ of which he was elected President in November 1990. Walker argued that the internationalisation of business, enforcement considerations and avoidance of both regulatory overlap and "underlap" required that conduct of business rules be harmonised at the level of principle.¹⁰⁴ The seven IOSCO Principles were adopted in December 1990 and broadly reflect SIB's Principles.

Harmonisation of regulation at an EC level was also a consideration. SIB stressed that "a greater focus on principles and core rules...facilitates discussions with the EC and the necessary moves for harmonisation which for the UK would be far more satisfactory if the starting point was developed in London."¹⁰⁵ There has in fact since been no attempt in the EC to harmonise the conduct of business rules beyond the level of principle due to "considerable divergences between Member States in the content of such rules and the way in which they are applied."¹⁰⁶ The

¹⁰³ D. Walker, "Conduct of Business Regulation: The International Dimension", speech to 14th Annual Conference of IOSCO, 20 September 1989.

¹⁰⁴ Ibid.

¹⁰⁵ *A Forward Look*, para 6.11.

¹⁰⁶ Explanatory Memorandum to the proposed Investment Services Directive, Com(88) 778-SYN 176, OJ No C 43/7, 22 February 1989, section 1.

Investment Services and Second Banking Co-ordination Directives therefore require that those carrying on business in other member states comply with host state conduct of business rules.¹⁰⁷

Conclusion

The chapter has drawn out the main influences affecting the formation of the conduct of business rules from the Act to the New Settlement rule system. Underlying the Act and the formation of the initial rules was the uncertainty of how the powers granted would be exercised, which led to increasing detail. In addition, pressures of time, the requirements of the Act, including their technical complexity, and the fact that regulation was being formulated for almost the entire investment services industry for the first time, albeit with some continuation from past requirements at least in the retail sector, contributed to the length and complexity of both the rules and the Act. These factors were enhanced by the perceptions the regulated had of s.62, and the requirements for specification which they made.

Criticisms of the rules prompted the Secretary of State and Bank of England to change SIB's chairman, and Walker's appointment was made on the understanding that he would promote a change in the rules. A re-drafting of the rule books alone did not require the full array of rule making powers that SIB was granted by the 1989 amendments, however, nor did the restriction of s.62. The chapter argues that the principal reason for the change to the New Settlement was to resolve the tensions inherent in the institutional structure through changing the nature of the rule system. The most significant aspects of the 1989 amendments in this respect were the political change to the adequacy requirement, and the substantive change which extended the application of SIB's Core Rules and Principles to the members of the SROs. In addition, the adoption of

¹⁰⁷ See Chapter 2. For the dangers of a "competition in laxity" developing, see C. Bradley, "Competitive Deregulation of Financial Services Activity in Europe after 1992", (1991) 11 *OJLS* 545.

Principles to reduce the formalism of the regulation and encourage compliance with the spirit of the law, facilitated by the change in sanctions attaching to them, echoed the implicit demands which had been initially made of the regulation when the institutional structure was being created. Paradoxically, the less formal aspects were introduced by the semi-statutory body, with the more formal and detailed rules being issued by the self regulatory organisations. Further, the change had the additional purpose of gaining acceptance in the City for the regulation and providing a defence against critics who argued that London was over-regulated, and the subsidiary purpose of serving as a base from which Walker could push for similar principles to be adopted on an international basis.

The solution to these issues was seen to be the introduction of a rule system which reflected the roles of the rule's issuer in the regulatory system. It also involved considerations of the implications of the rules with regards to compliance, but also a recognition of the distributional aspect of rules, and the manner in which they can be used to delegate decision making power.¹⁰⁸ The next chapter will analyse in greater detail the factors which influenced the formation of the rule system and the different rules within it, examining the different types of rules used and the functions which they perform.

¹⁰⁸ See Chapter 1.

Chapter 5: The Nature of the Rules

Introduction

The statutory amendments which comprised the New Settlement empowered SIB to issue a wider range of rule types than the original 1986 Act. Whereas the initial Act enabled SIB to issue rules and guidance which would apply only to its members, the 1989 amendments enabled it also to make "statements of principle" which applied to all authorised persons, breach of which would give rise to disciplinary action and exercise of the powers of intervention,¹ rules which may be designated to apply to members of SROs, though not RPBs,² and codes of practice relating to persons and matters covered in the principles or rules, which would have evidential status.³

Whilst the previous chapter indicated the reasons for these changes in SIB's rule making powers, this chapter will focus in more depth on how these powers have been used. The Act does not contain any indication of the structure of the rules, it only specifies the status of the rules and in relation to which of the substantive rule making powers these different types of powers may be used. The statements of principle may be made in relation to the "conduct and financial standing" of authorised persons,⁴ and the designation powers may be used in relation to conduct of business rules, financial resources rules, client's money regulations, and unsolicited call rules.⁵ The Act gives no indication of the number or level of generality of those rules or statements of principle. This chapter will explore the issues involved in debates which surrounded the formation of these new rules, and analyse their structure and that of the "third tier" rule books of the SROs.⁶

¹ S.47A, inserted by s.192 Companies Act 1989.

² S.63A, inserted by s.194 CA 1989.

³ S.63C, inserted by s.195 CA 1989.

⁴ S.47A(1), inserted by s.192 CA 1989.

⁵ S.63A(1), inserted by s.194 CA 1989.

⁶ No codes of practice have been issued to date, so they will not be discussed.

The chapter will examine the drafting process of the rules and the different considerations involved in the formation of the rules. It will explore the factors which operated at a more detailed level to influence their structure, illustrating in particular the manner in which the function of each type of rule has affected the character, status and structure of that rule and of the other different types of rules within the system.

In analysing the nature of the rules the analytical structure set out in Chapter 1 will be used. This identifies four dimensions of rules: substance, status, character and structure. The chapter identified four different aspects of rule structure: scope, clarity/opacity, precision/vagueness and simplicity/complexity. The scope of a rule relates directly to its substance, and refers to the range of persons or situations to which the rule applies. Clarity relates to the degree to which the rule contains words with well-defined and universally accepted meanings. Simplicity refers both to the degree to which the rule is applicable to concrete situations without excessive difficulty or effort and to the action required under the rule. It may refer to an individual rule or to a rule system as a whole. Precision is the degree to which behaviour under the rule is prescribed. Describing a rule as detailed means that it is precise and complex (if *x*, *y* and/or *z* exist, do *a*, *b* and/or *c*); as "bright line" that it is clear, simple and precise (speed limits); and as general that it is principally opaque and may be simple (in *x* situation, act reasonably, fairly, suitably), but essentially requires the exercise of judgement in its application.

The chapter first analyses the structure of the initial rules, referring back to Chapter 4 which indicated the factors which gave rise to their detailed structure. The chapter then considers in turn the Principles, Core Rules and third tier rules, considering the debate which surrounded their formation, focussing on the debates about what structure each should have, particularly the use of derogations and the glossary in the Core Rules, and the changes in the nature of the rules of the SROs. It concludes by analysing the rules as a system, looking at the changes in structure which have occurred and the factors influencing the rule making decisions.

The 1987 Rules

The Structure of the Rules

The 1987 rules varied in their clarity, precision and complexity. The rules setting out information to be contained in documents, for example customer agreements and advertisements,⁷ were on the whole clearer than rules which imposed requirements which involved judgements and assessments to be made. The latter were more opaque, for example the know your customer,⁸ suitability⁹ and independence rules.¹⁰ The rules varied in their precision. The rules, for example, on customer agreements, contract notes and advertising were precise, setting out the exact contents and even prescribing the wording of, for example, risk warnings in customer agreements.¹¹ By contrast, the rule on churning was less precise: it prohibited deals "of unnecessary frequency or in excessive size."¹² The precision or vagueness of a rule often reflected the decision of what types of judgement had to be left to the firm. For example the rules on allocation of transactions between customers stated that the basis of the allocation had to be "in a manner in which the firm in good faith believes does not unfairly benefit one customer at the expense of another", but the time of the allocation was specified.¹³

The most striking aspect of the rules was their complexity. Chapter 1 indicated that the analytical framework could be applied to groups of rules as well as individual rules. In the 1987 rules, complexity came principally from the number of requirements or conditions which were imposed either by one rule or by the rule book as a whole. These were greatest in those rules relating to the disclosure of information, for example customer agreements, risk warnings, life

⁷ Rr.4.05-4.09, 7.07-7.22.

⁸ Part 3.

⁹ R.5.01.

¹⁰ R.2.03.

¹¹ R.4.15.

¹² R.2.08(3).

¹³ Rr.5.17 and 5.19.

assurance policy disclosures and advertisements. So although each individual requirement may have been clear, the sheer number of them made the rule highly complex. The use of cross-references also increased the complexity of the rules. Cross-references were usually made to another part of the same section of rules, less frequently to other parts of the rules, and in some cases it meant that the rule did not stand alone.¹⁴ Cross references were also implicit in the sense that contractually excluding a duty under one rule had a knock on effect disapplying other rules, but this was not apparent on the face of the initial rule. This was the case in the best execution rule,¹⁵ disapplication of which led to the exclusion of the requirements to disclose remuneration or commission, and the rules on self-dealing and dual agency.¹⁶ Implicit cross-references were also made through the use of terms which had particular meanings, defined in the definitions section. They were most frequently made to the rules defining types of advertisements,¹⁷ and discretionary management portfolios.¹⁸ As such, they are little different from the use of a phrase which is defined in a glossary.¹⁹

Complexity was exacerbated by the combination of the character of the rule with a negatively defined scope. Most rules stated that a firm "must do/is prohibited from doing x, unless the situation/customer falls into categories *a*, *b*, or *c*." The number of categories arose from the different types of business which the rules covered, and these businesses were complexly defined, for example that of corporate finance.²⁰ It also stemmed from the number of categories into which SIB had divided customers, and from the absence of a definition of private customer and of customer. Required by the Act to recognise that "provisions that are appropriate for regulating the conduct of business in relation to some classes of investors may not...be appropriate in relation

¹⁴ Eg., r.4.06.

¹⁵ R.5.04.

¹⁶ Rr.5.05 and 5.07.

¹⁷ Rr.7.23 and 7.25.

¹⁸ R.1.09.

¹⁹ See below.

²⁰ R.1.12.

to others",²¹ SIB developed six categories of customer. The application of rules varied with the different classes of customer, and different duties were owed to each, reducing in number as one moved up the scale of customer sophistication. In fact, professional and business investors were invariably treated the same, and frequently either market counterparties or experienced investors were exempted along with professionals and business customers. Amalgamating these groups and introducing a private customer definition facilitated one of the most significant changes in the Core Rules as far as rule structure was concerned. It enabled a simpler definition of the rule's scope. Instead of the prohibition/mandatory requirement which applied to all, followed by a narrowing of the scope (a negative definition of scope), the Core Rules define the scope positively: the rule applies to *x*.²² This makes the rule simpler, although the number of classifications remains the same.

The Use of Guidance

SIB's initial rule making powers enabled it to make rules which applied to its own members, and to issue guidance. SIB made some use of guidance in the rule book, inserting Practice Notes which occurred after the rule or rule section to which they related. These were used quite extensively, principally to give examples of the rule's application in specific circumstances,²³ to clarify duties,²⁴ or to give reminders of associated duties that were also owed. Very few gave explicit guidance on what would constitute compliance²⁵ or acted as

²¹ Sch 8, para 12.

²² See Chapter 2 for a discussion of these terms.

²³ For example, the Practice Notes to rules 1.04 (marketing group associate), 2.02(4) (description of business), 4.09(1) (customer agreement and discretionary management portfolio), 5.04 (best execution), 5.08 (material interest), 7.08 (advertisements) and 8.08 (disclosure of material interests).

²⁴ For example, Practice Notes to rules 1.02(1) (application), 5.01 (suitability), 5.03 (best execution), 5.07 (self dealing and dual agency), 7.25 (off the page collective investment scheme advertisements) and 9.02 (obligation on market makers to continue to deal).

²⁵ Practice Notes to rules 4.02(1) (customer agreement), 5.13(2) (statement on the MCA) and 5.17 (allocation of bargains: what would not be reasonable).

general interpretations of the rules.²⁶

SIB also issued guidance, not simply to explain the particular application of a rule, but as a form of informal rules. The status of the Guidance differed from the rules as contravention did not lead to the sanctions which attached to the breach of a rule, notably liability under s.62. Guidance was initially used to inform investors, in strong terms, that they should not deal with a particular overseas firm.²⁷ SIB then used the flexibility which resulted from its informal status to use Guidance as a substitute for rules to regulate the professional oil markets.²⁸ The Oil Markets Code of Conduct deals with particular market abuses, but breach of the Code did not give rise to the sanctions attaching to breach of a rule.²⁹ Instead, SIB stated that compliance with the Code would be relevant to the Board's exercise of its statutory powers, and disregard of the Code "could call into question whether the firm is fit and proper to carry on investment business".³⁰

Reactions to the rules

The rules were received both by the SROs and the regulated with a considerable degree of hostility, well described by SIB's current chairman, Andrew Large, as "a sense of outrage".³¹ Criticisms of the 1987 Rules focused primarily on their complexity and the difficulty of understanding what they required. This, it was argued, gave rise to uncertainty. The above analysis indicates that the rules were indeed inaccessible. As we saw in Chapter 1, accessibility refers to comprehensibility: the ability of the reader to understand at first sight the rule's

²⁶ Practice Notes to rules 1.02(3) (application), 4.05 (contents of full customer agreement), 4.10(4) (customer agreement) and 7.01 (application: advertisements).

²⁷ This was the subject of litigation in US, but SIB was held to have sovereign immunity: *European American Corporation v. SIB* US District Court for District of Columbia, civil action no.89/2333.

²⁸ Because it involves some trading for profit, it involves an investment element which brings it within the Act. Sch.1, para.8, Note 1.

²⁹ The Code is still subject to the competition provisions as it is issued by SIB in written form and intended to have continuing effect, Sch.9 para.4.

³⁰ SIB, *Consultative Document on the Control of the Oil Markets*, February 1988, para 14.

³¹ Treasury and Civil Service Select Committee, Financial Services Regulation, Minutes of Evidence, HC Paper no. 733-i, 14.6.93, Mr Andrew Large, para 7.

application. It is affected not just by the structure of the individual rule, but the number of other rules or provisions which apply to that situation which the reader has to remember. If an individual rule refers to a complex definition, or is part of a range of requirements, or has consequences for the application of other rules, this reduces its accessibility. This can provide uncertainty, as the rule applier is not sure whether there are other rules which apply to the situation of which he or she is not aware.

Criticisms also related to the lack of flexibility provided by the rules. Many of the rules were very precise, and they were criticised as not allowing a firm sufficient room to conduct its business in a manner which required less cost, but which would not prejudice the underlying purpose of the rule. The scope of the duties imposed was not accepted: regulated firms argued that too many duties were imposed on dealings with professional and business customers which impeded business operations. Finally, it was argued by firms and recognised by the regulators that the precise and detailed nature of the rules, although in part prompted by a desire to block loopholes and define duties closely,³² was in fact enabling firms to either to avoid the rules, or to use them in an unintended manner. One of the regulators' principal concerns on this account was the abuse of the customer agreement provisions. Inserted in an attempt to ensure that relations between the firm and the customer were clearly defined, the regulators had required that a wide range of matters be covered in the agreement, but had made no provision as to what should not be included. Firms were in fact using these agreements to exclude a wide range of duties that they would otherwise owe. It was these criticisms and concerns, as well as the more political reasons for the changes in the rule system, that the new rules had to address.

Changing the Structure: the Role of Principles

Chapter 4 identified two principal motivations for the introduction of the New Settlement:

³² See Chapter 4.

a desire to alleviate the tensions between the regulators and define their roles more clearly, and a particular regulatory philosophy which stressed the need for simplicity, coherence and the need for the regulated to adopt an attitude of compliance which emphasised the importance of the spirit of the rule over the letter. One of the main purposes of the New Settlement had been to change firms' perceptions of the regulation. An "essential objective" was to "move away from the detailed and complex rules which apply at present and towards providing an adequate level of protection by means of the principles and core rules",³³ with some amplification of the Core Rules by the SROs.

The first stage in this process was the New Approach, published in November 1988. Its purpose was to "refashion the...Conduct of Business requirements so as to enable the principles underlying them to be more readily discerned".³⁴ Principles were introduced in the New Approach in an attempt to make the underlying purpose or duties of the rule better understood. Walker stressed five qualities which he felt principles had:

- "- consistency and cohesiveness in the standards applying, as a backbone which draws the rules together;
- intellectual rigour on the part of the regulators, in ensuring that the new requirements really are justified;
- practitioner understanding of and support for the provisions made;
- emphasis on the spirit, rather than the letter, of what is prescribed; and
- a dynamic quality in the rule books, enabling them to apply to new situations without constant reformulation."³⁵

This sentiment was largely supported, but its execution in the New Approach and SIB's subsequent revisions were criticised by the SROs and the regulated as a misunderstanding of the role and nature of principles. The new rules contained 93 principles of conduct, described as "rules as such",³⁶ which varied in structure and substance. Some principles were quite detailed, others were very general, some set out the essential duties, others, for example that on best

³³ SIB, *Regulation of the Conduct of Investment Business: A Proposal*, August 1989, para.14.

³⁴ SIB, *Conduct of Business Rules: A New Approach*, November 1988, Commentary, para 1.

³⁵ D. Walker, "Financial Services: The Principles Initiative", (February 1989) *BJIBFL* 51.

³⁶ *A New Approach*, para.6.

execution, were really explanations. Some stood alone,³⁷ in which case the principle had to be observed according to its terms. The majority were followed by rules of conduct, usually re-phrased and summarised versions of the 1987 rules, and then acted as an indication of purpose and general guide.

Walker's views on the role of principles were only formed in a very general fashion and SIB's approach to the re-drafting exercise of the New Approach had been to extract principles on a "bottom up" basis from the rules.³⁸ When the SROs saw the new rules, SFA and IMRO particularly criticised the liberal use of principles, and the exact nature of principles and their appropriate role became the topic of debate between the regulators.

The debate concerned the appropriate function of principles within the rule and regulatory system. Their function was seen as the determinant of their structure, substance and status. The Chief Executive of IMRO, John Morgan, argued that SIB was confusing the role of principles with that of rules. Principles, he argued, "require observance at all times of high standards of conduct, when there may not be relevant rules to follow, and infringement may mean unfitness to practice... [they] serve a vital purpose in helping to enforce the standards of conduct which underlie authorisation." Rules, on the other hand, "tell members how to behave in certain circumstances." A short list of fundamental principles, therefore, should be segregated from the rest. These few principles should be an agreed statement of the essential requirements of fitness and properness. The remainder, "which are really rules masquerading as principles, should be redrafted for what they really are, and be used as benchmarks for SROs in drafting their rulebooks."³⁹

In addition IMRO argued that the Principles should be subject to disciplinary action only or they would risk losing the advantages they could otherwise offer.⁴⁰ Despite the precedent of

³⁷ NA R.2.03 (good practice), 7.03 (responsible behaviour in dealings by officers and employees) and 7.04 (responsible behaviour on the telephone or on visits).

³⁸ B. Riley interview with D. Walker, *FT*, 2.5.89.

³⁹ John Morgan, "The Difference between Rules and Principles", *FT*, 29.3.89.

⁴⁰ *FT*, 6.3.89.

the Oil Markets Code, Walker initially rejected this status for principles on the grounds that it would create different provisions applying in different contexts, and the dynamic effect of principles would be missed.⁴¹ Walker subsequently accepted the advantages the change in status could have, principally that it would enable the principles to have the general structure which he required:

"the essential purpose [of not providing a right of action for breach of a principle] is to enable the nature of these statements of principle to be different from that of rules, and for the general standards expected which they express to be reiterated less precisely than is necessary in a rule."

The Principles are thus excluded from s.62, and the sanction for breach is disciplinary action by SIB or the relevant SRO,⁴² though breach calls into question a firm's fitness and properness.⁴³

*Drafting the Principles*⁴⁴

These sentiments prompted the decision that there should be only a few principles containing the essential duties of the regulation, and in March 1990 SIB issued ten Principles.⁴⁵ These were formed prior to the Core Rules, and the drafting process was one of negotiation between SIB and the SROs. One SRO had already submitted a draft set of principles, as had a leading investment bank. These dealt mainly with those issues which are now dealt with in the first six principles. The statutory consultation process had been extended to apply to the statements of principle, and a draft was sent out for consultation once it had been formed by SIB and the SROs.⁴⁶ The Principles were derived from a distillation of the most important of the 93 Principles contained in the New Approach, including the Introduction to the 1987 Rules, and the

⁴¹ Walker, (1989) *BJIBFL*, op.cit., p.53.

⁴² See M. Blair, *Financial Services: The New Core Rules* (London, 1991), p.35.

⁴³ Initially in the Introduction to the Principles, this was moved to the third tier rule books in later drafts.

⁴⁴ The material in the following section is based on interviews with the legal advisers at SIB, SFA and IMRO conducted from November 1991 to July 1992.

⁴⁵ SIB, *Statements of Principle*, March 1990.

⁴⁶ SIB, August 1989, Annex B and *The Proposed Principles for Investment Business*, CP 33, January 1990.

principles set out in Schedule 8 to the FSA 1986.⁴⁷

Chapter 4 indicated that one of the rationales behind the introduction of the Principles was to provide a clear statement of the aims of the regulatory regime, setting out the essence of the duties in an attempt to instil a less formalistic approach to the regulation by those subject to it. They were expected to provide consistency and cohesiveness of standards. They had to be readily applicable to changing circumstances so avoiding the need for frequent updating, be readily understood by all involved in financial markets and underline the need for compliance with the spirit rather than the letter of the rules.⁴⁸

The Principles were a radical departure from the initial style of regulation expressed by, and required of, SIB. One of the main concerns when drafting the Principles was therefore not so much their wording, but to enable people to believe that it was possible to draft ten general guiding rules which would be effective. What was seen as important was to sell the idea that the rules did not have to be as specific as those of the old rule book to work. It was therefore important to keep the Principles "short and sweet", and to indicate to firms and customers that there was more than one approach possible to regulation. This led to a variety of drafting techniques being used, for example there is no definitions section attached to the Principles apart from the meaning of the word "customer".⁴⁹ Certain phrases were deliberately avoided to escape the need for definition: the example was given of the phrase, "customer that the firm advises", used instead of "advisory customer" as the latter was felt to need a definition.

On first reading the Principles appear vague and open-ended, with frequent use of words such as "reasonable", "proper", "adequate", "fair". The Principles are phrased in a very deliberate way, however, and though expressed in general terms SIB is sensitive to the suggestion that they are vague. The first two Principles are the most general, and are described as "arch Principles",

⁴⁷ The *Statements of Principle* came into effect on 30 April 1990.

⁴⁸ See CP 33, para 14.

⁴⁹ See further below.

covering in general terms all the material in the other eight.⁵⁰ They state that a firm should observe high standards of integrity and fair dealing, and should act with due skill, care and diligence, so repeating the words of the FSA.⁵¹ The remaining eight deal with standards of market conduct, information about customers, information for customers, conflicts of interest, customer assets, financial resources, internal organisation, and a late addition to the drafts, relations with regulators. The Principles are prefaced by an Introduction which explains their nature and purpose.

The Introduction

The Introduction serves the purpose of reducing the length and detail of the Principles and is used to set out some of the more complex issues or concepts, a role taken by the Glossary in the Core Rules (below).⁵² It states that the Principles are a "universal" statement of the standards expected; they may be taken to express existing standards, but do not claim to be exhaustive.⁵³ They apply in relation to customers, which includes clients and potential customers. The phrase replaces explicit provisions specifying those to whom the Principles applied, including appointed representatives, and a statement that they "may also be relevant" to non-investment business and business carried on outside the UK.⁵⁴ The phrase was used for two main reasons. Firstly, it still addressed known concerns of the regulatees, indicating that appointed representatives, whose regulation was a matter of concern, were to be subject to Principles. Secondly, it provided the facility for the regulator to postpone decision on some of the legal issues relating to the ambit and status of the rules which are unclear. For example, it is unclear whether

⁵⁰ Blair, op.cit., p.6.

⁵¹ Schedule 8, paras 1A and 2.

⁵² The two previous consultative drafts were set out in the SIB, August 1989 and CP 33, op.cit.

⁵³ Their universality is subject to the limitations of the Act, and so they are limited in territorial scope, apply only to the marketing of life policies and management of pension funds by life assurance companies and friendly societies and the financial resources aspects do not apply to either of these bodies; finally they have no retrospective effect: see Blair, op cit., pp.30-34.

⁵⁴ SIB, August 1989, Annex B, Statements of Principle.

the Act, and so the Principles, apply to UK based authorised firms carrying on investment business abroad, and SIB's chief legal adviser is of the view that "it is possible that this will continue to be an area lacking in technical precision."⁵⁵ The phrase "authorised persons" therefore replaces the specification that the Principles apply to "investment business carried on in the UK"⁵⁶ and so leaves open the question of the exact territorial ambit of the Principles, enabling SIB to avoid the question for the moment.⁵⁷

Paragraph 2 of the Introduction provides that "the principles are not exhaustive of standards expected" and that conformity with them "does not absolve a failure to observe other requirements, while the observance of other requirements does not necessarily amount to conformity with the Principles." It replaces a provision that compliance with the letter was not sufficient, and its use involved a similar range of decisions to those above. The phrase implies that if operating in a foreign country, even if the Principles do apply, conformity with them would not be a defence to an allegation of breach of any other requirement that may be imposed by that country.⁵⁸ It also enables SIB to remain equivocal on the nature of the relationship between the regulatory rules and the common law, a matter currently under consideration by the Law Commission and on which SIB did not wish to make a pre-emptive judgement.⁵⁹ Finally the phrase embraces the notion that compliance must be with the spirit, not just the letter of the law: even if a firm has complied with a rule, it may have breached a Principle.

The Principles

The status of the Principles had been determined prior to their drafting, and was felt by the regulators to enable a more opaque and simple rule to be formed. Each aspect of the

⁵⁵ Blair, op.cit., p.32.

⁵⁶ SIB, August 1989, Annex B.

⁵⁷ See Blair, op cit., pp.31-33 for a discussion of the issue.

⁵⁸ See *ibid.*, p.32.

⁵⁹ Law Commission, *Regulatory Rules and Fiduciary Duties*, Consultative Paper No.124 (HMSO, London, 1992).

Principles' structure was the subject of consideration, however. The Principles are concerned with three sets of relationships, all of which have the firm, the authorised person, at the fulcrum. These are the relationship of the firm and the customer, the firm and the market and the firm and the regulator.

The scope of the Principles varies. With the exception of Principles 4 and 5, they apply to all customers. The range of business to which they apply is left undefined. The phrase "investment business" which initially appeared in five of the principles, including the first three, was removed in the final draft. This was a policy decision to make the Principles as broad in their application possible to ensure that the Principles applied to all aspects of the firms' activities, including financial standing. This followed the philosophy in prudential supervision in relation to capital adequacy that risks arising in one set of activities cannot be isolated from the rest, and SIB's belief that matters affecting financial standing are indivisible from conduct of business.⁶⁰ The only limitation is that which is inherent: when the principles clearly apply to business to apply only to investment business.⁶¹

Other Principles define their scope more clearly as a result of criticism of their range, opacity and imprecision. The Principles affected by these considerations were those relating to information about and for customers, Principles 4 and 5 respectively. Initially the duties contained in these principles were activated only "wherever it is appropriate". This general phrasing had not been the result of a conscious policy decision, however, unlike the use of the phrase "universal" in the Introduction, rather it reflected the absence of any clear policy. The demand for specificity required the drafters to exercise more rigour in defining the purpose of the rule, and thus the situations to which the duty should apply. The answers to the question were determined by one of the wider substantive aims of the New Settlement, a reduction in the documentation necessary between professionals, made to meet the criticism that such dealings were burdened by

⁶⁰ Blair, *op.cit.*, p.30

⁶¹ *Ibid.*, p.30.

unnecessary paper work. The scope of these Principles was consequently eventually limited to advisory and advisory and discretionary customers respectively.⁶²

Determining the substance of the rule also meant that differences which had hitherto not been confronted had to be addressed. One of the more contentious related to how conflicts of interest should be dealt with. The differences here largely reflected the approaches of the different types of groups who undertook investment business: SRO and RPB members. The initial draft of the Principle (Principle 6) stipulated that a firm "should be vigilant to identify" potential conflicts of interest, and where conflict could not be avoided the firm should nevertheless "take all reasonable steps" to ensure fair treatment to all of its customers.⁶³ "Reasonable steps" to take to manage the conflicts would be "disclosure, internal rules of confidentiality or otherwise". The second and final drafts contained an "either/or" provision, providing that either firms had to avoid conflicts arising, or if they did arise, the firm was under an absolute duty to ensure fair treatment for its customers, which may require declining to act. The character of the rule became mandatory, removing the "reasonable steps" provision and changing the suggested courses of action into required behaviour.

The changes in the rule's structure and character reflect the substantive debate about how conflicts of interest should be handled by the regulation. Professional bodies are used to dealing with conflicts of interest by declining to act, or otherwise acting to avoid them arising. Integrated finance houses, however, were not prepared to avoid conflicts: it would force them to fragment, and so reverse the whole integration process which had been part of "Big Bang".⁶⁴ They wanted to be able to manage the conflict. The "reasonable steps" provision which initially appeared was an attempt at a compromise between these two views. However the "avoiders" felt that the duty was not expressed sufficiently strongly, and so the "either/or" approach, which stipulated more

⁶² Principle 5 was only limited in the second draft.

⁶³ SIB, August 1989, *op.cit.*, para 7.

⁶⁴ See Chapter 3.

clearly a duty to avoid, was adopted.

The substance of the Principles was also influenced by the regulatory context in which the Principles were to operate. This includes not just the Act, but the wider context of "City regulation", that is, the other codes which regulate FSA authorised persons, and an international context. Principle 3 comes from the Anglo-French Principles, which were the precursor to the IOSCO principles,⁶⁵ and was included to reflect the concern for market regulation.⁶⁶ The Principle also integrates other City codes with the FSA regulation by providing that a firm should comply with any code or standard in force to the extent endorsed by the Principle. The principle is enabled by the FSA, as amended, which allows outlying informal obligations to be incorporated into the principle, so that an investment firm would be required to observe them in the course of investment business. It is SIB's intention to endorse the Takeover Code and the Bank of England's Code of Conduct: the Grey Book, and SIB's own Oil Market Code, although mainly due to reluctance of the RPBs no instrument of endorsement has yet been issued. The question of responsibility for enforcement is dealt with in the statute, and though it was repeated in earlier drafts of the principles this duplication was removed.⁶⁷

Over the course of drafting, Principle 3 was widened to interact not only with the international and City regulatory context, but also to clarify provisions in the Act. This arose from the experience of regulators and the regulated concerning the interpretation of one of the statutory provisions, the offence of misleading the market.⁶⁸ Practices which had been standard methods of business appeared to be caught by the section, and there was much uncertainty as to its

⁶⁵ International Organisation of Securities Commissions, Conduct of Business Principles, December 1990. See Chapter 3.

⁶⁶ This concern is greater in the US and EC than the UK and earlier drafts of the IOSCO Principle contained far more about the relationships between the firms and the market. All that remains of these drafts is contained in Principle 3.

⁶⁷ S 47A(5)(b) preserves the regulatory responsibilities and demarcations of the organisations involved by providing that no disciplinary or intervening action shall be taken except at the request of the person issuing the code.

⁶⁸ S.47.

interpretation. The aim of the Principles was to address this problem of the interpretation by stipulating that when operating on a market, as long as the firm acts according to the standards of that market, and with honesty and integrity, then the firm is complying with the section. This includes an obligation to avoid misleading practices, including market manipulation. The Principle thus performs an interpretative function.

The drafting process as well as substantive policy questions affected the structure and character of the Principles. Principle 6, for example, is more detailed than the corresponding Core Rule.⁶⁹ The increase in detail was a result differences in approach to the policy issue by those involved in the formation of the Principles. Negotiation and compromise lead not to a more general rule, as some writers might predict,⁷⁰ but to a more detailed one. The level of detail was also due to more pragmatic factors: it is partly explained by one of the drafters to be the result of very strong urging on the part of one of the representatives of one of the SROs who felt that there should be recognised at a higher level a variety of ways in which conflicts could be addressed. The absence of such detail in the corresponding Core Rule is attributed simply to the absence of this representative from the consultative group which drafted those rules.

The effects of demands of different participants is also illustrated in Principle 10, which focuses on the relationship between the firm and the regulators. It provides that a firm "should deal with its regulator in an open and co-operative manner and keep the regulator promptly informed of anything which might reasonably be expected to be disclosed to it." The phrasing was changed from the more precise requirement of "anything relevant to the regulator's task" due to possible conflict with other duties that members of professional bodies are under: the Law Society in particular was concerned that as originally phrased the Principle overrode the rights of professional privilege and self-incrimination. The phrase "reasonably expected" enables a level of judgement to be exercised in applying the rule, and is implicitly intended to relate to such

⁶⁹ CR 2.

⁷⁰ See Chapter 1.

rights.

This implicit indication of the nature of the rule's interpretation was preferred to a more precise and clear list for two reasons. Firstly, the Principle would then have a structure which was not shared by the others. Secondly, a list carried the risk that it would be considered exhaustive and omit something that the regulators might subsequently find should have been included, and provide the basis for avoidance on technical grounds. These considerations were given impetus by the rationale of the Principles themselves: to err on the side of over- rather than under-inclusiveness, and to prevent avoidance on the basis of technical interpretations.

Assessment

From the above analysis it is clear that the Principles are not simply generalised appeals for honesty, integrity and fair dealing. They are carefully and legally structured requirements, which vary in their applicability. The implications of using standards as opposed to detailed rules were discussed in Chapter 1, and have impacted on the formation of the Principles in a number of ways. Certain definitions have been chosen in such a way as to enable SIB to postpone a decision on the principle's application in uncertain areas, for example, the phrase "universal" in paragraph 1 of the Introduction noted above. The regulators have preferred to err on the side of over-inclusiveness and to mitigate this effect through flexible application to individual situations.⁷¹ The amenability of the Principles to disciplinary action by the regulator only means that SIB and the SROs have the flexibility to reserve judgement on such fundamental issues as, for example, their territorial application as they retain control of the ultimate interpretation and application of the Principles. The decision is not being delegated to another body, for example a court, over whose interpretation of the Principles it would have no control and so would have to include more guidance in the Principle itself as to the interpretation SIB would wish it to be given.

⁷¹ See Chapter 1.

However, the recognition that the rule must provide some indication of its scope and requirements where possible, and a desire to ensure that certain conduct is followed, meant that despite their status, even the Principles were not free from the pressures for specification. They do not stop at prescribing that things be done, going on, for example in Principle 6, to set out the manner in which they should be done. Further, words and phrases have been carefully chosen to impart a particular legal meaning, for example the phrases "universal" and "not exhaustive" in the Introduction. Finally, when regarded as a system of rules both within themselves and in relation to other rules within and outside the regulatory system, it may be seen that the Principles are complex. Their interrelationship, moreover, is not explicit. Principle 3 (market practice) overlaps to a considerable extent with Principle 1 (integrity). The Principles give no explicit indication of how any conflict between them should be resolved, but Blair argues that Principle 1 overrides Principle 3.⁷² So although a firm could be acting in accordance with the standards of a market, if it is not acting with high standards of integrity and fair dealing then Principle 3 provides no defence to the breach of Principle 1. However, he argues that Principle 1 does not act as a safety net to all the Principles: it does not require a higher standard of conduct than that set out in a detailed Principle, for example Principle 6.⁷³ On their face, however, the Principles give little indication that such interpretations should be given.

Core Rules⁷⁴

The drafting processes of the Principles and Core Rules were two separate exercises: the Principles were drafted first, when few ideas had yet been formed on the exact number or content of the Core Rules. It had thus become clear what form and structure the Principles would take

⁷² Blair, *op.cit.*, p.10.

⁷³ *Ibid.*, p.7.

⁷⁴ This section draws on interviews with legal and policy officials at SIB and the SROs conducted between November 1991 and July 1993.

and it was evident that the SROs' rules would contained the detailed provisions; the issue which remained was what structure should a Core Rule have, and with what matters should it deal. The Core Rules were in fact a "second distillation" of the initial rules, following the first distillation in the New Approach.

The rules are the outcome of protracted negotiations between SIB and the SROs. The drafting process involved the legal staff of SIB and the SROs and the policy directors at SIB. Further action on the New Approach had been prompted principally by strong representations, particularly by IMRO, that 93 principles was too many. It was followed by a bilateral working group of SFA and IMRO, the two SROs most concerned about the state of the initial rules. The drafting process continued over a period of several months, with meetings of several hours rising from once to twice a week as the process neared completion. These were chaired by SIB and attended by the legal staff of the all the SROs and SIB and the policy directors of SIB. Approval of the Board of SIB was necessary and was sought on a continuing basis, the Board making final decisions where the meetings had failed to reach a solution. On the basis of these negotiations, in August 1989 SIB produced a draft reworking of the New Approach in the form of Principles and designated rules, which was subject to the statutory consultation process.⁷⁵ Two subsequent drafts were produced in October and November 1990,⁷⁶ and the rules were published in January 1991.⁷⁷

Drafting Considerations

The process of drafting was affected by several factors, political and pragmatic, which had a direct impact on the structure of the rules. Politically important was the requirement for speed in their formation and publication, and the requirement of brevity: the overall message of the New

⁷⁵ SIB, August 1989, op.cit.

⁷⁶ SIB, *The Proposed Core Rules* CP 42, October 1990, and *The Proposed Core Rules: Derogations and other certain points*, CP 47, November 1990.

⁷⁷ SIB, *The Core Conduct of Business Rules*, January 1991.

Settlement was that the rules should be simple. SIB could not afford long and complex Core Rules. Also important was the requirement for durability: the frequent amendments to both the SIB and SRO rules had increased the uncertainty and complexity of the initial rules, and the New Settlement was a further regulatory change demanding the attention of firms. The Core Rules were meant to lend stability to the system, to provide a common core, a backbone of regulatory requirements. Frequent amendments would operate against the achievement of this aim. The final factor was the requirement that they be relatively few in number: the initial number of fifty was chosen, fairly arbitrarily, and subsequently reduced to forty.

As noted above, there was initially no clear idea in SIB or the SROs what the structure of a core rule should be. The structure, status and substance of the rules were determined essentially by the function of the rules within the rule and regulatory system. They were meant to provide a "common core" or "backbone" to the rule system, containing the essential duties, which would apply to all members of the SROs. They were thus meant to provide coherence and central control of regulatory standards, whilst allowing the SROs room to write their own rule books.

This aim of control over the central provisions of the rules had led to the statutory definition of the rules as applying to all members of SROs. As noted above, it had been SIB's intention that they should apply also to RPBs; it was the Government's decision that they did not. Their substance was determined by this statutorily defined status and scope of the rules, rather than the suitability of a particular substantive issue to the proposed rule structure. The decision as to the rules' substance, what matters the designated rules should deal with was in part governed by an intuitive sense of what was felt by the drafters to be important, arrived at by induction from the old rule books and the principles in the New Approach rules which had not been used in the 10 Principles, and whether the rule applied to all SROs. The more an issue had a single SRO focus, the less was the impetus to include it in the Core Rules. The third tier would be used for the particular application of the rule to the SRO's own section of the financial community.

There were other, more pragmatic, demands made upon the rules. The Core Rules were to be the root of the third tier rules; they therefore had to be capable of incorporation into the third tier rules, unamended, and be structured in such a way that the third tier rules could flow easily from them. Some Core Rules were more relevant to some SROs than others, however. There were also inevitable differences between the SROs as to how their third tier rule would build on the Core Rule, differences which SIB felt the Core Rules had to accommodate. One participant commented that it was as if the draftsman was "drafting in a hall of mirrors".

The hallmark of the drafting process was negotiation and compromise. The concomitant of the position of the Core Rules as the "common core", applying directly to SRO members, was that SROs wanted to ensure the Core Rule contained the seeds of the third tier requirements which they wished to include in their own rule books. In the words of one participant in the process: "each SRO had a difference of emphasis that it thought should be in the Core Rule, but there were no cases where resolution was impossible." Or as another put it more bluntly, "there was a great deal of horsetrading going on". The negotiating technique of making compromises in one area in the hope that your view will hold sway in another was also used: in the words of one participant: "decisions were made very much on the basis of allowing a compromise here as there are many more issues which need to be dealt with and battles to fight in the future." This applied to SIB as much as to the SROs. Although SIB was in the legal position of being able to impose its rules on the members of the SROs and controlled the ability for derogation, relations between SIB and the SROs were such that negotiation of the Core Rules was essential for the effective, continuing functioning of the regulatory system. Further, the fact that SIB and the SROs have an on-going relationship in which SIB requires SRO co-operation on other matters such as monitoring, enforcement and intervention was mentioned as an important factor in this negotiation process, SIB had to consider this relationship as a whole. Gaining agreement on the Core Rules was also of prime importance given the rationale of the rules was their function as a "common core", and that their introduction was meant to reduce, not increase, tensions between the two tiers.

The formation of the Core Rules was more than an exercise in drafting or capturing the essence of the old rules in a more "user friendly" way. The rules were used as vehicles to embody various policy decisions which had already been made in relation to the regulation of PEPs and investment trusts, for example,⁷⁸ and the control of appointed representatives.⁷⁹ Criticisms of the initial rule books had prompted a review of the scope of some of the rules, and a desire on the part of most to introduce a greater distinction between the regulation of dealings with private and non-private customers. In relation to other areas, the participants differed. An official at SIB commented that SIB and the SROs approached the exercise with different objectives in mind. SFA thought the opportunity should be taken to reduce the demands of the regulation, particularly in relation to client agreements, whereas IMRO saw the exercise as principally one of codification. SIB was concerned to modify some aspects of the regulation, but not go as far on some matters, for example polarisation, as SFA would have liked. Lautro and Fimbra were essentially unconcerned with the majority of the rules, and were concerned principally to preserve polarisation.

The view of whether the Core Rules should be a maximum or minimum standard became a crucial decision in this negotiation process. If they were a minimum standard, negotiating agreement was far easier. Those SROs who wanted to impose a higher standard were free to do so in their own rules. However, this was not favoured by those who wanted higher standards for their own members. A certain amount of self interest on the part of those involved informed their approach to the issue of maximum or minimum standards. Those SROs who did wish to impose higher standards, for example SFA in relation to advisory business customers, wanted to be able to use the shield of the Core Rules to defend their position. Without this they would have to justify to their members why the Core Rule requirement was not sufficient. For SIB's part,

⁷⁸ Following the report of a review committee in March 1990, *Regulation of the Marketing of Investment Services and Products*.

⁷⁹ CR 13.

however, minimum standards were more in line with the philosophy of allowing practitioner input into the third tier; it also provided SIB with a defence to charges of overbearing rules and a justification for being very strict on permitting derogations.

These considerations accompanied the more general concerns of rule drafting as an exercise independent of its political context. The main concerns of the SIB drafter who drafted the Core Rules were to define the objectives, to ensure the rule targetted who and what was intended and to communicate the purpose of the rule clearly. The intended addressees were compliance officers, who could then interpret the rule for the benefit of the firm's dealers and fund managers. In ensuring the rule had the appropriate scope, the drafter placed heavy reliance on those experienced in the market to indicate what in fact would be caught, not because the meaning of the words was unclear, but because the rule may cover a market practice of which the rule drafter is unaware, the whole or part of which may or may not be legitimate. Without this knowledge, he stated, it is impossible to draft an ideal rule.

The structure of the rules

The Core Rules are arranged broadly according to their subject matter, and fall under the headings of independence, advertising and marketing, customer relations, dealing for customers, market integrity, administration and general. The scope of the rules is expressed positively: the rule is stated to apply to a certain class of customer, rather than excluding a long list of persons as in the 1987 Rules. Even so, the focus of the rules on the private investor meant SFA had to amend some of the rules for its *Professional Dealers' Handbook* to make them self-standing. The rules are quite short: at the most four subsections long, there are no cross references between them and on the whole appear much easier to understand.

The structure of the Core Rules had been dictated by the three tier design of rules, itself introduced for reasons indicated in Chapter 4. They were to be short and as far as possible capable of application to changing circumstances and new situations without amendment, and to leave the

detail to the third tier rules. The rules do not themselves contain lists of factors which must be considered or actions which must be taken; however the use of the Glossary⁸⁰ argues against a conclusion that they are simple. They are imprecise in that they do not indicate the manner in which, for example, disclosures are to be made or the periods at which notification of transactions or portfolio compositions must be given. Indeed, in one instance, conflict of interest, the corresponding Principle is more precise than the Core Rule.⁸¹ Phrases such as "due despatch" have replaced complicated definitions of "business day" and details about the relevant twenty-four hour period in the rule on confirmations, for example.⁸² The rules on customer agreements,⁸³ contract notes,⁸⁴ customer order priority⁸⁵ and timely allocation⁸⁶ provide the most striking contrasts with the initial rules, and were themselves made less specific over the successive drafts of the Core Rules.⁸⁷

There are two features of the Core Rules which belie statements both as to their brevity and simplicity, and as to their function as a common core. These are the provision of derogations and the use of the glossary. Their history and use is explored below to give a greater indication of the considerations involved in the formation of the rules, and the use to which different types of rules have been put. In particular, the derogations which have been sought by the SROs under the Act for market counterparties and indirect customers are discussed to illustrate the different approaches each may adopt, and the implications this has for the function of the core rules as a common core.

⁸⁰ See below.

⁸¹ P.6 and CR 2.

⁸² CR 19(1).

⁸³ CR 9(2).

⁸⁴ CR 19.

⁸⁵ CR 20.

⁸⁶ CR 23.

⁸⁷ For treatment of these issues in the third tier rules, see below.

Derogations

The reasons for derogations lie in the institutional structure of the regulation. We have seen that one of the principal reasons for the New Settlement was to clarify the roles of the different regulators: SIB would be responsible for setting the core regulatory standards, and hence the core rules, the SROs for providing rules suited to the needs of their regulated community. The designation of the Core Rules as directly applicable to SRO members had been received by the SROs with a certain amount of hostility. Partly as a trade off, and partly with the legitimate aim of enabling the necessary practitioner input to take effect, derogations from the Core Rules by the SRO rule books had been provided for in the amendments to the FSA 1986.⁸⁸

Derogations are thus an attempt to resolve the tension between the roles of SIB and the SROs and they may be seen as a manifestation of that tension. The two objectives of having a common core of rules and duties and of facilitating practitioner input into the regulation exert contradictory pressures. The idea of a common core militates against derogations, as they have the potential to undermine this commonality, yet the demands for practitioner input require that the SROs have the ability to tailor the regulation to suit the market in which their members operate. The primary aim of the Core Rules was to be a harmonising backbone of regulation, however, and SIB therefore felt that provision of derogations had to be controlled. In addition, SIB stated that part of the adequacy test would be consistency of a rule book with other SRO rules.⁸⁹

The statutory amendments made provision for the designated rules to specify the extent to which the rules would apply to a firm, subject to the rules of its self-regulatory organisation, and for the rules to prohibit any modification or waiver in respect of any member.⁹⁰ The Core Rules thus indicated when the SRO rules would apply with the effect of replacing or amending

⁸⁸ S.47B and s.63B.

⁸⁹ CP 39.

⁹⁰ S.63A(2) and s.63B, introduced by s.194 Companies Act 1989.

the Core Rule. Derogations were used both to facilitate amplification of the Core Rule, and to permit limitations on the rule. The form the derogations took altered during the course of drafting, as did their incidence. Initially where amplification was felt to be necessary, either as to the scope of the obligation or to the manner of complying with it, the Core Rule would state that the firm comply with "rules made by" or "requirements of" the firm's regulator.⁹¹ Amplification was also implicitly indicated by such words as "adequate", "relevant" or "unfairly" or other terms requiring judgement. Third tier rules could then provide greater precision, or safe harbours.⁹²

The use of these express "look through" provisions, or "empty carriages", was continued in the second draft of the rules.⁹³ They were criticised on two grounds, however, their structure and their legality. Firstly, the effect of such provisions was that the rule was not self standing: it made no sense on its own. Take, for example, the rule on material interest contained in the second draft of the rules:

"Where a firm has a material interest in the subject matter of a possible transaction, or a relationship which gives rise to a conflict of interests in relation to that transaction, it must not advise, or deal in the exercise of discretion, in relation to that transaction unless it has observed such requirements as may be imposed by its regulator in order to ensure fair treatment for all its customers."⁹⁴

As we can see, the rule failed in its objective to provide a "backbone" or a "common core" as it had no content. It required a cross-reference to a further rulebook, and left it to the test of adequacy to ensure that the requirements were consistent between the SROs. On its own it provides no indication of what conduct is necessary. The rule was indeed criticised on the ground that it was not a rule, but an indication of something to follow.

Secondly, the question of vires and unlawful sub-delegation of rule making power was

⁹¹ These express "look through" provisions were provided in the rules on inducements, advertisements, risk warnings, stabilisation and client money contained in the August 1989 draft.

⁹² SIB, August 1989, paras 15 and 16.

⁹³ CP 42, draft rules 2 (soft commissions), 9 (off the page advertisements), 10 (information on packaged products), 13 (customer agreements), 15 (material interest), 30 (margined transactions) and 33 (reportable transactions).

⁹⁴ CP 42, draft rule 15.

raised, in particular by the DTI, which was concerned about the legal ability of SIB to create a rule of that kind. The statutory rule-making power had been given to make a rule, not effectively to delegate that power to the SROs. Moreover, it was argued that the safeguards built into the system: the fact that the rules are made by the Board not the staff of SIB, would not be applicable. Finally, derogations in that form it was felt would go against the objective of the durability of the rules, and of SIB's control over the standards of behaviour required: the rule would be subject to the changes in the third tier rules.

These considerations led to the removing of the "empty carriages". This led in some instances to a specification of the duty or re-definition of the application of the rule,⁹⁵ in others to the inclusion of an implicit "look through" provision.⁹⁶ For example the rule on off-the-page advertisements became more specific in that a further category of advertisements was identified, and part of the rule narrowed in its application to private investors.⁹⁷ Similarly the empty carriage in relation to customer agreements was replaced by the confinement of the rule to private customers only.⁹⁸ On the other hand, in the rule on material interest, the express "look through" provision was replaced by an implied provision: the firm must take "reasonable steps" to provide fair treatment for the customer;⁹⁹ in relation to information on packaged products the requirement changed from "written product particulars as prescribed by the firm's regulator" to "appropriate written product particulars".¹⁰⁰

Derogations were still provided for explicitly, however. In the final version, derogations from the rules are flagged by the phrase "subject to exceptions of the SROs". These appear in only in six instances: rules on termination of contracts with appointed representatives,¹⁰¹

⁹⁵ CP 42, draft rules 2, 9, 13 and 30.

⁹⁶ CP 42, draft rules 10 and 15.

⁹⁷ CR 5.

⁹⁸ CR 14.

⁹⁹ CR 2.

¹⁰⁰ CR 12(2).

¹⁰¹ CR 13.

suitability in relation to non-private customers,¹⁰² what charges and remuneration should be disclosed,¹⁰³ when confirmations and periodic information should be given,¹⁰⁴ in what circumstances dealing ahead of publication should be allowed,¹⁰⁵ and how customer investments should be safeguarded.¹⁰⁶

Initially the working rule was adopted that derogations should be conferred for any exception in an SRO rulebook that could be traced to the current version of SIB's own rules. As noted above, however, given the intended purpose of the Core Rules to provide a 'common core', it was feared that over-use of the derogation provisions would undermine this purpose, as they would negate their commonality. For this reason, they were very much discouraged by the Board of SIB. Some use of derogations was required by the aim of brevity of the rules, however, and the desire to keep them at an "intermediate level of generality". "To include...within the Core Rules themselves all the various exceptions that will be required in particular sectors.....would over-complicate them."¹⁰⁷ Some of the Core Rules contained exceptions within them in that they applied only to private investors or certain types of business. Further exceptions would be necessary in relation to different types of business, and for the sake of brevity and generality, and if SIB was to keep to its line that the New Settlement would hand "the baton of adaptation and innovation in the third tier"¹⁰⁸ to the SROs, it had to leave the definition of these exceptions to them. Derogations were also used where agreement could not be reached, as a form of compromise.

This use of derogations by SROs means that SIB can leave it to the SROs to make

¹⁰² CR 16.

¹⁰³ CR 18.

¹⁰⁴ CR 19.

¹⁰⁵ CR 25.

¹⁰⁶ CR 32. The other two instances of derogation indicate that the SRO may completely disregard the core rule (CR 33, reportable transactions, and CR 39, classes of customer).

¹⁰⁷ SIB, August 1989, para 20.

¹⁰⁸ M. Blair, "Regulation of the Conduct of Investment Business: SIB's Proposal", (September 1989) *BJIBFL* 398.

provisional arrangements to deal with places where the Core Rule "has got it wrong", and where most of the instances have been discovered then SIB will bring these amendments up into the Core Rules. This facilitates the achievement of SIB's aims on two counts: it aids the durability of the Core Rule (changes are only made to meet the difficulties when SIB is confident that all the problems have been identified), and it also enables SIB to shift to the SROs the problem of detailed working out and the handling of unexpected applications of the rule. SROs can specifically request derogations, and both IMRO and SFA have done so. Some derogations have been permitted because of the nature of business being done, the derogations in the case of corporate finance for example, or because they continue exceptions made in the SRO's previous rule books, SFA's definition of market counterparty, for example.¹⁰⁹

The derogations also allow different approaches of the SROs to be reflected in their rules. Differences in the rules of SFA and IMRO are principally ones of rule structure, with IMRO on the whole having more detailed rules, discussed below. Some of the derogations relate to more fundamental issues, however, as they manifest a different answer to the question of which types of customer should receive which level of protection.¹¹⁰ They may therefore in practice undermine the common core by going against the regulatory philosophy underlying those rules. The following examples of the different treatment of market counterparties and indirect customers illustrate this point, and indicate the extent, or limit, to which there is a common core.

Market Counterparties

Because of the way the Core Rules are crafted, premised on a relationship between a firm and a customer, the narrower the definition of 'customer' the narrower the range of application of the rule. The Core Rule customer definition does not include persons who are market counterparties (MCPs) so the rules which will apply to them are the few of general application

¹⁰⁹ See below.

¹¹⁰ See Chapter 2.

which do not mention the word customer.¹¹¹ The definition of customer and market counterparties were included very late in the drafting, and the latter are defined in the Core Rules as:

"a person dealing with a firm:

(a) as principal or as agent for an unidentified principal

(b) in the course of investment business of the same description as that in the course of which the firm acts".¹¹²

The definition does not create a generic category: it applies on a transaction by transaction basis depending on the status of the person with whom the firm is dealing and the parity of the investment business being conducted.

SFA felt the transaction by transaction approach was impractical for its members, following representations that firm's systems could not be designed to accommodate the provisions, and so the rule was one with which they would find it very difficult to comply. Instead SFA wished to preserve its old generic Market Professional definitions with which its members were familiar and which had enabled them to operate under their own contractual terms with other members. SFA therefore sought a derogation to extend the range of the definition. SFA Rule 5-4 provides that in relation to persons dealing in the course of investment business of the same description as that in the course of which the firm acts, that person may be a MCP.¹¹³ This was

¹¹¹ Those Core Rules applying to MCPs are:

CR 5(1-3): issue and approval of advertisements

CR 9(1) : fair and clear communication

CR 13 : appointed representatives

CR 23 : timely allocation

CR 28(1) : insider dealing (own account transactions)

CR 29 : stabilisation

CR 31 : reportable transactions

CR 33 : scope of business

CR 34 : compliance

CR 35 : complaints

CR 36 : chinese walls

CR 38 : reliance on others

CR 40 : application of CCBs.

¹¹² Agents acting for identified principals are therefore customers.

¹¹³ SFA r.5-4 also applies to: trading members of investment exchanges for investments/derivatives traded on that exchange; inter-dealer brokers when acting in that capacity; and in relation to debt and money market investments, a country, central bank, international organisation of countries and listed money market

an issue on which SIB and SFA did not agree, and the dispute went to the level of chairmen. SIB was not happy with SFA's provision, but because of the "standing back" requirements felt it could do no more than require a compromise. SIB insisted that for a person to be a MCP the firm must send to the person a written notice informing it that it is to be treated as a MCP without the benefits of protections afforded to customers, and that person has not notified the firm that it does not wish to be treated as a MCP.¹¹⁴

A firm with private customers may permit itself to be treated as a MCP by another firm where it believes on reasonable grounds that those customers will be properly protected under the rules of SFA.¹¹⁵ However, the Guidance stresses that a firm should take into account customer protections it will lose as a result of such treatment. Where a firm believes that it will be unable to fulfill the duties and obligations owed to its private customers under the rules of SFA, it should not permit itself to be treated as a MCP.¹¹⁶

SIB was also reluctant in permitted this derogation. Its main concern was that an SFA member would no longer be owed duties by other SFA members which would be owed to it if it were a customer: those relating to execution of orders¹¹⁷ and those requiring fair treatment in one form or another.¹¹⁸ Nor would the other SFA firm owe any duties to the MCP's customers where it might otherwise do so. SIB stressed, therefore, that in forming the reasonable belief about its ability to fulfil all the duties owed to its private customers the firm would have to have regard to the extent to which it was reliant on others for the fulfilment of its obligations to its customers. For example, the timeliness and quality of execution of deals done for it, or when obtaining advice from another member firm what material interests or benefits to that firm may

institutions.

¹¹⁴ Either generally or in relation to particular kinds of investments.

¹¹⁵ SFA r.5-4(4).

¹¹⁶ SFA r.5-4 Guidance 3.

¹¹⁷ Core Rules 19-24.

¹¹⁸ Core rules 1-3, 25, 26, 32 and 35.

exist that are not disclosed.¹¹⁹ These concerns are not shared by SFA, who are of the view that other SFA member firms should be sufficiently experienced to realise the potential for soft commission agreements, conflicts and other potential abuses which are not being disclosed and dictate their own terms of business. In fact under the present Core Rules MCPs are owed more duties than they were under the old system.¹²⁰

Indirect Customers

The notion of indirect customers (IDCs) came from the old TSA rule book and was not contained in the initial SIB rules.¹²¹ The Glossary definition provides that an indirect customer means:

"where a customer is known to be acting as agent, an identified principal who would be a customer if he were dealt with direct".

The definition is wider than the old TSA rule in three respects: it applies to all intermediaries not just those engaged in another profession such as banks and solicitors, to all duties, and there is no mention of being able to limit the application of the duties owed in the contract between the intermediary and the member firm. So where an SFA firm deals with an RPB member (for example) who is acting for an identified individual,¹²² under the Core Rules the SFA firm has to act as if the RPB's customer is its own, which is of significance principally where that customer is a private customer. The SFA firm therefore has to comply with, for example, the best execution rule where this may otherwise have been disapplied in relation to non-private customers. The

¹¹⁹ SIB, *Core Conduct of Business Rules: Commencement for Members of SFA*, CP 55, December 1991, paras 8-12.

¹²⁰ CR 9(1): fair and clear communication and CR 23: timely allocation.

¹²¹ TSA r.140.01 provided that where a bank or similar institution, or a professional lawyer, accountant or actuary acted as intermediary for a private customer, then certain specified rules would apply in the firm's dealing with the intermediary as if the client were a direct private customer of the firm, including the duty of best execution, know your customer, suitability, material interests, self-dealing and dual agency and churning. These could all, however, be varied or excluded in the customer documentation with the intermediary: TSA r.150.1.

¹²² Ie a private customer. What constitutes identification has been the source of some difficulty.

definition interacts with that of market-counterparty. If an agent is acting for an unidentified principal, then the agent is a market counterparty. If the agent is acting for an identified principal, then the agent is a customer not a MCP, and his or her principal is also a customer of the firm, though there is no contract between them.

SIB's rationale for the concept is that duties should flow through to the principal: the broker and fund manager must comply with the rules relating to private customers when dealing between themselves not for any protections it may provide them, but for the protection of the ultimate investor.¹²³ IMRO and SFA feel that it should be the firm nearest the customer which should owe the duties; SFA members cannot ensure that the suitability rule, for example, has been complied with by the RPB firm. Both IMRO and SFA have amended the Core Rule definition of IDC, however. IMRO has provided that a member may treat an agent of the IDC as its customer where the agent is reasonably believed to be an authorised person in respect of the investment services concerned, which would cover other IMRO members.¹²⁴ SFA has achieved the same effect through its market counterparty definition: SFA member firms are not customers of one another and so indirect customers cannot arise (the agent has to be a customer of the firm for the purposes of the IDC definition).¹²⁵ SFA has gone further and provided that the IDC relationship can be contracted out of in whole or in part by the agent and the firm, again to preserve continuity in substance between their old rule book and the third tier rules. The SROs' approach and concerns thus differ from SIB's, and through the provision of a derogation have been allowed to take effect.

¹²³ CP 55, para 15.

¹²⁴ Also where the agent does not conduct business in the UK, or the agent has refused to answer enquiries about his principal, IMRO 91 II-2.1(4).

¹²⁵ SFA firms have to be reasonably satisfied that they can fulfil the obligations to private customers before accepting market counterparty status.

Glossary

The requirements of brevity and durability led to extensive reliance being placed by the draftsman on the Glossary. It was anticipated when drafting the rules that various changes would have to be made, and so to ensure that they would be the object of minimum amendment the rules were drafted in such a way that any alterations of scope or application could be made in the Glossary. The Glossary is a drafting technique, described by one senior participant as a "sleight of hand", which removes the complexity of the rule from its face into an appendix. It is not until reading the Glossary that it becomes apparent that the Core Rules are not really simple and accessible.

The Core Rules use artificial concepts to refer to a host of factors and situations which are defined in the Glossary. The Glossary contains many of the more complex elements of the rules. For example, the rules relating to the retail sector are defined in their application by the phrases "packaged products" and "extended group". These are phrases are used in the rules, and then defined in the Glossary. The phrase "extended group" is defined as "members of a group of undertakings and the marketing group associates of any of them." A group of undertakings is defined with reference to the Act,¹²⁶ which itself refers to the Companies Act 1985.¹²⁷ This cross-referencing back to a recognised relationship elsewhere in company law replaced the notion of a connected firm which was defined by a complex description of arrangements of relationships between companies. The definition of marketing group is also in the glossary, and facilitates the exception from the "better than best" rule for investment management which was introduced in the final rule, mirroring the position in TSA's old rule book.¹²⁸

The Glossary posed a number of advantages for the draftsman, as well as enabling the Core Rules to remain brief and apparently simple. For example, the invention in CR 17 of the

¹²⁶ Sch 1, para 30.

¹²⁷ Sch 4, para 92.

¹²⁸ CR 17(4).

concept of "extended group" enabled the manipulation of the idea in a way which produced a more sophisticated result. The definition of marketing group also altered, with both definitions looking more to the substance of the relationship than its form. The Glossary could also be used to correct mistakes made in the drafting of the Core Rule which would otherwise be complicated to rectify. For example, the best execution rule refers to an "order from a non-private customer."¹²⁹ In the Glossary "order, in relation to a customer" is defined as an order which causes the firm to act as agent, or a decision by the firm in the exercise of discretion for the customer. The definition arose as a result of a failing in the drafting process. The term "customer" was not defined until towards the end of the process. When the rules were viewed as a whole it became apparent that the definition of customer meant that the best execution rule applied to all customers, including professionals, a substantial widening of the 1987 requirement and contrary to the philosophy of the new rules. Inserting the occasions when the rule would have applied would have made it unacceptably long. Here the political demand for brevity informed the decision: the rule had dramatically increased in length by the final draft already.¹³⁰ Altering the definition of "customer" would have affected other rules where the limitation was not appropriate. So the definition of "order" was used as the vehicle for the limitation of application of the rule. It also applies to other rules referring to customer orders, however, limiting their application to where the firm is in a fiduciary relationship with the customer.¹³¹ Without referring to the Glossary this cannot be gleaned from the rule, but for the draftsman the definition could be altered independently from the text of the rule, and the rule is simply stated.

The Glossary was also used to provide safe harbours to rules: the rules on soft commissions, material interests, and inducements. CR 1 (Inducements) states that a firm must take

¹²⁹ CR 22.

¹³⁰ See Chapter 6.

¹³¹ CR 20: customer order priority, also applying to own account orders, CR 21: timely execution and CR 22: best execution in relation to non-private customers. All private customers, fiduciary or otherwise, must receive best execution.

reasonable steps to ensure that neither it or any of its agents offers, gives, solicits or accepts an inducement which is likely to conflict significantly with any duties owed by the recipient to customers. "Inducement" is defined in a negative or residual sense in the Glossary, as not including "disclosable commission" or "goods or services which can reasonably be expected to assist in the provision of investment services to customers" and which are provided under a soft commission agreement: so providing a safe harbour from the rule. The same technique is used in CR 2 (material interest). The rule states that where a firm has a material interest in a transaction for or with a customer which gives rise to a conflict of interest then it may not advise or deal without taking reasonable steps to ensure fair treatment for the customer. The Glossary definition on material interest is again a residual one: not including "disclosable commission on the transaction", and goods under a soft commission agreement, as above, again creating a safe harbour in relation to the customer. This is bolstered by paragraph 2 of the Glossary which provides that "[n]either a soft commission agreement nor an arrangement for the payment of disclosable commission" for the purposes of Core Rule 2 is to be taken as creating a conflict of interest in relation to transactions under the arrangement.¹³²

The Glossary thus provided a number of advantages for the drafter. Does it add to the comprehensibility of the rules, though? Some argue that it does not. This is partly because words are given definitions which are other than their normal market usage: "customer", "order" and "own account" are some examples. This can make the rules misleading to read, and led to some SROs dealing with the problem typographically, highlighting the terms to indicate to people that the words do not have their ordinary meaning. Others comment that the Glossary may have been a neat legalistic drafting trick, a "sleight of hand", but has not help market practitioners in the least. On the contrary, it has made it far more confusing for them, and rendered the rules much less accessible.

¹³² For a full discussion of the soft commission provisions, see Chapter 6.

Third Tier Rules¹³³

The third tier rules are the rules written by the SROs which are meant to flow from the designated or Core Rules, and cover matters relevant to their particular market areas which are not covered in the Core Rule, or covered only in a general manner. They were billed as the opportunity for practitioner input to find its way into the regulation in a way which, it was argued, it had been unable to do under the old equivalency structure. The designation of Core Rules has arguably limited the scope for practitioner input, but SROs differ in the extent to which they feel the Core Rules have limited their ability to draft the rules they want in the way they want. Some feel very little limitation: this may be because developments which had been made in their own initial rulebooks were carried up into the Core Rules. For example, Lautro feels that its categorisation of advertisements has been adopted by the Core Rules, the same occurred in relation to SFA's approach to the best execution duty. Other reasons may be that the provision of derogations within the rules marked instances where the Core Rules responded to the SROs' need for flexibility in their application. In relation to other substantive issues, the requests for extra derogations provide an indication of those areas where constraint was felt to be too great.

Otherwise, restrictions appear to have been due more to the style rather than the substance of the Core Rules. Whilst IMRO has not amended, and Lautro is not anticipating amending, the text of the Core Rules, both SFA and Fimbria have felt a need to do this. This is either, in the case of SFA, because amendment facilitates a logical reading of the following third tier rule, or, in the case of Fimbria, because there is a feeling that the language of the Core Rule would not be easily understood by their members. Fimbria's alterations are principally to put the rule into the second rather than the third person: "you must" rather than "a firm must", to give a more immediate and direct impact to the rule which Fimbria feels will improve the rule's communication

¹³³ This section draws on interviews with SIB and the SROs, particularly IMRO and SFA, conducted between November 1991 and July 1993.

to their members.

This section will concentrate on the third tier rules of SFA and IMRO. As the aim is not to give a comprehensive picture of the detailed regulation of the area: this is more effectively done in studies which can be updated as the rules change,¹³⁴ but to take a thematic view, not all third tier rules will be referred to. Instead, consistently with the approach thus far, the overall structure of the rules will be analysed, and the function of different rules highlighted.

The Nature of Third Tier Rules

The third tier rules of SFA and IMRO are more detailed than the Core Rules, as their role anticipates, and both SROs make a fairly extensive use of Guidance in the rules. The rules can be categorised as performing five main functions: detailing, clarifying, expanding, gap-filling, and limiting, including defining the application of the rule. The role of the third tier as detailing the requirements of the Core Rule is that which fits most obviously with the idea of the hierarchy of generality of the Principles, Core Rules and third tier rules. These rules are primarily concerned with information provision: advertising,¹³⁵ customer agreements,¹³⁶ contract notes¹³⁷ and portfolio evaluations,¹³⁸ and dealing rules which impose open textured obligations: timely¹³⁹ and fair¹⁴⁰ allocation. Whilst guidance is the usual mode for clarifying rules (see below), SFA have used rules for this purpose on two occasions: in relation to CR 9(1) on fair and clear communications, and in the case of CR 24, aggregated orders. In the first case, the Core Rule does not make it clear whether it applies to oral as well as written communications; SFA amends

¹³⁴ See, for example, Butterworth's *Financial Services Law and Practice* (London, 1987, updated), and E.Z. Lominicka and J.L. Powell, *Encyclopedia of Financial Services Law* (London, 1987, updated). See also Butterworth's *Journal of International Business and Finance Law*.

¹³⁵ CR 5; SFA rr.5-9 - 5-11; IMRO 1991 II-1.1.

¹³⁶ CR 14(2); SFA r.5-23; IMRO 1991 II-2.2 - 2.4.

¹³⁷ SFA r.5-34.

¹³⁸ CR 19(2); SFA r.5-35; IMRO 1991 II-4.5(3).

¹³⁹ CR 21; SFA r.5-40.

¹⁴⁰ CR 24; IMRO 1991 II-3.10(2).

the text of the Core Rule to indicate that oral communications are included.¹⁴¹ In the second, the Core Rule does not define "aggregated orders", which is the operational basis of the rule; SFA therefore specify when orders can be aggregated to clarify the Core Rule's application.¹⁴²

The third tier rules also expand, or impose more duties on members than required by the Core Rules. SFA extend the application of the two-way customer agreement, for example,¹⁴³ and the application of the suitability rule to all discretionary customers including non-private.¹⁴⁴ SFA also extend the requirements of the suitability rule to impose a continuing duty to ensure that the account/portfolio remains suitable for the customer.¹⁴⁵ SFA have increased the degree of obligation in the rules on customer order priority: requiring that a firm "must" deal with customer and own account orders fairly and in due turn, not simply "should".¹⁴⁶ IMRO imposes additional duties in requiring non-private customers to have written terms of agreement: the Core Rule requires this only for private customers.¹⁴⁷ The third tier also fill gaps in the coverage of the Core Rules: in relation to, for example, broker funds, PEPs, Business Expansion Schemes, management of collective investment schemes, underwriting, customer borrowing, margin requirements, averaging of prices and other matters particular to the SRO's range of investment business.

Finally, the third tier rules limit the application of the Core Rules, either by requiring application of only some of the Rules to certain types of business: corporate finance, management of occupational pension schemes, PEPs, Business Expansion Schemes, etc., or at a more detailed level, restricting the application of a particular rule. Limitations in the first case are made

¹⁴¹ SFA r.5-41.

¹⁴² SFA r.5-41.

¹⁴³ CR 14(2); SFA r.5-23(2)(b).

¹⁴⁴ CR 16; SFA r.5-31.

¹⁴⁵ CR 16; SFA r.5-31(3).

¹⁴⁶ CR 20; SFA r.5-37.

¹⁴⁷ CR 14(1); IMRO 1991 II-2.4(4).

subsequent to a derogation order from SIB,¹⁴⁸ in the second using the inbuilt derogation, "subject to the rules of the SRO", which occurs in the seven Rules noted above. These have been used on all seven occasions by SFA,¹⁴⁹ whereas IMRO has made use of five.¹⁵⁰ Specific derogations have been sought by, and granted to, SFA on the definitions of indirect customer and market counterparty, above;¹⁵¹ IMRO requested, but was refused, derogations on disclosure requirements in soft commissions and advertising.¹⁵² The third tier rules can also limit the application of the Core Rule by providing more safe havens, a technique which does not make use of the derogation provisions. This has been done by SFA, for example, in relation to reliance on others and independence policies: the former permits wider reliance on others than the Core Rule; the latter provides that an independence policy will satisfy the material interest rule requirements.¹⁵³

Guidance

The status of the guidance is set out in CR 38: a person is taken to act in conformity with a rule to the extent that formal guidance has been issued by SIB or an SRO on compliance with that rule,¹⁵⁴ and relying on those standards, the person believes on reasonable grounds that he is acting in conformity with the rule. IMRO has added that any conduct which differs from that described in such guidance shall not raise or be construed as raising any presumption of a breach of any rule.

¹⁴⁸ Made under s.63A FSA 1986 (as amended).

¹⁴⁹ Though once to extend the application of the rule: the suitability rule is extended to apply to all discretionary customers - see above.

¹⁵⁰ The additional SFA derogation was to exclude from CR 18(2) the need to disclose commissions arising from simultaneous matching transactions: SFA r.5-35.

¹⁵¹ SIB, CP 55, December 1991.

¹⁵² The former as the exception would go against the objective of the rule, the latter because a derogation would be contrary to the EC Misleading Advertisements Directive: SIB, *Core Conduct of Business Rules: Commencement for Members of IMRO*, CP 54, August 1991.

¹⁵³ CR 39, SFA r.5-2; CR 2, SFA r.5-29.

¹⁵⁴ Defined as written communication of intended to have general and continuing effect, Core Rule Glossary.

Guidance is used in both rulebooks, but is of a different nature and used to a different extent. IMRO use guidance on roughly 55 occasions, SFA only 17.¹⁵⁵ The function of guidance in both rule books is similar. Both SROs use guidance to explain the application of a rule and indicate methods of compliance. It is also used to stipulate conditions or standards that *must* be met, limit the application of a rule and stipulate what information should be given to a customer.

Guidance is used to explain the application of a rule and on occasion clarify doubts as to the meaning of the Core Rule. Examples of the latter are found in SFA's rules, where in relation to the soft commission rule it is unclear whether the term "broker" in the rule includes market makers. A guidance to the rule indicates that it does not.¹⁵⁶ Examples of the former, explaining the application of the rule, are guidance on inducements,¹⁵⁷ soft commissions,¹⁵⁸ and the definition of market counterparty.¹⁵⁹ Guidance is used to indicate methods of compliance, ie indicate what would be considered to be reasonable grounds or reasonable steps in the case of, for example, classes of customer (matters to be taken into account),¹⁶⁰ soft commissions,¹⁶¹ compliance procedures for unsolicited calls,¹⁶² and best execution (to indicate what the regulator will have regard to).¹⁶³ IMRO's guidance frequently takes the form of recommendations: IMRO "recommends", for example, that allocation take place within 24 hours,¹⁶⁴ an independent valuation be made for non-readily realisable investments,¹⁶⁵ the frequency of periodic statements, and fair dealing and fair allocation procedures.¹⁶⁶ Guidance further provides suggestions as to

¹⁵⁵ Excluding in both cases guidance which refers to the application of transitional rules.

¹⁵⁶ SFA r.5-8.

¹⁵⁷ IMRO 1991 II-1.6.

¹⁵⁸ SFA r.5-8.

¹⁵⁹ SFA r.5-4, Guidance 1 and 2.

¹⁶⁰ SFA r.5-5, Guidance 1.

¹⁶¹ SFA r.5-8, Guidance 3-6.

¹⁶² SFA r.5-17.

¹⁶³ SFA r.5-39(4).

¹⁶⁴ IMRO 1991 II-3.9(1).

¹⁶⁵ IMRO 1991 II-3.4(2).

¹⁶⁶ IMRO 1991 II-4.5(1), II-3.11(1) and II-3.10(1), respectively.

where the information required to be disclosed can be obtained.¹⁶⁷

However, the Guidance of both rulebooks can take a more commanding tone: the IMRO Guidance to periodic disclosures stipulates that they *should* include certain information,¹⁶⁸ for example, and the contents for policy statements for soft commissions are stipulated in the guidance of both rulebooks.¹⁶⁹ Guidance is also used on occasion by IMRO to limit the application of a rule. This is so in the case of customer order priority, where IMRO provides in a guidance what own account transactions do not include, and so are not subject to the rule.¹⁷⁰

IMRO has two particular uses of guidance which it does not share with SFA. The first is to insert many provisions which used to be part of a rule into a guidance. This is so in the case of, for example, material interest,¹⁷¹ best execution,¹⁷² fair allocation,¹⁷³ and churning.¹⁷⁴ The second is the extensive use of guidance in relation to the contents of advertisements. In the case of advertisements, IMRO "recommends" that the advertisement comply with the provisions of the Advertising Code, which is roughly seven pages long. This does not appear to have the status of a rule,¹⁷⁵ although the advertising requirements of SFA are in the form of rules.

Both SROs also issue formal guidance through periodic bulletins. Formal guidance is defined as guidance which is general, written and intended to have continuing effect. The role of the bulletins is seen as drawing members' attention to a problem the regulators have discovered, or giving notice of the SROs' view on matters which may have been referred to it through enquiries or arisen in the course of the enforcement process. Informal guidance, interpretations

¹⁶⁷ IMRO 1991, II-1.5(2): cancellation rights; II-6.1(2): tied firm acting as investment manager; II-6.5(2): cold calling - explaining cancellation rights.

¹⁶⁸ IMRO 1991 II-1.7(4).

¹⁶⁹ SFA r.5-8(3); IMRO 1991 II-1.7(3).

¹⁷⁰ IMRO 1991 II-r.3.6(1).

¹⁷¹ IMRO 1991 II-3.3; taken from IMRO 1988 IV-9.02.

¹⁷² Provision as to counterparty reliability in IMRO 1988 IV-3.8 now in the guidance to IMRO 1991 II-3.8.

¹⁷³ IMRO 1991 II-3.10 is roughly the contents of IMRO 1988 IV-12.02.

¹⁷⁴ The Guidance to IMRO 1991 II-3.11 is taken from IMRO 1988 IV-8.01.

¹⁷⁵ It is referred to only in the Guidance; although the same is true for the contents of customer agreements, these are set out in tables which we are told in the definitions section have the status of rules.

given to a particular firm for example over the telephone or in the course of a monitoring visit in relation to a particular matter, are not regarded as binding by the SROs, although the common law position may differ from their conception of the position in this case. Both SFA and IMRO ensure that the guidance given is consistent by recording it on central computer systems, which are referred to whenever inquiries by members are made.

Comparing the Rule Books

SFA and IMRO have taken a notably different approach to the nature of their rule books. We have noted above the different use of guidance of the two SROs; SFA have also been content not to elaborate the Core Rules on more occasions than IMRO: SFA have left seventeen Core Rules entirely without third tier elaboration or expansion,¹⁷⁶ and have not included any third tier support for parts of eight Core Rules.¹⁷⁷ They have amended the text of the Core Rule instead of writing a third tier rule in the case of two Core Rules,¹⁷⁸ and in relation to two others have

¹⁷⁶ These are Core Rules numbers (SFA rule number shown in brackets):

- 1: inducements (5-7)
- 4: polarisation (5-19)
- 6: issue or approval of advertisements for an overseas person (5-12)
- 7: overseas business for UK private customers (5-13)
- 8: business conducted from an overseas place of business for overseas customers (5-14)
- 15: customers' rights (5-24)
- 20: customer order priority (5-37)
- 21: timely execution (5-40)
- 24: fair allocation (5-42)
- 26: churning and switching (5-43)
- 27: derivatives transactions to be on exchange (5-44)
- 28: insider dealing (5-46)
- 30: off-exchange market makers (5-45)

¹⁷⁷ It has issued no third tier for the following parts of Core Rules:

- 11(1): information about the firm (5-16)
- 13(1), (3) & (4): appointed representatives
- 18(1): unreasonable charges (5-33(1))
- 35(2): co-operation in investigation of complaints (6-3)
- 36(1),(3),(4): chinese walls
- 37(1): cessation of authorised business (2-21)
- 38(3): reliance on others - communication sent to the order of the customer (5-2(3))

¹⁷⁸ CR 9: fair and clear communications (SFA r.5-15)
CR 36(2): chinese walls (established and effective arrangement)

issued short guidance only.¹⁷⁹

The main changes in the SFA rules have been in relation to customer agreements, where model customer documentation is no longer provided either in a rule or in guidance, and the considerable simplification of the corporate finance business and customer definitions.¹⁸⁰ The overall size of the rulebook has shrunk (a phenomenon enhanced by the judicious reduction to A5 paper, also used by the Stock Exchange Yellow Book and the Code of Takeovers and Mergers): just under fifty rules have been deleted, either because of policy changes, for example in customer categorisation, or vis a vis customer agreements, or because the requirement is now covered in a broader Core Rule: for example the timing of disclosure, product bias, and volume overrides. A further twenty three rules are now mirrored in the Core Rules, and eighteen further rules have been combined into Core Rule requirements.¹⁸¹ Dealing rules are on the whole less detailed and prescriptive, for example the rules on timely execution, timing of contract notes, and the best execution rule (deletion of definitions of best execution investment and illiquid investment). Rules relating to customer documentation have been relieved by the deletion of model customer agreements from the new rules, and the non-extension of the Core Rule provision that customer agreements need only be concluded with private customers (in contrast to the IMRO provisions). Other customer documentation rules mainly repeat the requirements of the TSA 1988 rules, and the provisions as to the contents of contract notes, periodic valuations, advertisements are similar to the TSA 1988 rules.

IMRO has not expanded on the whole of five Core Rules,¹⁸² nor on parts of eight.¹⁸³

¹⁷⁹ CR 11(2): information about the firm (SFA r.5-21) and CR 22: best execution (SFA r.5-39).

¹⁸⁰ TSA r.1090; SFA r.5-1.

¹⁸¹ Figures calculated from an analysis of the changes contained in TSA Board Notice 220, 1.10.90 and further analysis of the changes between the 1990 draft and the 1991 rules.

¹⁸² These are Core Rule numbers (IMRO 1991 rule numbers in brackets):

7: advertising: overseas business for UK private customers (II-1.8(1))

8: advertising: business conducted from an overseas place of business with overseas customers (II-1.9(1))

15: customer's rights (II-2.5(1))

27: derivatives transactions to be on exchange (II-3.13(1))

28: insider dealing (II-3.14(1))

IMRO has not always followed the change of policy of SIB and SFA: for example it has not followed the policy of using best price as the principal indicator of best execution, but has included its old Commentary into the new rulebook in the form of guidance which places more emphasis on the terms of the transaction than SFA's rule.¹⁸⁴ It still requires customer documentation with both private and non-private customers, specifying in full and in rule form the expected contents. It has retained its previous format of different tiers of agreement: the full customer agreement which must be concluded with private investors, with additional contents for discretionary customers, terms of business letters and statements of protection, which replace the occasional customer agreement. Where SFA has included no further expansion of a Core Rule, IMRO has on occasion used detailed guidance, for example in the rules on customer order priority.¹⁸⁵

IMRO has also retained much of its old rule book either in the form of rules or guidance. The rules on timely allocation are taken from the old rule book,¹⁸⁶ and other rules which mirror the requirements of the 1988 Rules include dealing ahead of published research or analysis,¹⁸⁷ periodic information,¹⁸⁸ and contract notes.¹⁸⁹ Elsewhere, provisions of the 1988 Rules have been incorporated into guidance. This is the case, for example, in the rules on fair allocation,¹⁹⁰

¹⁸³ These are:

4.2: polarisation status (II-6.1(2))
4.4: polarisation: investment managers (II-6.1(2))
16.2: suitability: pooled funds (II-3.1(2))
17.1.b: standards of advice on packaged products: independent intermediaries (II-6.3(2))
17.3: independent intermediaries: best advice (II-6.3(2))
17.5: independent intermediaries not acting as investment managers (II-6.3(2))
17.6: standards of advice: PEPs (II-6.3(2))
40.3: application of Core Conduct of Business rules as to Time (I-3.2(2))

¹⁸⁴ CR 22; IMRO 1991 II-3.8; SFA r.5-39.

¹⁸⁵ CR 20; IMRO 1991 II-3.6(1); SFA r.5-37.

¹⁸⁶ IMRO 1991 II-3.9; IMRO 1988 IV-12.01.

¹⁸⁷ IMRO 1988 IV-11.04 is transposed into IMRO 1991 II-3.12.

¹⁸⁸ Contents of the table to IMRO 1991 II-4.5(5) taken largely verbatim from IMRO 1988 IV-21.03A.

¹⁸⁹ The contents of IMRO 1991 II-Appendix 4.4(1) are largely verbatim those of IMRO 1988 IV-18.07 and 18.08.

¹⁹⁰ Guidance to IMRO 1991 II-3.10.1. taken from IMRO 1988 IV-12.02.

churning,¹⁹¹ and information about the firm.¹⁹² IMRO is also more concerned to detail the meaning of broad terms than SFA: for example IMRO detail the meaning of "due despatch" in relation to sending contract notes, whereas SFA does not.¹⁹³

The natural consequence, indeed the rationale for having, different regulators for different market areas is that each may have a slightly different approach to regulation. The trade off is between tailored regulation and consistency between the rule books. Whilst some substantive differences between the SFA and IMRO rule books do not appear to be based in fundamentally different attitudes to regulation, for example the advertising rules of each, they do adopt differing attitudes concerning the level of protection different customers should be afforded. The differences between their and SIB's treatment of market counterparties and indirect customers has been discussed above. The other principal difference in their treatment of customers relates to discretionary business customers. Generally speaking the TSA/SFA rules provide more protections to discretionary non-private customers than the IMRO rules. Under the old TSA rules, a person who would normally classify as a market professional would receive the extra protections of a business customer if they were a discretionary customer, for example under the rules on suitability, risk warnings, self dealing and dual agency, the illiquid investment warnings and portfolio valuation rules. Under IMRO's rules these provisions did not apply if the customer had contracted out of the best execution duty, and the suitability rule did not apply. The use that the two SROs have made of the available derogations in their new rules is illustrative of their different approaches: IMRO has maintained the minimum requirement in CR 14.2 (two way customer agreement to private discretionary customers)¹⁹⁴ but SFA has extended the requirement to all discretionary customers.¹⁹⁵ IMRO has used the derogation in CR 16.2 to exclude non-private

¹⁹¹ The Guidance to IMRO 1991 II-3.11 is the contents of IMRO 1988 IV-8.01.

¹⁹² Guidance to IMRO 1991 II-4.2(1) contains contents of IMRO 1988 IV-16.04.

¹⁹³ IMRO 1991 II-Appendix 4.4(1), Part II; SFA r.5-34(1).

¹⁹⁴ IMRO 1991 II-2(3).

¹⁹⁵ SFA r.5-23(2).

discretionary customers from the suitability rule,¹⁹⁶ maintaining the provisions of their old rule book. SFA has not used the derogation, rather it has imposed a continuing duty of suitability on managers to ensure that the account or portfolio remains suitable. Finally, IMRO permitted non-private customers to contract out of the application of the periodic valuation rule¹⁹⁷ whereas SFA used the derogation to exclude only non-discretionary customers where the firm is acting as investment manager mainly in securities.¹⁹⁸

In comparing the nature of the rules in the two rulebooks, can it be said that SFA has moved further away from detail and prescription of "how and when" than IMRO? In the Introduction to the final consultative draft of the rules,¹⁹⁹ SFA states that "the rules have been revised with the intention of minimising the current detailed prescriptive requirements and introducing a greater element of flexibility into the regulatory structure." On the face of the rulebooks, this appears to be the case. Certainly in relation to those rules which apply to non-private customers SFA felt that the removal of the right of action from these customers gave it a much greater freedom to write rules with a less precise and more opaque structure, relying on the Principles to act a safety net to catch actions the rule might not. It is likely, however, that the general prescriptions will be rendered more specific by informal guidance, which is likely to form patterns of expected behaviour and conduct. SFA implicitly indicate this:

"Since the rules are, in general, less prescriptive than their predecessors, it will be important for members to liaise closely with SFA, especially in the early stages, on the practical implications of particular rules. SFA has put in place internal arrangements which, while not bureaucratic, are designed to ensure the maximum level of consistency in interpretations and informal guidance given by staff."²⁰⁰

Interpretations of the more general requirements are also likely to be based on the provisions of the old TSA rulebook. Precision and complexity, it would seem, are difficult aspects of rules to

¹⁹⁶ IMRO 1991 II-3.1(3).

¹⁹⁷ CR 19.2, IMRO 1991 II-4.5(2).

¹⁹⁸ SFA r.5-35(2).

¹⁹⁹ SFA Board Notice 2, Part 2 (15.4.91).

²⁰⁰ SFA Briefing 2, p.3 (SFA, March 1992).

eliminate.

Conclusion

Through an analysis of the rules of the two different rule systems and an examination of the concerns involved in drafting the Core Rules and Principles, we have seen that whilst the debates covered all four dimensions of rules: substance, status, character and structure, it was on the rule's structure that the principal policy discussion was focussed. In a similar manner to the factors which operated on the formation of the 1987 Rules,²⁰¹ the decisions on these dimensions were fundamentally influenced by the objectives that the rules sought to achieve, which in turn defined their function. The chapter also indicates how decisions on one dimension of the rule can affect another, in this case, the impact of decisions on the rule's status on its structure.²⁰²

The New Settlement provided the SROs with a welcome opportunity to re-draft their rules. Many of the initial rule books had been written by lawyers in large City firms (those of IMRO and TSA) or by ex-Parliamentary or Departmental draftsmen (SIB and Lautro) and there was a desire, felt particularly by TSA/SFA and Lautro, to re-write the rules, which staff admit was a much needed exercise. The New Settlement was not necessary for these purposes, however. The previous chapter indicated the reasons why the three tier rule structure was chosen, indicating that the drafting was already constrained by a rule pattern chosen largely for political reasons. The Principles and Core Rules defined SIB's position within the regulatory system: a lead regulator and standard setter whose rules applied across the range of investment business. The initial intention had been for them to apply also to RPBs; it was the Government's decision rather than SIB's that they did not.

The function of the rules defined their status and structure. The Principles, the regulators

²⁰¹ See Chapter 4.

²⁰² See Chapter 1.

felt, had to be free of the right of action to function as the combination of exhortations and effective rules that the regulators required. The criticisms of the initial rule books moulded the demands Walker made of the Core Rules; they had to be brief, stable and enduring. This was achieved through the use of an appendix, the Glossary, which contains the detail and complexity of the Core Rules. The aim of the Core Rules was also to harmonise the rules and establish SIB's control over the essential elements of the regulation. This objective clashed with the second, however: to give the SROs room to write their own rules. The compromise: derogations. Finally their position within the rule system and their scope meant that they had to contain the roots of the third tier rules. This re-emphasised the degree of agreement which was necessary between SIB and the SROs as to their content as each tried to ensure that the Core Rule contained what it wanted. Chapter 6 indicates the results of two such debates in the soft commissions and best execution rules.

This study of the rules also indicates how the dimensions of rules are inter-related and decisions on one may affect decisions on another.²⁰³ In the New Settlement, altering the status of provisions has affected their structure, and the flexibility which they provide.²⁰⁴ Altering the status of the Principles was felt by IMRO and SFA particularly to be a necessary precondition to their more opaque structure. Removing the right of action from non-private customers, SFA state, also affected its ability to use less prescriptive rules in relation to these customers. Altering the status of detailed rules to guidance has also given a greater degree of flexibility to the rules. The extended use of guidance in IMRO's rules is explained as addressing the trade-offs involved in rule making: "there is a tension in the desires of members - they want vague, general rules like the Principles and detest the detailed rulebooks, but they also want certainty and detailed information of what is expected of them. Guidance is an attempt to resolve this tension." Guidance indicates what type of conduct will be taken to be compliance, but removes the irritant

²⁰³ See Chapter 1.

²⁰⁴ See Chapter 2.

of prescription. However, although the status of this guidance perhaps reduces the level of *prescribed* detailed conduct, in the realities of the day to day operation of business it may be that the difference between prescribed and recommended is merely semantic. The purposive interpretation is maintained, however, as the rules of the SROs now provide that acting in conformity with the guidance must be intended to be compliance with the rule: actions which comply with the guidance but not the rule will be taken to be a breach of the rule.

In relation to the substance of the rules it is clear that the New Settlement was in part an exercise in deregulation. The reduction in the requirements for customer documentation, one of the major sources of the criticism of the 1987 Rules, is a principal example. Similarly, the refinement of the customer classifications and the limitation in the duties owed to professionals follows the criticism that the 1987 Rules were insufficiently targetted and as a result too intrusive to business between professionals, and represents a clearer demarcation between the level of protection afforded to private investors and that felt to be necessary for more sophisticated investors. Professionals are subject to a lighter degree of regulation under the Principles and Core Rules than under the 1987 Rules, in many situations being subject only to the Principles. The approach of the SIB rules is that if a person is not subject to a Core Rule he or she is subject only to the Principles. Of the 35 Core Rules which impose duties,²⁰⁵ 13 whole rules apply only to private customers,²⁰⁶ and 7 parts of rules.²⁰⁷ Eight of these rules are newly limited in their application to private investors.²⁰⁸

Instances where technical interpretations had previously risked undermining the purpose of the rule were addressed: the firm now has to "enable" the private customer to understand the risk involved in an investment,²⁰⁹ which means sending out pro forma warnings may not be

²⁰⁵ Excluding core rules 29 (stabilisation), 36 (chinese walls), 38 (reliance on others), 39 (classes of customer) and 40 (application).

²⁰⁶ Core rules 4, 6-8, 10-12, 14, 17, 18, 27, 30 and 37.

²⁰⁷ Core rules 5(4), 9(2), 15(2), 16(1)(a), 22(1), 26(1)(a) and 26(2).

²⁰⁸ Core rules 4, 7, 8, 12, 14, 15(2), 17, and 30.

²⁰⁹ CR 10.

sufficient. To address the regulators' concern that many firms were in fact excluding liabilities in their customer agreements a rule was introduced prohibiting the exclusion of duties owed under the Act or regulatory system, and in relation to private customers prohibits the exclusion of any duties to act with skill, care or diligence, or liabilities arising from so failing to act.²¹⁰

It was on the structure of the rules that the main focus of rule making was placed. Chapter 1 identified and discussed four aspects to rule structure which have been used in this chapter to analyse the rules. The Principles and Core Rules together suggest a slimmer, more focused and refined set of rules which are simpler, less precise and more opaque than the former SIB rules. The complexity and uncertainty of the initial rules arose from their cross-referencing, their negative definition of the scope of the rule and the very precise stipulation of requirements. The Core Rules and third tier rules have managed to reduce one element of this complexity by defining private customers and expressing the scope of the rule in a positive manner, and through summarising provisions and expressing them in a more succinct fashion.

The transition to a more simple system of rules is only partial, however. The use of the Glossary in the Core Rules provides a similar element of complexity as the cross-references and definitions in the previous rules. The Glossary did enable the drafter to divide the decision on the rule's substance into two stages: the conduct required and the scope of the rule, and thus to develop and manipulate sophisticated concepts with greater ease. However, the use of specialised terms which are defined in the Glossary, and of terms which have been given a different definition from their normal market usage (for example "order") adds to the complexity of the rules. The Glossary is also a different technique for dealing with a problem faced by the 1987 Rules: how to facilitate amendments. The 1987 Rules responded with a breakdown of the rules into a number of sub-sections and a complex network of cross-referencing in an attempt to render parts of the rule completely separate to facilitate their total deletion, if necessary, without altering the rest of the rule, whilst at the same time creating an interdependence between the rules which enabled a

²¹⁰ CR 15.

change in one part of the rulebook to be reflected automatically elsewhere, without requiring the draftsman to alter each rule individually. The use of the Glossary to achieve the same end in the Core Rules means that the application of, for example, the better than best rule, can be altered by a change in the Glossary definition of "extended group" rather than an alteration in the text of the rule.²¹¹ The impact has not changed however: the structure is still complex, it simply exhibits that complexity in a different form. Certain improvements have been made, however, to limit this source of complexity. The use of a common set of definitions throughout the rule books, for example, which was not the case for the old TSA and Lautro rules, is undoubtedly a welcome simplification.

More significantly, the initial rule system has been replaced by one of greater complexity. To an extent, it is immaterial to the functioning of the system as a whole whether or not the Core Rules have become simpler. The nature of the overall rule structure and the interlinking of the three tiers means that the Core Rules alone are relatively uninformative. Whereas the Principles may help a chief executive to see the moral wood for the technical trees, the Core Rules do not assist anyone in working out what the rules for investment business are in a particular area. The Core Rule may in fact be the only rule applying to a particular situation, but there is no indication from reading it alone whether it has been elaborated by the third tier or not: this is the decision of the SROs. Further, the SRO rules have become the vehicles for detailed policy changes: the entire policy review of retail regulation will be reflected in two Core Rule changes;²¹² the extensive debates on what information should be provided and when will be contained in the rules of Lautro and Fimbra, not in the Core Rules.²¹³ The Core Rules were addressed to the SROs, not those to whom they apply. The limited information which the Core Rules convey emphasises

²¹¹ CR 17(5).

²¹² An addition to CR 16 to require written reasons for the recommendation of a long term investment (as yet undefined) and an amendment to CR 12 (information on packaged products) to include PEPs. See SIB, *Retail Regulation Review: Disclosure, Polarisation and Standards of Advice*, CP 60, March 1992.

²¹³ See Chapter 7.

that their role was to control and set the core of the third tier rule books, not communicate directly to any member firm what the entirety of the regulation affecting it may be.

The layering of the rules causes certain problems, both for drafting and interpretation. The SRO drafters must fully understand all the applications, intentions and objectives of the Core Rule in order to draft third tier rules effectively. The compressed style of the Core Rules and the particular role of the Glossary defining the rules' scope and application led one drafter to comment: "there could be things in there that we don't know about yet." Further, in relation to the interpretation of the Core Rules, interpretations given by one SRO could affect how another should interpret the rule. Interviews conducted in the course of this research indicate that each SRO is generally unaware of detailed provisions in the others' rules, however.

The three tier system is complex, but it has enabled the benefits of rules to be combined within one system. Chapter 1 examined the implications of different types of rules. Detailed rules provide control and predictability, but at a loss of flexibility and a threat of legalistic interpretations. Standards inject a substantive purpose into the rule and provided flexibility, but leave more to the discretion of the rule's applier and provide less predictability. The Principles have a structure which is more towards the "standards" end of the continuum.²¹⁴ They introduce a purposive interpretation and enable flexibility in their application. They have been used in disciplinary proceedings by the SROs, either in conjunction with rule breaches or where no specific rule breach could be shown. Their presence in the rule system was a factor which enabled SFA to feel that it could be less prescriptive in its requirements, particularly in relation to non-private customers. The third tier rules, on the other hand, provide more detailed indications of the conduct required.

The system of rules also enables SIB to adopt a gradual approach to policy changes where necessary. The third tier rules can address difficulties of interpretation or application of the Core Rule. The Core Rule may not need to be amended, but if it does prove necessary either to ensure

²¹⁴ Described in Chapter 1.

that all SROs comply with the amended interpretation, or rid the third tier rules of unnecessary duplication of interpretation, then this can be done after the appropriate form of the amendment has been decided.

Although the formation of the Principles had some of these benefits in mind, albeit ill-formed and ill-articulated, the three tier system was not established primarily to achieve them. The rule system, it has been argued in this and the previous chapter, was addressed more to the definition of the functions of the regulators than to optimal rule structure and design. The structure of the rules was determined by their function within the system, which was directly related to the function of the issuing agency. The designation of the core rules and the provision of derogations together indicate the conflicting objectives of the re-formulation, indeed the tension which is fundamental in the institutional structure itself: what is the appropriate division of roles between SIB and the SROs.

The rules had a wider range of functions than either their role in defining the functions of the regulators or their role in the rule system would suggest, however. Other objectives were also sought from the rules, primarily the building of confidence and respect of the regulated in the regulatory system. The direction of this aim was essentially one part of the regulated industry, the City. Participants comment that it is no coincidence that the first third tier rules to have been written under the new system are those of SFA and IMRO. Whilst the formation of a single retail regulator has slowed the production of third tier rules for Lautro and Fimbra, it was the City regulators who were those most involved in the initial policy decisions to form a three tier rule system.²¹⁵ Most of the activities of the members of SFA and IMRO had been unregulated prior to the Act, and the culture of City regulation in other areas, banking or takeovers, had been one of influence and persuasion over prescription and coercion.²¹⁶ This regulatory culture defined the expectations of the rules, and the introduction of the three tier rule system was an attempt to

²¹⁵ See above.

²¹⁶ See Chapter 3.

match these expectations. In the words of participant: "[t]he essential issue of regulatory technique is "how can people best be influenced to act in a particular way?"".²¹⁷ It was the attempt to change both the regulators' and regulated's perceptions of the regulation which ensured that it was not the rules' substance which was the principal policy issue in the rule making process, but their structure.

²¹⁷ A.M. Whittaker, "Legal Technique in City Regulation", (1990) 43 *Current Legal Problems* 35.

Chapter 6: Forming the Soft Commission Rules

The previous two chapters have indicated the principal considerations involved in the formation of the two different rule systems, the nature of the rules comprising them and the reasons for their use. Whilst brief attention has been paid to the substance of the rules in relation to the initial rules and some particular examples in the New Settlement rule system, the chapters have focused primarily on the other dimensions of rules and their interaction. The aim of this and the following chapter is to examine more closely considerations involved in drafting individual rules to regulate particular substantive contexts.

This chapter examines the formation of the soft commission rule and its interaction with one of the principal dealing rules, the best execution rule. The chapter shows the difficulties regulators encounter in interpreting and balancing the objectives of the regulation, particularly when it is not clear which course of action will serve which objective. The chapter shows that the decision over what form of regulation to impose is therefore significantly affected by the regulator's own perceptions of the appropriate role of regulation, and the desire to protect through further regulation existing provisions which are threatened by market practices. The chapter illustrates the impact of the market area in which the rule is to operate on the rule making decision, and how the ability of regulation to affect market conditions means that rules can become tools in the competitive battles of different market operators, complicating the regulator's decision as to the substance of the rule. The formation of the soft commission rule also illustrates the impact of the institutional structure on the formation of the rules, and the affect which differences in approach between the regulators can have on the rule. The chapter explores the decisions as to the appropriate structure of the rule, and indicates how decisions on structure were affected by the aim of the rule and the decisions which had been made as to its substance. Finally, in examining the difficulties with the soft commissions rule and its relationship with the best execution rule, the chapter illustrates how this combination of factors, substantive, institutional and

the regulators' own perceptions, may result in a rule which may not in fact achieve its aim.

The nature of soft commission arrangements

Soft commissions are arrangements between fund managers and brokers whereby in return for an agreed amount of commission business from the fund manager, the broker will pay for services which the manager has received from third parties, taking the money out of the commission the broker received from the manager on each trade.¹ Soft commissions differ from traditional arrangements, in which the fund manager pays the broker a commission in return for which the broker provides a total servicing of the fund manager's accounts: execution, custodianship of the securities, and research, all of which are provided in-house, and none of which are separately priced. The two principal differences between the two types of arrangement are that, firstly, under a soft commissions (or "softing") agreement the manager and broker agree an amount of business to be given to the broker to cover the payment for services received by the manager. The broker does not provide the service, he pays for its provision by a third party. Secondly, the manager can choose and price the services he receives, simply sending the invoices to the broker to be paid. The most common services are Reuters screens (which provide on line stock price quotations), performance measurement, custodian services and independent research. Under a traditional arrangement an amount of business is not agreed, and the manager cannot choose, or price, the services he receives in return, which are provided by the broker.

Under a soft commissions agreement, the fund manager and the broker agree what the ratio of commission should be to the value of services supplied. This is termed the multiple. The broker pays for the services out of commissions and retains the balance. In 1986 the multiple was 2; it is currently 1.5, that is, for every £1.50 in commission paid the manager receives £1 in services, and some integrated houses offer multiples of 1.2. These are average figures: multiples

¹ The market context is outlined in Chapter 2.

vary with the volume of business, the markets in which transactions are being executed and the manner in which the service invoices are paid.

Soft commissions crossed the Atlantic from the US and entered the UK market whilst the old Stock Exchange minimum commission rules were operative. Unable to compete on the basis of commission levels, brokers began to compete on the basis of services that would be provided to investors and fund managers in return for business. As the volume of business declined rapidly following the stock market crash of October 1987,² brokers competed fiercely for business. Because of the advantages soft commissions offer brokers and managers (see below), brokers continued to offer them after the abolition of minimum commissions in the competition for market share, and increased the proportion of commission income used to pay for the services. In addition, some *market makers* also had arrangements with fund managers whereby managers agreed to provide an agreed volume of turnover in return for services, usually computer hardware. These were termed "soft for net" arrangements as managers would deal with the market maker on a "net" or no commission basis.

Two principal types of stockbroking firms use soft commissions agreements: specialist houses that only supply third party services, and integrated houses that use softing alongside their traditional arrangements. The extent of soft commission business was estimated to be approximately thirteen per cent of total commissions paid by the institutions in 1990, up from five per cent from the year before,³ though others put the figure at twenty per cent.⁴ Over eighty per cent of unit trust or investment companies' fund managers, nearly seventy per cent of investment advisers and forty per cent of the insurance companies used soft commissions in 1990, and

² In 1988 securities houses made a collective loss of approximately £500 million on dealings in British equities and by September 1990 daily turnover in British shares on the Stock Exchange was £630 million, a third less than the previous year and nearly half of the pre-crash levels. See the *Economist*, 8.7.89 and 27.20.90.

³ "Soft Commissions", Winter 1991, *SEQ with Quality of Markets Review*, p.27 from a survey by Greenwich Associates.

⁴ Suggestions put to SIB and cited in *Soft Commissions in the Securities Markets*, CP 29, October 1989. This is to be contrasted with the US where soft commission business is said to account for 50% of business done on the New York Stock Exchange, and the practice has extended beyond equities into bond dealing.

typically managers had softing arrangements with three brokers.⁵ The figure is still much lower than the US, where soft commission business accounts for thirty five per cent of all commission business.⁶

Regulatory concerns

Soft commissions provide both brokers and fund managers with a number of advantages. The fund manager can choose which service he or she requires and can have these paid for out of commissions without having to charge the investor directly. This enables managers to keep their fees to the client lower than if the services were paid for directly by the manager. The broker in return is assured a certain amount of business. The customer may also benefit if the services provided assist the fund manager in providing an investment service, though it is likely that all accounts will benefit, not just those in which trades are executed as part of the soft commission arrangement.

Soft commissions raise a number of concerns for regulators, however, which the regulators recognised had to be addressed in the course of the rule's formation. These relate primarily to conflicts of interest, particularly the probity of the fund manager and misuse of customer's funds, and market distortion and competition. Soft commission agreements, as we have seen, have two essential elements, an agreed amount of commission business and the provision of services chosen by the fund manager. These raise concerns that the fund manager will feel constrained to deal through the broker even when the broker is not executing the transaction at the best price, and that the fund manager will be tempted to "churn" the accounts (deal excessively) in order to generate the required commission levels. Also, they raise the issue of whether the manager is in fact receiving benefits or inducements which are paid for from commission taken out of the customer's

⁵ "Soft Commissions", *op.cit.*

⁶ *Ibid.*

account, but from which the account does not benefit, either at all, or in proportion to the amount of services generated through it. The practice thus raises the question of whether the manager is taking secret profits under fiduciary law,⁷ or whether the customer is receiving, in SIB's terms, "value for money".⁸ Alternatively, or in addition, the manager may over charge the customer by failing to deduct from the management fee services paid for out of the brokerage commissions, for which the customer is also charged. The customer thus pays twice for the same service. Further, the manager may not negotiate the lowest commission rates available, and may choose the broker not on the basis of the execution but on the nature of the ancillary services provided. One of the principal concerns is the threat posed to best execution: the manager may not have the incentive to demand best execution, and the broker may accept a worse execution to subsidise the cost of providing the services. The agreements also have the potential to distort market structure and competition as the fund manager could be effectively tied to the broker, and brokers may compete on terms other than price and execution.

The practice of "soft for net" poses even greater problems for competition and standards of conduct as fund managers are then entering agreements with market makers to provide an agreed volume of turnover in return for services. The managers deal with the market maker on a "net" or no commission basis. The issue of best execution is enhanced as the manager is accepting that market maker's prices, whereas at least when dealing through a broker the broker has the capacity to "shop around" for the best deal. In addition, there exists the danger that market makers, in the absence of commission payments, will widen their spread (the difference between their buy and sell prices) to subsidise the provision of softened services, threatening best execution further. This also has an effect on market liquidity,⁹ as the wider the spread, the greater the price movements on the sale and purchase of large blocks of shares.

⁷ See the Law Commission, *Fiduciary Duties and Regulatory Rules*, CP No. 24, (HMSO, 1992), p.121-3.

⁸ CP 29, para 10.

⁹ The ability to buy and sell large blocks without moving prices.

Soft commission agreements with brokers of integrated houses pose similar concerns. Brokers will put the deal through their market making arm, so the fund manager is effectively tied to the market maker by the actions of the broker, and the temptation exists for the market making arm to widen the spread on the deal, so that the manager gets a less advantageous price and the house's increased profit on the sale subsidises the payment of services by the firm for the manager.

The regulation

The soft commissions and best execution rules form part of the independence and conduct of dealing rules which are essentially aimed at addressing problems of conflict of interest, and the difficulties principals have in monitoring the activities of their agents.¹⁰ The independence rules require firms which have a material interest in transactions to ensure fair treatment for the customer,¹¹ and prohibit the gift, offer, solicitation or acceptance of inducements.¹² The soft commissions rule provides a safe harbour from this prohibition.¹³

Soft commissions were permitted by US regulation in 1975 when the Securities and Exchange Act 1934 was amended to allow fund managers to direct business to brokers other than the cheapest broker without breaching his fiduciary duties under certain circumstances, specifying the services which could be provided (section 28(e)). As a result, brokers could procure independent services and pay for them out of commission charges. The London Stock Exchange rules had not specified services, but had provided that they be intended to improve the ability of the recipient to make investment decisions or evaluate the performance of his or her

¹⁰ See Chapter 2.

¹¹ CR 2 and Principle 6, advisory and discretionary customers. See Chapter 5.

¹² CR 1, any customer. The independence rules also include the polarisation requirements, CR 4: see Chapter 7.

¹³ CR 3.

investments.¹⁴

The 1987 SIB Rules permitted the supply of "services and benefits the nature of which is such that their provision will improve the performance of the recipient firm in providing services to its customers".¹⁵ IMRO and TSA were not so categorical, requiring that the services must be designed to improve the fund manager's services to its customers,¹⁶ or the firm must reasonably believe that they would.¹⁷ Under SIB and IMRO rules either best execution had to be given, or disclosure had to be made containing the "specified particulars" of the arrangement and stating that the services were dependent on business being placed with the provider.¹⁸ The aim of disclosure was "to ensure that clients had sufficient information to enable them to judge whether they were getting value for money."¹⁹ Disclosure was only required by TSA's rules if the agreement operated against the best interests of the customer.

Concern about soft commissions began to be raised in mid-1988 when a group of market participants, principally the integrated houses who operated under traditional arrangements, called on SIB to examine the issue. SIB stated that it would not act unless someone indicated that the rules were being broken, or otherwise set out reasons for concern.²⁰ In late 1988 a group of full-service stockbroking firms called on SIB to ban the practice completely.²¹ They argued that in practice the rules did not require a level of disclosure sufficient to achieve SIB's objectives. Firstly, the definition of the nature of services which could be provided was too broadly defined and a wide range of interpretations as to legitimate services existed, with the result that services were being provided which were marginal to the fund manager's performance and which the

¹⁴ Stock Exchange Rules, r.310.

¹⁵ SIB 1987 r. 5.09.

¹⁶ IMRO 1988 IV-6.01.

¹⁷ TSA r.280.

¹⁸ SIB 1987 rule 5.09; IMRO 1988 IV-6.02.

¹⁹ CP 29, op.cit., para.11.

²⁰ *Economist*, 9.7.88.

²¹ *FT*, 7.3.89.

manager would not otherwise purchase. Secondly, they argued that the exceptions to the disclosure requirements were widely used and specific disclosure was rarely being made under either the IMRO or TSA rules.²²

In its February 1989 discussion paper SIB reported that most respondents felt that the rules were giving insufficient guidance, and that disclosure was "woefully inadequate".²³ These weaknesses in the rules, it was felt, were contributing to the potential for abuse. For example, broker dealers were widening their spreads on "softed" deals²⁴ so that their net revenue from the manager remained the same, some managers were closing accounts with those brokers who did not offer a softed service, and to reward brokers for the provision of soft services, some fund managers were placing the brokers' new issues in their clients' accounts.

In 1991 the soft commission rule was amended after a period of consultation and policy development which took two years (discussed below). The rule covers

"oral or written agreements under which a firm which deals in securities on an advisory basis or in the exercise of discretion receives goods or services in return for an assurance that not less than a certain amount of such business will be given to another person."²⁵

It is widely drafted and covers arrangements which were otherwise not considered by the market to be softing agreements, for example, a guarantee given for a certain amount of business in return for access to a top analyst within the integrated house, or a service such as a Reuter's screen. The Core Rule provides that the services must only be such as could reasonably be expected to assist in the provision of investment services to the manager's customer (these are defined in the third tier rules), that the broker has agreed to provide best execution, that the manager is satisfied that the fund will not suffer any comparative price disadvantage, and adequate prior and periodic disclosure is made (detailed in the third tier rules, below). It prohibits soft commission

²² SIB, *Soft Commission Arrangements in the Securities Markets: A Discussion Paper*, February 1989, para.13.

²³ *Ibid.*, para 23.

²⁴ *I.e.*, those conducted under a soft commission agreement.

²⁵ Core Conduct of Business Rules, Glossary, "soft commission agreement".

arrangements were the broker is acting as principal and "is not remunerated by spread alone."

The best execution rule, with which the soft commission rule interacts, is the central plank of the dealing rules.²⁶ A firm provides best execution if

"(a) it takes reasonable care to ascertain the price which is the best available for the customer in the relevant market at the time for the transactions of the kind and size concerned; and

(b) unless the circumstances require it to do otherwise in the interests of the customer, it deals at a price which is no less disadvantageous to him."²⁷

In the debate concerning the regulation of soft commissions, several issues were involved which raised fundamental questions about the appropriate role for regulation in a situation where regulators have the capacity to alter the competitive basis of the market. Should regulators employ structural techniques of regulation which impose a particular market structure and alter competition accordingly, or should less direct forms of regulation, such as disclosure be used? How, in other words, should the demands of investor protection and market competition be balanced? The debate also centred not just on the type of regulation but on the type of rule. The general rules of the previous rule books were being criticised as insufficient - what type of rule should replace them? Detailed rules ran the risk of not catching all the different types of arrangements that it was sought to regulate, or of being too easily avoided; however the more general requirements had been shown not to work. The next section explores the development of the debate, illustrating how these issues were raised and addressed.

Drafting the Rules

SIB made it clear that soft commissions raised regulatory issues that could not be ignored.²⁸ SIB was not prepared to rely solely on other rules of the regulatory system, best

²⁶ CR 22.

²⁷ CR 22(4).

²⁸ SIB, February 1989.

execution and the ban on churning, to provide protection for investors. Some form of regulation would be introduced, the question was what form. Following representations made to it by the traditional houses and a general feeling on the part of the regulated that the existing rules were not working, SIB decided to issue a discussion paper aimed at airing all views on the issue in February 1989.²⁹ The response was one of the greatest SIB had ever received for a consultation paper. The contents of the responses were synthesised in the following consultative paper in October 1989,³⁰ together with SIB's own views on what its own policy should be. These were developed through further consultation with the industry and the formation of a working party of board members of SIB and the SROs, whose proposals formed the subsequent consultative papers in July and November 1990³¹ and February 1991.³²

Over the course of the consultative process, SIB considered various options either alone or in combination: banning soft commissions completely, indicating what type of services could be softened, requiring more detailed disclosure, if so about what, prescribing a maximum amount of business which could be softened, setting guidance on the multiple which should be given, requiring best execution, and imposing duties for monitoring compliance not just on the regulators but the different actors in the market. Each involved a different role for the regulator and would have different affects on the level of investor protection provided, and on the market structure.

The key regulatory concerns, as noted above, were conflicts of interest, inducements, secret profits, malign competition and best execution. In addressing these concerns, SIB also realised that the regulation would affect competitive positions in the market. Soft commissions favoured smaller fund managers who could receive a large part of their overheads, particularly information services, through soft commission agreements, without having to raise their fees to clients. They

²⁹ Ibid.

³⁰ CP 29, op.cit.

³¹ SIB, *Soft Commission Arrangements in the Securities Market, Policy Statement*, July 1990; SIB, *Soft Commission Arrangements in the Securities Market: Soft for Net*, CP 46, November 1990.

³² SIB, *Soft Commission Arrangements in the Securities Market, Second Policy Statement*, February 1991.

could also select the services they needed, without having to pay for the full servicing provided by the integrated houses. As these services were often bought in from third parties, soft commission arrangements also favoured independent research firms, whose research would be bought in by the broking firm who would then provide it to the manager. The fiercest competition was between the broking houses, however. Soft commission business had been initially concentrated with three broking firms (houses) which provided only softing services. Integrated houses, concerned at the threat of loss of business to specialist houses, started to offer their own soft commission deals at very low multiples. The smaller broking houses then accused them of subsidising these arrangements from other activities of the firm, particularly market making. Decisions about how to regulate one small part of this complicated market therefore inevitably involved the regulators in what were essentially "turf fights" for competitive advantage between the different market participants, and the issue illustrates how regulatory rules can become important tools in the battle to gain market share.

The decisions about what rules to form was complicated further by the issue of whether soft commissions were entirely harmful, or whether they had the potential to offer advantages to investors and improve competition in the market place. Soft commissions did raise concerns about probity, market distortion, competition and whether clients were getting "value for money",³³ but because the services were separately priced the agreements provided price transparency, and in addition because managers could choose services from third parties, encouraged independent service providers and research and introduced competition between them. Traditional arrangements, on the other hand, provided no choice, no impetus for competition in service provision as all services were provided in-house, and no price transparency as there was no breakdown of the costs of the services for which the commission was paying. Furthermore, although under traditional arrangements there was no agreement that a certain amount of business would be sent the broker's way, there was usually an understanding that a certain amount of

³³ CP 29, para 10.

business would be generated.³⁴

These considerations shaped the substance of the rule and the type of regulation used. SIB took the view that soft commissions, properly regulated, could provide a legitimate source of services and advice, and whilst SIB recognised that it would have to address the issue of competition between integrated and specialist houses, it felt should not become involved in structuring competitive conditions in the market to the advantage of one part over the other. This led to different rules being formed in relation to soft commission and soft for net agreements. The latter, SIB felt, had no potential advantages for the investor and SIB felt that a ban, rather than distorting the market, would "restore the status quo for principal dealing".³⁵ Soft for net agreements, SIB felt, could undermine market liquidity by causing the market maker to widen his spread to accommodate softing costs.³⁶ Moreover, they threatened to prejudice compliance with other rules designed to protect the investor. If a fund manager was tied to a broker, then the broker could still use different market makers. However, if a fund manager was tied to a market maker, SIB argued, then "he is constrained in his ability to negotiate the best price, and the confrontational interface between market makers and fund managers is undermined."³⁷ Best execution, the principal dealing rule, was at too great a risk. The decision was thus made to ban the practice.³⁸

Although SIB considered structural regulation in the form of a ban on soft commissions in its first discussion paper in February 1989, it quickly rejected the idea.³⁹ A ban would favour the large integrated houses and in-house researchers, and could force the specialist houses, smaller fund managers and independent researchers out of business. Enforcement considerations also

³⁴ CP 29, para 25.

³⁵ March 1989, para 47.

³⁶ Ibid., para 46.

³⁷ March 1989, para 46.

³⁸ CP 29 and July 1990.

³⁹ CP 29. See Chapter 3 for a discussion of structural regulation, and Chapter 7 for a discussion of it in the context of the retail sector.

informed the decision: a ban would be difficult to enforce in the absence of unbundling (itemised pricing of services by integrated houses) as it would be difficult to judge whether soft commission arrangements were being entered into or not,⁴⁰ also the regulators considered that the internationalisation of the business would make it very difficult to enforce a ban imposed by one national regulator in isolation.⁴¹ Considerations of London's competitiveness also played a role: a ban could simply force business to those jurisdictions which permitted softing, for example the US.⁴² It was principally considerations of the appropriate role for regulation in the market which motivated the decision not to ban, however. SIB stated that traditional brokers were "not entitled to a particular market share in perpetuity",⁴³ that a ban would favour in-house service providers and hinder the ability of independent researchers to market their services on a commission basis, "vital for small fund managers and those competing in an international arena".⁴⁴ Moreover, although softing arrangements distorted management fee structures by not reflecting the charges of services, the lack of unbundling meant that traditional arrangements had the same effect.⁴⁵

In sum, although soft commissions could themselves distort the market by tying a manager to a broker, SIB felt that "on balance, the threat was not so great as to justify the interference in the market which would be caused by a ban, partial or total."⁴⁶ In fact, SIB did consider as an alternative that SROs could set limits on the amount of business which could be softed, a figure of 25% was suggested,⁴⁷ but this was dropped on similar grounds after opposition that it would artificially reserve a large sector of the market to traditional brokers, would discriminate against those in fixed commission markets, and against specialist houses and independent researchers.⁴⁸

⁴⁰ Ibid., para 18.

⁴¹ CP 46, para 2.

⁴² CP 29, para 21.

⁴³ Ibid., para 15.

⁴⁴ CP 46, para 2.

⁴⁵ CP 29, para 18.

⁴⁶ Ibid.

⁴⁷ CP 29, Supplementary.

⁴⁸ July 1990, paras 13-14, and see below.

A precise and "bright line" rule which set levels on the amount of permitted softened business was rejected on three further grounds: it would in fact go against the purpose of the rule as it would be interpreted as the norm and pressure could be placed on fund managers to increase their softing business to that level; it could be easily avoided as firms could do all their business on one market on a soft basis and on another on a traditional basis, again going against the purpose of the rule; and finally on the basis that it was unenforceable as it did not understand the business it was regulating. Commission was paid in advance, whereas the total amount of commission business fluctuated. It would therefore be difficult to assess what value of commission would be 25% of an undefined total.⁴⁹

Having rejected imposing structural regulation in the substance of the rule, other forms of regulation were therefore considered. SIB suggested that SROs could set guidance on the levels of multiples which should be paid.⁵⁰ However, this would effectively amount to price control, and as with the limits on business SIB was advised that it would be contrary to EC provisions. In these two decisions, the opinion of the OFT was influential. The OFT considered that the broking industry was not sufficiently responsive to the needs of investors and fund managers and wished to see greater unbundling and price transparency, and disaggregation of service provision. It therefore favoured soft commissions for the competition they provided in the market, and considered that banning them would prevent the disaggregation and unbundling which it wished to see from the traditional houses. Similarly it was opposed to a limit on the amount of business which could be softened as it would guarantee a percentage of the market to traditionals and hamper unbundling. Disclosure of the nature of soft commission business conducted was the approach which it argued regulation should adopt instead.

Proposals as to the substance of the soft commission rule therefore concentrated on the definition of the arrangements to be regulated and permitted softing services (see below), and on

⁴⁹ Ibid.

⁵⁰ CP 29, Supplementary.

disclosure provisions. Disclosure was to be one of the central planks of the proposed rule. In line with its approach in other areas, SIB stated that it saw disclosure as "a necessary and vital part of an investor protection regime",⁵¹ and stressed that the information had to be in a form that could be readily used by the client in making decisions. However, SIB also extended responsibilities to investors. Stating that the situation was "unusual" as disclosure was being made to mainly professional clients, it stressed that the duty of disclosure had to be balanced by a duty on these clients to use and monitor the information to satisfy themselves that the services were legitimate.⁵²

The initial drafts of the rule thus concentrated solely on the definition of the arrangement and permitted services, and disclosure provisions. These drafts in fact imposed a lower standard of duty than the initial SIB rules, as there was no explicit requirement for best execution. Although SIB stated in October 1989 that "best execution applies to all transactions whether carried out under soft commission arrangements or not",⁵³ it was relying on the best execution rule alone to provide this duty. There was therefore a dissonance between the policy proposals and the draft rules. The regulators' views of what conduct was required under the rule were not explicitly stated in the rule itself.⁵⁴

It was changes in market practice which caused the regulators to alter their perception of how precise the soft commission rule should be, and to state that "the rule structure is not sufficiently specific, and does not enable regulators readily to detect breaches."⁵⁵ These emerging practices resulted in a change of the focus of the rule formation process from almost an exclusive concern with disclosure to conduct requirements. Integrated houses, concerned at the competition for business coming from specialist softing houses and attracted by the guaranteed order flow

⁵¹ February 1989, para 28.

⁵² CP 29, paras 36 and 52.

⁵³ CP 29, Summary of Proposals.

⁵⁴ CP 29 and July 1990 drafts.

⁵⁵ CP 46, para 6.

which softing provided, were already beginning to offer softing services. In summer 1990, during the course of the rule formation process, one major house, S.G. Warburgs, started to offer multiples of 1.2, well below the industry average and with which the specialist houses said they could not compete. It obtained a ruling from SIB that it was not infringing the rules, as long as brokers explicitly accepted the obligation to secure best execution. The ruling was denounced by independent houses as going against the spirit of the rules.⁵⁶ Prompted by this practice and a large number of requests from fund managers and brokers for clarification, and the regulators' own concerns about the threats posed to best execution, the regulators began to consider how the draft soft commissions rule should be tightened to address this practice, and the main concerns of the rule formation process then became directed at the integrated houses.

In November 1990, SIB issued a consultative paper to consider whether the practices amounted to soft for net agreements.⁵⁷ In this issue, considerations of investor protection and regulatory interference in the market met head on. The low multiples, SIB concluded, must be being subsidised by market makers widening their spreads on the softened deals.⁵⁸ However, imposing a ban on soft commission agreements with brokers in integrated houses would be a far greater intrusion into market structures and operations than banning soft for net arrangements with market makers. It would require integrated houses to establish separate broker subsidiaries to handle all softened business. One house had already adopted this course in 1989 (Barclays de Zoete Wedd, which established Thamesway), and the SEC had just imposed such a ban in the US. However, SIB was wary of adopting such a course as it could threaten the integration between brokers and market makers which had been at the heart of the Stock Exchange's deregulation in 1986. Hence it decided that

"[w]hile not ruling out this approach in the longer term, SIB is reluctant to accept that questions concerning the fulfilment of obligations owed to investors by

⁵⁶ See reports in the *FT*, 31.7.90, 2.8.90 and 16.8.90.

⁵⁷ CP 46, op.cit.

⁵⁸ Ibid., para 7.

brokers, dealers and fund managers should be resolved by adaptation of corporate structures in response to regulatory fiat. SIB would much prefer responsibilities to be clearly agreed amongst market participants and for the core rules to *reflect* that agreement. SIB believes that in the context of an evolving UK securities market and a fund management industry of ever increasing sophistication this would be the most desirable outcome of the present debate."⁵⁹

If the market evolved into a structure of separate broker subsidiaries, that was one matter; it was not the regulators' role to require it. The role of regulation, in other words, was not to structure but to shape and influence.

The practice had thrown the issue of best execution into sharp relief. As structural regulation had been rejected as too severe, conduct regulation was considered instead. The rule was to impose three duties on fund managers: establishing with the broker that the latter had to provide best execution, making a professional judgement on the terms and conditions of the agreement to ensure that the multiple, rate and other relevant factors were consistent with best execution, and assessing their own skills and resources and the leverage which they could exert in the market place, and on the basis of this judgement determining with which type of broker they could enter into soft commission agreements:

"If [the manager] concludes that he is able to monitor and enforce compliance by a broker with the best execution obligation on a trade by trade basis, he can enter into a soft commission agreement under the proposed rule with any broker who satisfies the conditions [pertaining to best execution]. If not, he can only select a soft commission broker on the basis of the latter's demonstrating independence of action within the market place. This is unlikely to be fulfilled in circumstances where the broker deals exclusively with one market maker."⁶⁰

The aim was to achieve the same effect as a rule which effectively imposed a structural requirement prohibiting integrated houses from undertaking soft business, but through conduct requirements on managers to ensure that best execution would in fact be given. The danger at which the rule was directed was market makers widening the spread. Hence the rule focused on best execution, and on one aspect of it, price.⁶¹ The rule requires fund managers to ensure that

⁵⁹ Ibid., para 14. (Emphasis added).

⁶⁰ CP 46, para 11.

⁶¹ See below.

"the broker's terms of business and methods [of operation]... do not involve any potential for comparative price disadvantage".⁶²

This responsibility was fiercely opposed by fund managers and resisted by their regulator, IMRO. Fund managers argued that ensuring compliance with the rule would be impossible for smaller fund managers particularly, who would be incapable of assessing the business operations of a large integrated house and would be forced to deal through the specialist houses. The strictness of the obligations, they argued, favoured larger managers.⁶³ IMRO was firmly against the provision on three grounds, views which it still holds. Firstly, it was not happy with the idea that its members had to monitor SFA members and supervise their compliance with the soft commission rule. Secondly it argued that the rule is impractical, and in practice unenforceable as compliance requires the manager to investigate the internal costing structure of the integrated house, and finally it sees the provision to be unnecessary. If the broker has agreed to provide best execution, and is bound by SFA rules to do so, then IMRO members can accept that the broker will comply with the requirements and further monitoring is not necessary.

The structure of the rule

The 1987 rule had been criticised as too general, both in its policy and in its structure, and neither SIB nor the SRO rules had contained any details of permitted softing services.⁶⁴ In drafting the new rule, SIB was strongly influenced by the provisions of the US Securities and Exchange Act, section 28(e) and the Ontario Securities Commission, rule 1.9, which it included in its October 1989 discussion paper as possible models to adopt. Section 28(e) provided that research and brokerage services could be provided, indicating that this would comprise the

⁶² CR 3c.

⁶³ See below.

⁶⁴ See above.

furnishing of advice, analyses and reports and the effecting of securities transactions and performance of incidental functions. The Ontario Securities Commission rule 1.9 provided for a similar type of services, defined as "order execution" and "investment decision making", and it was this model which SIB proposed to adopt.⁶⁵

SIB was in favour of such a generic definition feeling that "it would be broad enough to embrace new product developments without amendment. It would also put the onus on the fund manager to demonstrate a positive link between the services and benefits."⁶⁶ The rule could cope with the heterogeneity of the subject matter, and a purposive approach would be injected. However, as we have seen in Chapter 1, decisions to have vague and general rules may involve a trade off with predictability, and with considerations of avoidance and regulatory time. SIB feared that such a definition would in fact be too broadly interpreted and that "any service could conceivably be covered if the fund manager were ingenious enough."⁶⁷ Moreover "SIB and the SROs might be called upon continually to provide interpretations for particular services."⁶⁸ So SIB proposed that the third tier rule structure could be used to include an exemplary list of services in the guidance of the SROs which could be updated from time to time.⁶⁹

The soft commissions rule was being drafted in parallel with the other Core Rules, and its structure changed as the role and structure of the Core Rules was formed.⁷⁰ Initially, the proposed core rule contained the type of services,⁷¹ then these were omitted and an "empty carriage" derogation inserted instead,⁷² and finally the rule stated the purpose of the rule: that the services had to be used for the provision of investment services to the customers.⁷³ The generic

⁶⁵ CP 29, para 33.

⁶⁶ CP 29, para 32.

⁶⁷ Ibid.

⁶⁸ Ibid.

⁶⁹ Ibid.

⁷⁰ See Chapter 5.

⁷¹ CP 29.

⁷² July 1990.

⁷³ CP 46 and CR 3.

definitions of the types of services are contained in the third tier rules, and the SFA rule contains guidance on particular services which are and are not permitted.⁷⁴

The initial draft rule also contained more detail on disclosure provisions than subsequent drafts. The initial proposals included provisions that the manager would state the maximum percentage of business planned for use in soft commission arrangements, and provide an annual statement listing the soft commission services used, confirming or amending the maximum percentage figure, identifying any services obtained for the benefit of a particular client, and naming any broker which received over 10% of the manager's business on a traditional basis.⁷⁵ Two of these provisions were dropped: the 10% rule was rejected as arbitrary and impractical, but the manager was still required to state the estimated breakdown of total commission, and the policy in dividing business between soft and traditional arrangements.⁷⁶ The requirement that services which benefited a particular client should be identified was dropped as impractical, and as a consequence the Law Commission has concluded that the rules do not satisfy agency law.⁷⁷

Again, in line with the emerging structure of the Core Rules the detailed provisions were moved to the third tier, and the Core Rule provides only that "adequate prior and periodic disclosure is made".⁷⁸ The IMRO and SFA rules contain disclosure provisions which are substantially the same, and provide that a firm must disclose its policy towards soft agreements at the outset of the relationship, and give periodic disclosure containing a statement detailing the percentage of total commission paid under a soft commission agreement, the summary and the value of goods and services received, a list of brokers with whom the firm has such agreements and a statement as to the firm's policy on soft commissions.⁷⁹

⁷⁴ SFA r.5-8; IMRO 1991 II r.1.7.

⁷⁵ October 1989.

⁷⁶ July 1990, para 9.

⁷⁷ Law Commission, *op.cit.*, p.123.

⁷⁸ CR 3e.

⁷⁹ IMRO 1991 II-1.7; SFA r.5-8(4) (although only the policy statement need be disclosed to beneficiaries of funds under the firm's management, and a private customer (unless a small business investor) need only receive a policy statement and estimated percentage of soft business; the other information to be made

Thus the Core Rule combines structural, conduct and disclosure requirements: it prohibits agreements where the broker is remunerated "by spread alone", it requires the broker to accept best execution and the manager to monitor the terms of the agreement and the broker's business operations for "comparative price disadvantage" and requires disclosure, which is not detailed. In line with the rest of the Core Rules the definition of "soft commission agreement" is contained in the Glossary. The Core Rule ties in with Core Rules 1 (inducements) and 2 (material interest), the Glossary definitions relating to which provide safe harbours for soft commissions from the effect of these rules. A further safe harbour is provided in paragraph 2 to the Glossary: soft commission agreements do not give rise to a conflict of interest. As we have seen in Chapter 5, this use of the Glossary to limit or extend the application of the rules is a distinctive feature of the drafting style of the Core Rules. The third tier rules are longer, in keeping with the structure of the three tier rule system, but contrary to the trends of the two rule books SFA's rule contains far more detailed guidance than IMRO's.⁸⁰

Assessment of the rules

There are a number of difficulties with the Core Rule. Firstly, the rule is addressed to the recipient of the services, the fund manager. This posed problems for SFA, as references to "the firm" in the rule could not mean the SFA member firm, which was the usual definition, but had to be interpreted to mean the fund manager, and "customer" meant not the customer of the SFA member, but of the fund manager. So in relation to CR 3b, which provides that the broker has agreed to provide best execution to the customer, SFA had to include guidance to indicate that "customer" there meant the recipient of the services, however this is confined to SFA member firms.⁸¹

available on request: SFA r.5-8(4)(c).

⁸⁰ See further below.

⁸¹ SFA r.5-8(1), Guidance 2.

The second difficulty concerns the provision that fund managers have to ensure that the terms and methods of business operations of the broker offer no potential for comparative price disadvantage, CR 3c. This provision of the rule was included to address the issue of the integrated houses, and its opaque structure and use of conduct regulation replaced the clearer and more precise, and severe, imposition of a prohibition on softened deals with these houses. The issue is whether the provision imposes duties which are enforceable. IMRO, as we have seen, is of the view that the regulation should focus on the enforcement of the best execution duty and not on requiring fund managers to exercise these judgements. Its attitude that compliance with the rule is impractical has influenced the structure of its rule: it has not provided any guidance on compliance with the provision. This is in contrast to SFA, who have adopted the policy of the consultative papers and provide that a manager will comply if it can monitor the individual transaction and is satisfied that the broker has complied with its best execution obligation, or that there is no need for the manager to disclose at the time of giving the order to the broker that the commission is to be allocated to the manager's softing account.⁸² If neither of these can be satisfied, then the firm should select a broker "on his ability to demonstrate independence of action in the market place. This is unlikely to be fulfilled in circumstances where the broker deals exclusively with one market maker."⁸³

SFA's rule thus provides guidance which both rule applier and enforcer can use in interpreting this opaque provision. The guidance tracks closely the policy statements issued prior to the formation of the rules, and so in that sense may be said to be a "better" rule as it more clearly implements the underlying policy, and the guidance aids clarification of the requirements. The regulatory and rule structure is such that the rule will in practice rarely apply, however. This is because this branch of the rule applies to fund managers, the majority of whom are regulated by IMRO and so subject to its rules. These rules, as we have noted, contain no similar provisions.

⁸² SFA r.5-8(1), Guidance 3.

⁸³ SFA r.5-8(1), Guidance 4.

So although neither rule removes the difficulties of interpreting the Core Rule provision, the majority of fund managers are not subject to the more helpful guidance of SFA's rule.⁸⁴

The third criticism which may be made of the rule is that the provision in CR 3d, which is meant to prohibit soft for net deals, is ineffective. It provides that

"A firm which deals for a customer on an advisory basis or in the exercise of discretion may not so deal through a broker pursuant to a soft commission agreement unless:....

(d) in transactions in which the broker acts as principal, he is not remunerated by spread alone;"

The rule is aimed at soft for net agreements, but also, again, at integrated houses. The provision that remuneration must not be only through the spread means that remuneration which includes commission will not be caught by the rule, however, making avoidance an easy matter. The rule is also difficult to monitor in the area at which it is in part addressed: integrated houses. The integrated house is acting in a dual capacity in such cases, receiving both commission and profits from the spread, and can so avoid the ban. Moreover, within an integrated house, the apportionment of commission and spread to a transaction is largely in the hands of the house. Integrated firms may pass business through the market making arm yet make most of the money on the spread while still satisfying the best execution requirements. Cross subsidies, which the rule aimed to prevent, are thus very difficult to detect. Requiring integrated houses to conduct all softing business through a specialist broker subsidiary would help to identify any cross subsidy, but because it considers this such a radical step, it is a course which SIB has not been willing to take.

SFA have addressed the issue and attempted to block this loophole through guidance which provides that the provision is not complied with unless the majority of the remuneration is in the form of commission.⁸⁵ Furthermore, it requires that the broker should set its multiple at a level which it can demonstrate would generate sufficient commission income from softing

⁸⁴ See below.

⁸⁵ SFA r.5-8(1), Guidance 5.

transactions to cover the cost of the services provided, dealing and settling the transaction and specialised softing administration.⁸⁶ There are still concerns, however, because of the difficulty of monitoring the apportionment of commission and spread, over whether the limit on remuneration from spreads can be monitored.⁸⁷

Soft Commission and Best Execution

The final difficulty with the soft commission rule is its relationship with the best execution obligation. The soft commission rule provides that a broker must agree to provide best execution. This imposes a requirement which is more onerous than the best execution rule itself, under which non-private customers may waive the requirement.⁸⁸ The best execution rule permits the fund manager to rely on another to provide best execution, but the soft commission rule also appears to go further in requiring fund managers to ensure that there is no potential for comparative price disadvantage.

The focus on price in the soft commission rule differs from the definition of best execution, which has two elements, price and terms. It provides that a firm must take reasonable care to ascertain the best price available on that market for transactions in the size and kind concerned, and deal at a price no less advantageous, but this requirement is waived if dealing at that price would not be in the interests of the customer.⁸⁹ The two parts to the rule reflect the two different approaches to best execution taken by SIB and IMRO on the one part, and TSA on the other. SIB and IMRO rules had followed the tenor of the CSI Draft Code by requiring that the terms of the transaction must be the best apparently available.⁹⁰ TSA's rule followed the

⁸⁶ SFA r.5-8(1) Guidance 6.

⁸⁷ See, for example, "Soft Commissions", *op.cit.*

⁸⁸ See its the amendments to CR 22 in SFA r.5-38 and IMRO II-3.8.

⁸⁹ CR 22(4). The rule does not apply to life policies or units in collective investment schemes, CR 22(5). See Chapter 7 for equivalent provisions in these cases.

⁹⁰ SIB 1987 r.5.4, IMRO 1988 IV-3. CSI Draft Code of Conduct on the Management of Conflicts of Interest, paras 7-9, printed in CSI, *Annual Report 1985*, Annex B.

Stock Exchange's draft rule, which focused on the transaction price, which could be ascertained from the price quoted by market makers on the Stock Exchange Automatic Quotation system (SEAQ) at the time of the transaction.⁹¹ The structure of the rule can be largely explained by the negotiation process which was the feature of the Core Rule drafting process, and the aims of the rules to provide harmonisation.⁹² In the words of one participant, "the best execution rule was an example where the SFA saw the issue through the eyes of their broking community and had their own corner to fight, whereas fund managers took a different view. The length of the rule is explained by this severe difference of opinion."

When the Core Rules were being drafted, such a difference of approach in one of the key rules could not continue. SFA pressed for price to be the principal determinant of best execution, and the Core Rule was amended to provide this, but IMRO, in line with its practice on other issues, continued the emphasis on terms of their 1988 rules in their third tier rules, placing the provisions of the old rule in guidance.⁹³ SFA wanted the primary focus of the best execution rule to be on price as it could then monitor compliance by comparing the prices of transactions with those prevailing on the market at the time. If the focus was on the terms of the transaction then it argues that monitoring is impeded as the inspectors have to examine the type of transaction, reliability of the counterparty and so on. Inspectors have a database of prices, and if the dealt price is worse than those quoted at the time then the firm has to justify why it dealt at the worse price, and only then does the inspector have to examine the terms. IMRO's concerns came from the management rather than the broking perspective: it was concerned that risks were posed to investors which went beyond price, and included the reliability of the counterparty and likely length of settlement, both of which can cause investors loss,⁹⁴ hence it wanted the emphasis of

⁹¹ TSA r.450. Stock Exchange, *Conflicts of Interest and their Regulation: Discussion Document*, paras 3.1 and 3.3.2, printed in 1984 *Stock Exchange Quarterly* 18.

⁹² See Chapters 4 and 5.

⁹³ IMRO 1991 II-3.8. See Chapter 5.

⁹⁴ See further J. Franks and C. Mayer, *Risk, Regulation and Investor Protection* (Oxford, 1991).

the rule to recognise that whilst price was important it was only one factor which should be taken into account. IMRO, however, did succeed in getting the provision that it could delegate its best execution duty to the broker.

There are two comments which may be made concerning the best execution rule and soft commissions. The first is that the inclusion of consideration of the terms of the transaction in the best execution provisions sits uneasily with the focus on price which is contained in the soft commissions rule. This tension between the two rules was not a consideration of the rule makers at the time of drafting however. This was because each rule was addressed at a slightly different issue, the best execution rule at providing protections for investors against brokers dealing as principal at less advantageous prices than those available generally and at providing protections against wider risks of counter-party unreliability, and this part of the soft commission rule at ensuring that integrated houses did not subsidise their softing services through widening the spread. The phrasing of the rule does not emphasise this particular focus however, and as we have seen, Core Rule 3c is viewed by IMRO as simply restating the best execution requirement. The initial drafts of the rule were in fact less explicit on this point, and required the fund manager to ensure that the terms of business offered by the broker were compatible with the satisfaction of its best execution duty.⁹⁵ Whilst the policy statements indicate clearly the aim of the rule, its implementation is only partial. This failing may in part be due to wider pressures on the drafting process. Although the soft commissions rule had been the subject of debate for nearly two years, this issue had only recently emerged. As it was an issue of importance and significance across more than one SRO it had to be addressed in the Core Rule.⁹⁶ However the rule had to fit the timetable for publication of these rules, already running behind the original schedule. This final version of the rule was therefore not put out to consultation, instead the Core Rules were published in January 1991 and a policy statement was issued in February explaining the rule.

⁹⁵ CP 46, draft core rule.

⁹⁶ See Chapter 5 on the decisions as to the substance of the Core Rules.

The second point relates to a more fundamental issue which the soft commissions debate brought into sharp relief. The soft commission rule, in addressing the problems posed by integrated houses, hinged itself on the provision of best execution. The concerns raised above relating to the difficulty of monitoring the limit on remuneration from spreads raise the question, however, of whether regulators can ever be sure that best execution is being provided in an integrated house. This was recognised by the regulators at the time, but because the implications of the suggestion were so fundamental to the whole structure of the City institutions, it was one which they chose not to address. Furthermore, not only is best execution difficult to monitor, the concept itself is difficult to define objectively. What is "best" execution for any trade of a particular size at any time is dependent on a number of factors including the liquidity of the stock and the size of the transaction. When transactions are done outside the standard sizes or in illiquid markets the "best" price is difficult to assess. Moreover, in concentrating on quoted prices for monitoring purposes, the rule is allowing execution at prices which the market would normally regard as unadvantageous. Execution is usually at prices better than those quoted on screen: one independent broker reckons that over 70% of its trade is done "inside the yellow strip", ie at better than quoted prices. Execution may thus be done at levels which are lower than those prevailing in the market, but which comply with the regulations, unless customers demand otherwise. This leaves open the possibility of the market maker making greater profits on some deals simply by executing them at the quoted price, which may then be used to subsidise other services. A rule based approach to this issue is difficult: the rule already states that the broker has to search for and ascertain the best price available, but for monitoring purposes using quoted prices as indicators is the most practical approach. Thus rules may be incapable of articulating their purpose sufficiently, and requirements for their enforcement may inhibit them further.

Conclusion

The process of forming the rules on soft commission agreements has been incremental, raising a wide range of factors and considerations with the result that the rule itself is directed at many different actors and problems. Soft commissions came onto the regulatory agenda because of concerns of widespread abuse in terms of the services being provided. The initial focus was thus on defining the legitimate services and on providing disclosure. Then changes in market practice (offering low multiples) prompted a change in concerns, this time to best execution and integrated houses. The focus of rule making then switched to this and the rule was altered to address these issues. Finally, further market developments (the increased amount of soft commission business done with integrated houses) prompted SIB to re-address the rule, this time to see if it was effective. The conclusion was that it was, and so no rule change was proposed.

In forming the substance and structure of the rule the rule makers were strongly affected by the rule's purpose, based on the perceptions the regulators had of what the rule should aim to achieve, and what means it should use. The regulatory concerns related to the potential for breaches of other rules, principally churning and best execution, whether the investor was receiving value for money, and the effect of the practices on competition. The answers to these issues were not clear cut and the objectives of market efficiency and investor protection did not provide clear guidance. Soft commissions could either improve or hinder the value investors received from the services; they could improve competitiveness through price transparency and encouraging disaggregation of services, but impede it by tying managers to brokers and encouraging brokers to compete on terms other than commission levels. Traditional arrangements were not themselves ideal: they disguised prices, and may not themselves aid the manager's performance, although the scope for abuse on this count was less than in soft commission arrangements. The potential for regulation to affect the competitive conditions in the market meant that support or criticism of soft commissions by the regulated could amount to little more than appeals to protect, or develop, their

market position. Through regulating soft commissions, the regulators have in fact provided a practice which was widely abused with legitimacy, and specialist houses state that it has been "a key factor in the development of a soft commission industry."⁹⁷

The regulators' perceptions of the appropriate role of regulation and what they felt they could require thus had a significant influence on their rule making decisions. There were certain approaches the regulators felt they could not adopt. These mainly concerned the imposition of structural and price regulation. Price regulation was quickly dropped due to its contravention of EC regulations. Structural regulation, as we have seen, was rejected in the form both of a ban on soft commissions and of limiting the amount of business which could be softed on the basis that such action by the regulator would effectively ensure one part of the market a competitive advantage over the other. This would not be the result of imposing a ban on soft for net: for these reasons, and because of the greater concerns soft for net raised, a ban was felt justified in that case.

Structural regulation was also rejected in relation to soft commission agreements with integrated houses. Here the considerations went beyond the impact of regulation on the competitive nature of the market into a more fundamental intrusion into the structure of the institutions participating in that market. The regulators had felt inhibited from requiring traditional houses to unbundle or separately price their services as it was felt this would require too great a change in customary business practices, and stated it could not be imposed in the short term.⁹⁸ Requiring integrated houses, the results of the huge re-structuring the City had undergone only a few years previously, to form separate subsidiaries for softed business SIB felt to be too fundamental a change to impose and thus an approach it could not take, at least until the rules had had time to operate.

Conduct regulation was imposed instead as a far less intrusive form of regulation. The

⁹⁷ Publications of Thamesway Ltd.

⁹⁸ July 1990, para 5.

structure of these rules is more general as the aim was to use the judgement and assessment of fund managers to achieve the rule's purpose of ensuring best execution. Conduct regulation, combined with different rule structure enabled SIB to avoid the difficulties of setting multiples, limits on business, and effectively imposing structural requirements on the market, and to avoid the implications these had for the role of the regulator. The problems of definition of limits and line drawing did not have to be addressed by the regulator or dealt with in the rule: they were delegated to the fund manager. The objectives in setting these multiples and limits would still be achieved, but the judgement would not be made in advance by the regulator, rather on an individualised basis by the fund manager. However, as we have seen, although a less intrusive form of regulation, the opacity of the rule structure may mean that the rule fails to communicate its purpose effectively.

The emphasis of the rules on the conduct of participants and the monitoring of one by the other, including the duties on trustees, follows the philosophy behind the Principles: that compliance is for each individual firm, and goes further in involving all who are party to investment agreements in monitoring others. Monitoring may be difficult, however,⁹⁹ and there are questions over whether trustees can monitor the agreements sufficiently, even if given detailed disclosure, as they may not understand the information. Although this problem is less than in other areas of the regulation, it illustrates that rules on disclosure are only as good as the comprehension the receiver has of the information given.¹⁰⁰

The problem of monitoring both by parties to the agreement, and by regulators, was also re-addressed by SIB following an increase in the amount of soft commission business being conducted by integrated houses. In December 1991 it issued a further policy statement asking managers to state how they were complying with Core Rule 3c.¹⁰¹ Managers replies included

⁹⁹ See Chapter 2.

¹⁰⁰ See further Chapter 7.

¹⁰¹ SIB, *Soft Commissions: Recent Developments*, CP 56 and Policy Statement, December 1991.

such measures as ensuring that they had a range of counterparties with whom they had agreements, calculating the amount of guaranteed business in accordance with what could be provided on best execution grounds, not using specialised softing desks in integrated houses, only concluding soft commission agreements with integrated houses with whom they have a large amount of business, and giving no prior disclosure or whether a transaction is soft or not. Although recognising that many of these measures may only be possible for larger houses, SIB, in agreement with SFA and IMRO concluded that on the basis of this that there was "insufficient evidence to justify a change in the Core Rule on the grounds of investor protection."¹⁰²

Finally the institutional structure has affected the formation of the rule. SIB was constrained in the detail it could include in the Core Rule by the overall structure which the Core Rules were required to have for wider political reasons.¹⁰³ These considerations were largely the basis on which provisions were divided between the Core Rules and third tier, rather than the wider considerations which had influenced this decision in relation to the Core Rules as a whole, which had been considerations of scope and significance.¹⁰⁴ This did provide certain drafting benefits, however, as the Core Rule could contain general statements which could be combined with detailed third tier rules. So in relation to the definition of services which could be softened a purposive statement was combined with more detailed requirements in an attempt to provide certainty whilst avoiding possibilities of "creative compliance".¹⁰⁵

However, the division of responsibility for rule drafting between SIB and the SROs meant that their differing approaches could affect whether and how the more general provisions of the Core Rule were in fact supplemented in the third tier. IMRO's reservations about the rule, particularly concerning its practicability, meant that unlike SFA it has not given any guidance on the policy behind the part of the rule which imposes monitoring duties on fund managers and has

¹⁰² SIB, Press Release, 3.4.92.

¹⁰³ See Chapters 4 and 5.

¹⁰⁴ See Chapter 5.

¹⁰⁵ See Chapter 1.

not chosen to adopt a listing of services as SFA has done. IMRO's reluctance about the rule was further indicated when it sought a derogation from the requirement to make disclosures to professional customers. This was refused by SIB on the grounds that it would be contrary to the purpose of the rule,¹⁰⁶ however SIB felt that it could not press IMRO to adopt a rule akin to SFA's due to the political requirement of "standing back".¹⁰⁷ The functional organisation of the regulators also means that whilst SFA's elaboration of the rule and duties of fund managers may be more in line with the policy documents which led up to the rule, as few fund managers are SFA members this part of SFA's rule will in fact rarely apply.

¹⁰⁶ SIB, *Core Conduct of Business Rules, Commencement for Members of IMRO*, CP 54, August 1991, para 9.

¹⁰⁷ See Chapter 5.

Chapter 7: Rule Formation in the Retail Sector

The retail sector is the area which has been the subject of the greatest number of changes in the substantive provisions of the rules of all the areas regulated under the conduct of business rules. This chapter continues the theme of the last in examining the factors and considerations which have affected rule formation in the context of substantive policy development, and will look at the formation, amendment, and further amendments of rules regulating the marketing of life assurance and unit trusts.

The market context in which the rules operate was described in Chapter 2. Three aspects of the retail market raise particular regulatory issues: the nature of products on offer; the nature of the retailing market, including its remuneration structure; and the nature of the investor. The products are of a long term nature and their quality is dependent on the future demonstration of skill and expertise by another. Products are sold through intermediaries who are remunerated by the product company on a commission basis. Consumers are largely unsophisticated and uneducated in the products they are purchasing. Which product to buy is a complex decision which the purchaser is not usually fit to make alone, and he or she therefore relies primarily on the advice of another. The combination of a complex and opaque product, an ignorant and unsophisticated consumer and a competitive market whose focus is sales and control of distribution rather than product quality is a recipe for poor quality products being sold to consumers who lack the skills and knowledge to make rational choices. The consequent regulatory concerns are imperfect market operation and a poor deal for consumers.¹

The regulators have addressed these issues using a range of regulatory techniques: structural regulation, price controls, conduct regulation and disclosure. Much of the debate has concerned the substance of the rule. However, in the formation of rules relating to the disclosure

¹ See Chapter 2.

of information about the product and particularly in relation to the suitability and best advice rules the structure of the rule has also been a consideration. Through examining rule making decisions which have been made over the course of the regulation, the chapter indicates the impact of the rule making procedure on the substance of the rules, the range of interpretations which have been given to the objectives of the regulation and the extent to which they may conflict. In exploring the four main elements of the regulation, polarisation, commission disclosure, product disclosure and suitability and best advice, the chapter illustrates the different balances which may be made between the objectives in the formation of different rules, and their evolutionary nature. Finally it discusses the different types of rules which have been used, and considers the limits of their effectiveness.

The regulation

The initial regulation was formed by the Marketing of Investments Board Organising Committee (MIBOC), which subsequently merged with SIB.² MIBOC's proposals were strongly influenced by the prevailing market practices and perceived failings of the pre-1986 regulation. The market, as we have seen, is highly competitive, but the competition centres on the distribution of products. Prior to 1986 there was no regulation of the conduct of intermediaries selling life assurance or unit trust products, nor was there any regulation of the number of companies' products an intermediary could sell. In the mid-1970s the practices of the intermediaries and salesmen had been the subject of Government attention. A consultative paper highlighted four areas of concern: the absence of rules on financial resources and handling client's money, inadequate training, the extent to which agents were controlled by the companies they worked for, and the lack of clear distinction between insurance brokers, who held themselves out as offering disinterested advice to their clients, and intermediaries who acted as agents representing one or

² See Chapter 3.

more companies.³ The introduction of the Insurance Brokers Registration Act 1977 was an attempt to address these issues and distinguish brokers and salesmen in the consumer's mind by allowing only brokers to call themselves "insurance brokers". A Government proposal to require an agent to be either tied or independent was not pursued.⁴

When Gower was conducting his regulation, the concerns which the Labour Government had felt were still alive.⁵ He rejected the individual registration of agents on the pragmatic basis that they were a large and fluctuating body which made registration extremely difficult,⁶ recommending instead that the company to which they were tied be made fully responsible for their activities, even where the salesman sold the product of another company.⁷ The IBRA 1977 had proved to be too easy to avoid (intermediaries could avoid regulation simply by not calling themselves "brokers") and he recommended that this loophole be plugged and all agents, selling insurance or not, be subject to a licensing scheme. Following the commission wars of the early 1980s and the collapse of the industry-imposed Register of Life Assurance Commissions (ROLAC),⁸ Gower also recommended that the Government intervene to control commissions of both tied agents and intermediaries, believing that the experience of voluntary agreements had shown that the interests of investors could not be protected in any other way.⁹

The regulation proposed by MIBOC comprised four main elements. First, a requirement that intermediaries sell either the products of one company or the products of all (polarisation); independent intermediaries required authorisation under the Act, but tied agents did not need

³ DoT, *Insurance Intermediaries*, Cmnd. 6715 (HMSO, 1977).

⁴ Ibid.

⁵ See L.C.B. Gower, *Review of Investor Protection: Discussion Document* (London, 1982) and *Review of Investor Protection, Report, Part I*, Cmnd. 9125 (London, 1984).

⁶ Gower, *Report Part I*, para 8.50. This had also been proposed by the Labour Government in 1977, but rejected by the trade associations on the grounds of practicability and cost: Cmnd 6715, paras 14-15.

⁷ Gower Report, para 8.35. This proposal had also been made by the Government in 1977, although they had tentatively foreseen that an agent would be permitted to sell the products of only one company. Ibid., para 15.

⁸ See Chapter 3.

⁹ Gower Report, para 8.40; see Chapter 3.

authorisation as they could be appointed representatives of product companies, who under the Act would be responsible for their actions.¹⁰ Second, polarisation would be supported by a control on the level of commissions which could be paid to independent intermediaries by the product companies, which would ensure that independent intermediaries were not tempted to recommend one company's products over another. This control of commission levels was seen as an essential part of the polarisation regime. SIB had been prohibited by the Act from introducing such controls, so an SRO would institute and monitor this maximum commissions agreement (MCA). Third, the regulation required that both tied and independent intermediaries recommended only investments which were suitable for the investor, and as a second buttress to polarisation the regulators imposed a "best advice rule": the product recommended had to be the product which would best meet the customer's needs out of either that company's range of products, or of products generally available on the market. Finally, the initial regulation provided that the investor should be given information on surrender values, charges and illustrations (the "product particulars"), although it did not provide that expenses on one type of life assurance product, with profits policies¹¹ should be disclosed.

A number of these provisions were assessed by the Director General of Fair Trading to be anti-competitive, and the Secretary of State required SIB to amend some of its provisions, notably to abolish the maximum commissions agreement and improve significantly on the disclosures made in the product particulars. A review of the rules was announced in December 1988, the results of which were implemented in January 1990. Some of these provisions were again judged to be anti-competitive by the DGFT, principally the failure to disclose information on product charges and expenses prior to sale, and failure of independent intermediaries to disclose the amount of their commission prior to sale. The Secretary of State again required SIB to revise

¹⁰ S.44.

¹¹ See Glossary of Terms.

its rules, and the Retail Regulation Review commenced in April 1991.¹² The DGFT again judged some of the provisions to be anti-competitive, notably the continuing failure to require independent intermediaries to disclose the amount of their commissions prior to sale, and the Chancellor required SIB to make provisions for this and also for tied agents to reveal the amount and nature of their remuneration.¹³ The debate so far has covered three SIB chairmen, two DGFTs, Sir Gordon Borrie, and from 1992 Sir Bryan Carsberg, and several government ministers.¹⁴

This chapter will explore the principal aspects of the retail regulation regime, examining the reasons for their introduction and amendment, and the source of the continuing differences between the financial services regulators, SIB, Lautro and Fimbra, and the Office of Fair Trading. It will take each of the four elements in turn: polarisation, commissions, disclosure and suitability and best advice, and analyse the objectives which both the financial services regulators and the OFT felt the rules should fulfil and the nature of the issues which have been involved in the debates surrounding the formation of rules in this area.

Polarisation

Polarisation is the hallmark of the regulatory regime: the structuring of the distribution networks of certain retail products, namely life assurance contracts,¹⁵ unit trusts, investment trusts and PEPs whose plan investments include these products. Described by SIB as "a regulatory fissure cutting deep across the market landscape",¹⁶ it is a form of structural regulation which requires intermediaries either to sell the products of one company, a tied agent, or to sell the

¹² SIB, *Retail Regulation: Issues for Review*, April 1991; SIB, DP 2, *Polarisation*, September 1991, SIB, DP 3, *Disclosure*, October 1991; SIB, *Disclosure, Polarisation and Standards of Advice*, CP 60, March 1992; SIB, *Disclosure and Standards of Advice*, A Policy Statement, May 1992.

¹³ July 1993.

¹⁴ Responsibility for financial services regulation was given to the Treasury in November 1992.

¹⁵ As covered by Schedule 1, para 10 of the Act.

¹⁶ DP 2, para 19.

products of all companies, an independent intermediary or financial adviser (IFA).

Polarisation was initially accompanied by the MCA, and requirements that the tied agent disclose his or her status to the investor. Initially, assuming that IFAs would want to capitalise on their independence as a marketing advantage and make their independence known at the earliest opportunity, rules on status disclosure were only made in relation to tied agents. It became clear that status disclosure was not being given by either side, however, and so SIB widened the scope of the rules and increased their precision, requiring both IFAs and tied agents to hand over a document giving their status. Termed the Buyer's Guide, it indicated what status the adviser had, and how that status was distinguished from the other type of adviser. The format and contents were specified by the regulators, and in the Retail Review the Guide was revised to enhance the distinction between the two types of seller, although allowed to be in the company's inhouse style (the Client's Guide).¹⁷ The rules on status disclosure have also been made more prescriptive by requiring disclosure of tied status on the premises of the adviser, and on advertisements for mortgages and mortgage related investments.¹⁸ These requirements have been opposed by the life offices, banks and building societies, and the regulators have been divided on the issue of the Guide. Lautro considers that advertisements and business cards should be relied upon instead of the Guide, fearing that the investor is bombarded with too many pieces of paper at the point of sale and will either not read any of them, or become confused.¹⁹ SIB, however, sees the Guide as essential to the polarisation regime.²⁰

Drafting the Rules

In all the debates concerning the rules on polarisation and their relaxation, the same considerations have been involved, but they have been weighed in a different manner in each

¹⁷ CP 60, paras 59-62.

¹⁸ CP 60, paras 56-58.

¹⁹ Lautro, CB No.11, *Disclosure*, October 1991, para 77.

²⁰ DP 3, paras 51-54.

particular issue. The concerns have been threefold: competition, consumer choice and consumer confusion. SIB has maintained that the objective of polarisation, ensuring that the investor is clear as to who is advising him or her and the range of products which the adviser can sell, should not be undermined even if this means a reduction in competition, the potential for stifling product innovation, extending the remit of the regulation beyond those products in which it is justified, and a reduction in consumer choice.

The rationale for the imposition of polarisation lies in the state of the market in the mid-1980s. The main concerns raised by the market situation were the rising commission levels and the lack of clarity over who the seller was acting for. Independent intermediaries existed, but these could in practice be selling the products of only a small number of companies. Some companies had their own direct salesforces, but the majority sold their products through agents who were tied to one company but whose contracts allowed them to sell the products of other companies in certain circumstances. The greatest confusion was caused by this "middle ground": those agents who were tied to two or three companies, but gave the impression that they were independent brokers. The forms of the "tie" varied: for example, a life office might give an interest free loan to a firm of intermediaries, on condition that the life office or group received a certain volume of business from that company. Or the life office might, on similar conditions, acquire a substantial interest in the ownership of the intermediary firm. Or the amount of commission received on an individual transaction would increase markedly with the increase in volume of total business the intermediary gave the office. Not only did these practices give rise to considerable confusion for the customer on the position and interests of the intermediary, this "quasi-independence" also raised a legal issue: under the principles of agency law the intermediary could not on the one hand claim to be acting for the customer as his/her agent, whilst on the other accepting benefits such as payment of office expenses, volume related bonuses and the like without disclosing this to the customer.

The aim of polarisation was to remove the confusion over the status of the person who

was selling the products by making the intermediary unambiguously either independent or tied. Whilst each of these examples of the middle ground could have been, and was, addressed by prohibitions on volume overrides,²¹ benefits in kind²² and differential pricing,²³ it was felt that given the character of the life assurance product "the customer has a particular need to know to whom he can turn for genuinely independent advice and on whose behalf the salesman is acting."²⁴ Conduct regulation and disclosure alone were felt to be necessary but not sufficient; the more draconian regulatory technique of imposing a particular market structure was required.

There was no necessary logic which required tied representatives to be tied to only one company. However, MIBOC decided that the "purist approach"²⁵ of single company tying should be adopted for two reasons. Firstly, against the background of an existing chaotic marketplace and with no experience of regulation or compliance departments, it was felt that single company representation was the safest way of avoiding any "halo effect".²⁶ Secondly, there was a desire to keep a balance between independents and non-independents. Independents were for the first time to be made subject to requirements of best advice and their independence was in effect to be ensured by compliance with a Maximum Commissions Agreement, which would limit their income, on pain of explicit commission disclosure.²⁷ MIBOC argued that the privilege of exemption from these requirements should go only to those who had accepted the limitation of their business of selling the products of only one company.²⁸ In forming rules which imposed a structural changes on the market, the regulators were concerned to achieve a balance between

²¹ Commission levels which are conditional on a specified amount of business being given in the future.

²² Giving services or other benefits instead of commission.

²³ Allowing some distribution outlets to sell the same product at a lower price.

²⁴ SIB and MIBOC, *Life Assurance, Unit Trusts and the Investor*, April 1986, para 7.

²⁵ SIB and MIBOC, *Life Assurance and Unit Trusts: Independent Intermediaries, Tied Agents and Company Representatives*, December 1985, para 24.

²⁶ The impression that the intermediary is authorised by the product company for all his actions, and that product company's name giving credence to the intermediary's actions.

²⁷ See below.

²⁸ December 1985, para 75.

the two market sectors.

The market has developed under the polarisation regulation in a manner which was unforeseen and unintended by the regulators, however, with the principal sources of advice and sales, the banks and building societies, tying to product companies. The main five high street banks and all but one of the top ten building societies have tied to one product company.²⁹ As these are the first places the majority of consumers go for advice and more significantly for their mortgages, which are frequently sold in combination with a life assurance product (endowment mortgages), there was, and is, a concern amongst the regulators that consumer choice was being curtailed. This prompted the review of the polarisation regime by SIB in 1991, which went beyond the requirements of the OFT and Secretary of State. SIB was concerned about the consequences of these developments for the widespread availability of independent advice and the constraints polarisation posed on the development of production / distribution relationships, and so in an issues paper asked if the rules should be altered in any respect in the light of these developments.³⁰

In the subsequent discussion paper, proposals to dilute the polarisation requirements were considered which echoed those considered by MIBOC when it was forming the initial polarisation rules. These focused on whether the division between IFAs and tied agents should be altered in two respects. Firstly, the ability of agents to tie to more than one company, multi-ties.³¹ It was suggested that the tie could take a variety of forms: the agent could be tied principally to one company but in certain circumstances sell the products of others (paramount tie), could sell different products of different companies (segmented tie) or sell all products of a range of companies (overlapping ties).³² All had been prevalent modes of business practice prior to 1985. These proposals have been rejected both in 1985 and 1991/2 on the grounds that they could

²⁹ The exception is the Bradford & Bingley Building Society.

³⁰ April 1991, para 7.

³¹ December 1985, paras 24-35, April 1986, paras 24-38; DP 2, paras 45-51.

³² DP 2, para 47.

undermine the purpose of the polarisation regime: to ensure clarity of status between types of intermediary, and that they would confuse the lines of responsibility for these agents: who would be responsible for the actions of the agent. Further, it was not clear how the intermediary could comply with the rules on standards of advice (below): how the intermediary should choose to which companies and for which products to tie, and what criteria he or she should use when advising an investor.³³

A second form of dilution, badging, has also been considered and rejected.³⁴ Badging would allow an intermediary to sell certain products of other companies to supplement the product range of the company to which it was tied. The arguments the regulators considered to be in its favour were that it would enable companies with smaller product ranges, for example specialist companies or new entrants into the market, to compete with the larger companies with full product ranges, thus increasing the competitiveness of the market and allowing companies to specialise. By 1991 a further consideration was included: badging could improve the standards of selling to consumers by improving compliance with the suitability rule.³⁵ The sale of unsuitable products, in breach of the regulatory requirements, has become one of the principal sources of criticism of the retail sector (see below). Tied agents recommend a product of their company even if it is not suitable in order to secure a sale. The argument in favour of badging was not that the suitability rule should be more rigorously observed and enforced, but that other rules could be amended to make compliance with it easier. However, both in 1986 and 1991 the proposals have been rejected, like multi-ties and badging, on the grounds that the lines of responsibility for the actions of the agent would be complex and uncertain, and the status of the seller would not be clear.³⁶

The final dilution of the polarisation rule which was considered in the Review was a limitation in its scope. SIB considered restricting the products to which polarisation applied by

³³ Ibid.

³⁴ December 1985, paras 36-45, April 1986, paras 33-38, and DP 2, paras 41-44.

³⁵ DP 2, para 42.

³⁶ July 1986, paras 35-38, CP 60, para 49.

excluding unit trust products from the rule.³⁷ This proposal was supported the unit trust industry, but not supported by the life companies who were consistent in their view that there should be no further dilution of the polarisation requirements and argued that the characteristics of products were not relevant. The rationale behind the proposals, despite the ABI's contrary view, was that it was the particular nature of life products, their complexity, opacity and illiquidity, and their commission driven distribution which gave rise to the need for such an emphasis on the status and independence of the seller. Unit trusts and investment trust savings schemes (ITSSs) do not share these product characteristics and SIB considered whether they should be treated more as equities.³⁸ It also considered the difficulties to which the definition of polarised products could lead when categorising new products, which could stifle product innovation.³⁹ However, although SIB recognised that polarisation was directed at life products and greater consumer choice could result from its limitation to these, it was swayed by the consideration that as unit trusts and ITSSs are sold alongside life products, the confusion over the status of the seller which could arise posed too great a risk to the polarisation regime. An investor would be unlikely to appreciate that an adviser who could sell the products of all unit trust companies could sell the products of only one life company.⁴⁰

Considerations of competition and consumer choice have thus been outweighed by a concern to maintain two aspects of polarisation: clear lines of responsibility between life companies and their agents, and maintaining clarity of status of the intermediary. The reason for the need to maintain this clarity lies in the nature of the products being sold, and the nature of the investor. SIB has thus placed a strong emphasis on the importance of status disclosure to supplement the structural regulation: the point of polarisation is missed, after all, if the investor does not know or understand who is advising him or her. The concern not to contaminate or

³⁷ DP 2, paras 52-4.

³⁸ Ibid., para 52.

³⁹ Ibid., para 53.

⁴⁰ CP 60, paras 45-49.

undermine polarisation by obscuring the status of the adviser has informed the debates on multi-tying, badging and status disclosure. All considerations of wider consumer choice or reducing barriers to entry into the market have been outweighed by the concern that nothing should confuse the investor as to who was advising him or her. The concern was not just that the adviser be independent or tied, but that the investor be absolutely clear what the status of the adviser was. Relaxations in the polarisation rule have been made, however, in two cases: investment managers of discretionary portfolios, and the ability of financial conglomerates to have both tied and independent companies within one group (dual status distribution). In the first case, the opportunity for confusion was felt not to arise and the exclusion for managers of investment portfolios is now in the Core Rules.⁴¹ In the second, the principle of clarity of status has been itself outweighed by another principle: the availability of independent advice.

Under the rules, financial conglomerates are permitted to comprise companies acting as tied agents and subsidiaries which act as IFAs, and maintain a "conduit" between the two so that the tied company may advise the investor to go to that IFA subsidiary. These rules were a source of dispute between SIB and Lautro when the initial rule books were being written. The provision is used principally by the banks and building societies, which have separate subsidiaries to which their branch staff can advise investors to go if the company to which the bank is tied has no suitable product. The banks and building societies strongly lobbied for and now support the provision. The life offices, members of Lautro, were not so strongly in favour, and Lautro's initial rules imposed far greater restrictions on the circumstances when customers could be referred to the independent branch. Following criticism of the DGFT that the rules were distorted and restricted competition to a significant extent,⁴² "and would tend to leave bank customers bereft of advice in a field where to act without advice is to leap in the dark,"⁴³ the Secretary of State

⁴¹ CR 4(4).

⁴² OFT, *Life Assurance and Unit Trust Regulatory Organisation*, March 1988, paras 1.12 and 4.39.

⁴³ *Ibid.*, para 1.13.

required Lautro to bring its rules in line with SIB's.

The maintenance of dual status distribution was re-considered in the Retail Review and the status disclosure provisions were tightened, requiring disclosure on the premises and on mortgage advertisements. Concern over consumer confusion, paramount in the debates on multi-ties and badging, has thus been outweighed by a greater concern for consumer choice and the availability of independent advice. Given the prominence of banks and building societies as distribution outlets for products and the frequency with which investors will go to them for advice, SIB felt that if banks and building societies could not direct customers to independent advisers then the customer would be less well served and there would be a substantial reduction in the availability of independent advice,⁴⁴ a view shared by the OFT and the Consumer's Association.⁴⁵

SIB has maintained that given the complexity of the products and the sophistication of the investment decision the consumer needs the benefit of independent advice. The belief that the independent sector is inherently beneficial to the market and to the consumer, and a consequent concern that it be at least maintained if not promoted, was dominant in the structuring of the initial regime and the limitation of the company representative to *one* product company. The threat to the integrity of independent advice posed by the dual status of financial conglomerates has been felt to be less than the reduction in independent advice which SIB and the OFT have felt would result from its prohibition. These concerns have also informed the debate on the next issue, commission regulation, but as debates on this issue shows, shared objectives do not necessarily lead to agreement on a rule's formation.

⁴⁴ DP 3, para 38.

⁴⁵ Consumers' Association response to DP2.

Regulation of Commissions

Gower's Report had been written against a background of a voluntary commissions agreement which had failed to work as companies broke away from it in the battle to gain distribution outlets.⁴⁶ He concluded that some control over the level of commissions was desirable, and that given the failures of voluntary agreements some form of statutory backing was necessary, a proposal supported by the life offices.⁴⁷ Just as it had rejected the appeals of the main life assurance trade associations for a statutory system after the failure of an industry-imposed agreement in 1982,⁴⁸ the Government rejected statutory control on the grounds that it would amount to price fixing. It explicitly prohibited SIB from making rules setting maximum amounts of commission levels, the only statutory provision on SIB's legislative powers which prohibits it from making a rule on a particular issue.⁴⁹ However, it suggested in the White Paper that commission levels of independent intermediaries could be regulated by a voluntary agreement, and companies adhering to it would simply have to state that the commission was within these limits ("soft" disclosure). Those who did not adhere would have to disclose the amount and nature of the commission to be paid ("hard" disclosure).⁵⁰

MIBOC followed the White Paper proposals, partly themselves drawn up by a group of advisers on the life assurance industry, and proposed that an agreement on commission levels be drawn up and enforced by an SRO, Lautro. Both Gower and MIBOC⁵¹ felt that mere disclosure of commission would not be a solution to the problem of commission driven sales as without information on other rates or other products, or the same products between different IFAs, the

⁴⁶ The Register of Life Offices Commissions Agreement. (ROLAC).

⁴⁷ Gower Report, Part I, op.cit., paras 8.42-3, Recommendation 46.

⁴⁸ See Chapter 3.

⁴⁹ S.48(3).

⁵⁰ DTI, *Financial Services in the United Kingdom: A New Framework for Investor Protection*, Cmnd. 9432 (HMSO, London, 1985), paras 10.10-11.

⁵¹ April 1986, para 58.

consumer could not evaluate the information. Greater restriction on the amounts of commission which could be paid were necessary. The task of setting up and monitoring the Maximum Commissions Agreement was the main reason for Lautro's existence; its members were already automatically authorised under the Act and so it was unique among the SROs in not being formed to enable firms to conduct investment business. As with the MCA's predecessor, the Agreement only applied to the commissions paid to independent intermediaries, payments to tied agents were exempt. Those companies who joined the agreement were constrained in the amount of commission which they could pay IFAs, and through the rules of their SRO, Fimbra, IFAs were obliged not to accept a greater level of commission from those companies.

In order to ensure the MCA greater longevity than its predecessors, as a bait to ensure companies adhered to it the MCA was accompanied by "soft disclosure", ie disclosure that the commission level was in accordance with levels set by Lautro.⁵² Those companies which did not join the MCA, and the IFAs selling that company's product, had to give hard disclosure, ie disclosure of the amount of commission paid, at the point of sale. Firms directly authorised by SIB therefore had to give hard disclosure. In addition, the Lautro rules required that the MCA had to apply to the whole of a financial conglomerate, not just part. So corporate groups which comprised both tied and independent subsidiaries had to apply the agreement across both IFAs and tied agents.⁵³

The MCA was seen by MIBOC as the second pillar of the polarisation regulation, the division of the distribution outlets being the first. The structural regulation, Gower felt, could only be effective if supported by price regulation to ensure that commission driven selling by IFAs did not lead to company bias (selling the products of one company on the basis of commission paid) and the return of the "middle ground". The nature of the products sold, particularly life products, and the reliance the investor placed on the adviser were again the two rationales which drove the

⁵² Parts 4 and 5 of the Lautro Rules 1988.

⁵³ Lautro Rules 1988, r.4.8(2).

rule formation process. The MCA would ensure the effectiveness of the independent pole and prevent the undermining of polarisation.

The decision to have an MCA occurred amidst a fierce debate, however, between those who saw the agreement as a means of protecting the consumer from biased advice and avoiding escalating commission costs, and those who saw it as little more than a cartel arrangement through which those companies with large market share and established reputations could protect themselves from smaller, newer companies. These companies, unable to attract the intermediaries' attention through past performance figures or well-known names, would be prevented from using higher commission levels as a way of entering the market and securing distribution. The accompanying soft disclosure was described in some quarters as "a cosy agreement between the insurance companies and the regulators."⁵⁴

The MCA followed its predecessors to an early grave, this time one dug not by the life companies but by the DGFT. In his report on Lautro in 1988 the DGFT stated that the combined effect of the MCA and soft disclosure restricted and distorted competition to a significant extent and was in danger of falling foul of EC requirements on competition and price control.⁵⁵ They should be replaced by a wide promulgation of the standard rates of commissions coupled with disclosure of the amount of commission prior to sale.⁵⁶

As a consequence of the OFT report and difficulties with EC competition law, the Secretary of State, Lord Young, advised SIB and Lautro that Lautro's recognition as an SRO should not be granted until a date was set for the removal of the MCA and soft disclosure rules. The date for the abolition of the MCA was set at 1.1.90. In December 1988 SIB produced a consultative document on what should replace the MCA. In fact it became clear that an interim regime would have to be introduced between May and December 1989 as the differences between

⁵⁴ *FT*, Leader 31.5.89.

⁵⁵ March 1988, *op.cit.*, paras 3.21-30.

⁵⁶ *Ibid*, para 3.31.

the commission levels paid to IFAs and those paid to tied agents was becoming so great that many firms were leaving the independent sector to become tied. Some reports put tied agents' commissions as much as 70% higher than MCA levels. SIB and Lautro therefore required that IFAs paid in excess of the MCA rates should disclose at the point of sale the fact that they were receiving commission, and that details of the amount would be forthcoming from the product company. These rules formed the basis for the rules introduced in December 1989, which provided that after the point of sale details of commission would be sent to the investor, expressed as a percentage of premium.⁵⁷ These were rejected by the DGFT in his report in April 1990 as restricting and distorting competition to a significant extent.⁵⁸ In its Retail Review SIB remained fast to its position that soft disclosure was adequate. The OFT again rejected the provisions,⁵⁹ and the Chancellor has now directed SIB to amend its proposals to require hard disclosure for IFAs.

The arguments of SIB and the OFT have focused on four issues. Initially the issue arose as to whether cash disclosure was technically feasible. SIB argued that it was not, the DGFT argued that it was, and that anyway this was not sufficient ground for avoiding point of sale disclosure.⁶⁰ The second argument centres on the necessity of the information. SIB argue that information on commission levels is "interesting and important rather than vital", and that if disclosed at the point of sale the investor will attach undue importance to it.⁶¹ The DGFT argues that the information is vital as it affects competition between IFAs,⁶² and should therefore be disclosed as early as possible in the sales process. He argues further that objection of undue

⁵⁷ Following consultation papers, SIB, *Life Assurance and Unit Trust Disclosure*, CP 23, *Life Assurance and Unit Trust Disclosure*, May 1989, CP 27 Parts 1 and 2, August 1989, and SIB, *Life Assurance and Unit Trust Disclosure: Outstanding Matters*, CP 30, November 1989.

⁵⁸ OFT, *Disclosure of Information about Life Insurance Products and Commissions paid to IFAs*, April 1990, paras 4.3-4.12.

⁵⁹ OFT, *The Marketing and Sale of Investment-Linked Insurance Products, The Rules of the Securities and Investments Board and the Life Assurance and Unit Trust Regulatory Organisation*, March 1993.

⁶⁰ March 1988, para 3.24, April 1990, para 4.7.

⁶¹ CP 60, para 40.

⁶² April 1990, paras 4.3 and 4.6, March 1993, para 5.22.

importance "has never been a respectable argument" as the IFA should be capable of putting the information in context.⁶³

The third argument centres around different perceptions of what the commission payment is. SIB argues that there is no reason in principle to distinguish between the disclosure of commissions for tied agents and IFAs as both are paid by the product company. IFA commission is not a price paid by the client for independent advice, but the price paid by the product company for the introduction of business to it, and reflects the value to that company of the business received rather than the value of advice given to the client.⁶⁴ The OFT agrees, but says the commission is ultimately paid for by the investor and disclosure should come from the IFA to indicate the nature of the relations between the IFA and the investor, and the IFA and the company.⁶⁵ Points about agency law have also been introduced, by SIB as an argument in favour of commission disclosure,⁶⁶ and by the OFT as an argument for hard disclosure.⁶⁷ The Law Commission has concluded that agency and fiduciary law do not require hard disclosure provided the amount of commission is normal,⁶⁸ but this conclusion has not figured in the arguments of either.

The OFT's views on this point and the next, the impact on the independent sector of hard disclosure, are largely informed by its perception of the market. Although not articulated in its previous reports, the OFT has now explicitly taken the view that the polarisation rules have created two markets, the retail market and the advice market. The IFAs compete in the advice market, and the IFAs and tied agents compete in the retail market.⁶⁹ It is worth noting at this stage that

⁶³ March 1988, para 3.26, April 1990, para 4.10.

⁶⁴ DP 3, para 43.

⁶⁵ April 1990, para 4.11, March 1993, paras 5.24-5.

⁶⁶ December 1988, para 18.

⁶⁷ March 1993, para 5.26.

⁶⁸ Law Commission, *Fiduciary Duties and Regulatory Rules: A Consultation Paper*, CP No. 124 (HMSO, London, 1992), para 3.4.20.

⁶⁹ March 1993, paras 2.4 and 5.29.

the OFT has never advocated that the remuneration of tied agents should be disclosed,⁷⁰ a point to which we will return below. SIB and Lautro argue that there is only one market: that for advice. It is this perception which has led SIB to the fourth argument, that treating IFAs and tied agent remuneration disclosure differently creates a risk of distribution bias.⁷¹ Investors would consider that advice and products from a tied agent was "free", and so buy a product through them. The OFT has argued that IFAs would be able to counter the effect disclosure might have on the investor's perceptions by indicating "the secrecy of arrangements" when buying through tied agents,⁷² a view which SIB describes as "naive".⁷³

The debate on commission disclosure thus centres on two key issues: what has regulation created, and what would be the effect of further regulation. Would automatic cash disclosure of commission without any similar disclosure by company representatives lead to the demise of the independent sector, or would it lead to a better service for the consumer in the form of lower commission levels? The FSA regulators believe that upfront commission disclosure would result in consumers being discouraged from seeking independent advice and would go to tied agents in the illusion that the advice they received there was free, leading to a significant erosion in the independent sector. The OFT believes that this is not the case. Each has commissioned its own research on the matter, but neither has been conclusive.⁷⁴ Further, whilst support of the independent sector has been the objective of both, the OFT has recently slightly amended its view, arguing, with the Consumer's Association, that the regulators should not become involved in supporting the independent sector: "the size and health of this market must depend, once the

⁷⁰ See April 1990, para 4.8 and March 1993, para 5.32.

⁷¹ DP 3, para 37, CP 60, para 43.

⁷² March 1988, para 3.29, and April 1990, para 4.10.

⁷³ CP 60, para 40.

⁷⁴ SIB, Retail Regulation Review, *Consumer Research by Taylor Nelson Financial*, March 1992, pp.30-31; OFT, *Independent Financial Advisers and the Impact of Commission Disclosure by London Economics Ltd*, October 1992. A Consumer's Association survey of 209 IFAs found only 4% would definitely go tied if commission had to be disclosed at the point of sale. The main reasons for tying were the regulatory costs involved in being independent. *FT*, 17.4.89.

conditions for proper competition are in place, on the demand for independent advice; there is no other objectively correct measure of what its size and turnover should be."⁷⁵ The issue still remains, however, of what these conditions are.

The Chancellor has also stated that tied agents should be required to disclose their remuneration.⁷⁶ This proposal has previously been consistently rejected by both SIB and the OFT. SIB has maintained that the remuneration of the tied agent is only part of the overall cost of the investment, including advertising, administration, dividends etc, and so does not require separate disclosure. Secondly, it feels that it would be almost impossible to form rules which would make sense or could not be avoided. Some tied agents may not themselves receive commission: bank and building society staff do not receive separate payments for products sold. The form of remuneration will also come not just in the form of commission but other benefits: payments of overheads, computer systems, cars and bonus payments. Calculating the proportion of these which was attributable to each sale would be very difficult, but focussing only on commission would enable the rules to be easily avoided as product companies could pay very low commissions, but give remuneration in other forms. Given these difficulties, it has argued that status disclosure should be used to clarify the tied agent's position instead.⁷⁷ The DGFT reckons that disclosure of remuneration across the board is feasible, but the costs would probably outweigh the benefits and it would be difficult to devise a means of measuring and comparing the remuneration of tied agents and IFAs.⁷⁸ He also introduced a new argument against the disclosure in its March 1993 report: hard disclosure of remuneration by all intermediaries would blur the effectiveness of status disclosure and partially recreate a single market for product distribution.⁷⁹

The remuneration structure of the intermediaries is one which both SIB and the OFT have

⁷⁵ March 1993, para 5.27.

⁷⁶ July 1993.

⁷⁷ December 1988, paras 48-50; CP 23, para 21.

⁷⁸ March 1993, paras 5.31-2.

⁷⁹ March 1993, para 5.32.

criticised at various points. The SIB chairman, Sir David Walker, criticised the practice of front-end loading, whereby the majority of commission charges are loaded onto the first few years of the policy instead of being spread evenly over it, and SIB has appointed Mr Marshall Field to enquire into the structure of remuneration and the possibilities of moving to a level commission structure.⁸⁰ The DGFT has gone further and criticised the commission structure itself in his first report on Lautro. He argued that a move to a fee-based system would clarify the dual roles of the adviser: giving advice and performing a service for the product company, would remove or reduce distortions in their advice (intermediaries ensuring that advice always leads to a purchase in order to ensure remuneration), the malign competition between product companies (competing on commission payments not product quality) and the distortions between investment products (different products have different commission levels attached to them). It would also give intermediaries an incentive to compete on the quality of their advice, rather than their sales performance.⁸¹ However, he felt at that stage that an immediate move to a fee basis would result in a considerable reduction in the availability of independent advice.⁸²

Moves to a fee based remuneration structure are trenchantly resisted by independents, tied agents and product companies. Their arguments have on the whole been accepted by the regulators. Essentially the argument is the maxim, "life assurance is not bought, it is sold", and it could not be sold if people were aware of its true cost. As life assurance is associated with morbid possibilities, ie death, it is argued, people are not inclined to take out insurance on their own initiative. It must therefore be sold to them. However, for every ten people advised, only one purchases. That purchase therefore has to subsidise the other nine situations in which no purchase was made. The maxim plays on an often unstated assumption that life assurance is socially beneficial and relieves the State from a financial burden that may otherwise fall on it in

⁸⁰ Report not completed in October 1993.

⁸¹ March 1988, paras 3.11-3.17.

⁸² Ibid., para 3.17.

the way of welfare provisions, an argument which has been recognised by previous Governments.⁸³ It is a theme which runs through part of the next aspect of the rules comprising the regulatory regime, provision of information on costs and expenses.

Product Disclosure

There were two possible approaches to the regulation of the product which the intermediary sold. The first, put forward by many insurers at the time of the FSA, was that SIB would sanction the companies, policies, agents and commissions; the investor's only decision would be to choose a policy. This was rejected, however, as too restrictive. The second was the market orientated approach: the investor was to be told everything about the product. In the political and economic climate of the 1980s, this was the only acceptable manner of government intervention: enabling a person to make his or her own choice, and letting the market operate as free as possible from restrictions. As much information as possible should therefore be disclosed to the customer.⁸⁴ The rationale for regulation was to be found in the incidences of market failure: the role of regulation was to repair these and enable the market to operate properly. The remedy: the investor was to be equipped with the tools to make "an informed decision".⁸⁵

Information provision is generally covered by Principle 5, which requires that advisory customers should be given, in a "comprehensible and timely way, any information needed to enable him to make a balanced and informed decision", and by Core Rule 9(1), which provides that information given to promote the provision of investment services should be "clear and not misleading". Debates on the rules on product disclosure have centred on two main issues, the timing of information provision, and the nature of the information that should be provided.

⁸³ Cmnd 6715, para 3.

⁸⁴ See the White Paper, para 3.2.

⁸⁵ Schedule 8, para 7.

The Timing of Disclosure

The initial rules provided for the information on surrender values, charges and illustrations (the "product particulars") to be given to the investor at the point of recommendation, or if advice was given by an IFA, immediately after, and to be provided by the product company on effecting the transaction. In December 1988, when reviewing the regime, the SIB Board accepted the arguments of the life offices and the view of Lautro that this involved too much duplication, and did not adequately recognise the extent to which detailed information on product particulars would be in the hands not of the person making the recommendation but of the life office or unit trust manager.⁸⁶ The resulting rules consequently made no provision for this information to be provided in written form at the point of sale. It would instead be sent by the product company prior to the ending of the cancellation period. The rule simply provided that the adviser should provide the investor with sufficient information to make an informed investment decision.

The reasons SIB gave were both principled and pragmatic. To require the objective of an "informed investment decision" to be achieved by the provision of specific pieces of written information was, in SIB's view, "impracticable" given the complexity of the information and the variety of selling situations, which, given the cold-calling rules, could include telephone calls. Further, SIB argued that

"a prescriptive approach by it as to how the onus on the adviser is to be discharged in each and every case would be inappropriate and less effective, in regulatory terms, than requiring the adviser to ensure that the information he provides, and the form in which he provides it, meets the needs of the particular investor with whom he is dealing."⁸⁷

Detailed rules were thus rejected on the grounds of effectiveness, and on the basis that it would represent too much prescription and control by the regulator, which SIB felt, at this time, not to be appropriate.

The DGFT stated that disclosure of expenses after the point of sale restricted and distorted

⁸⁶ December 1988, para 86.

⁸⁷ CP 23, para 12.

competition to a significant extent.⁸⁸ The purpose of the cancellation period was to enable the investor to re-consider his decision, not to compare the merits of one life assurance product with another, information on which he or she would not have in any case.⁸⁹ A subsequent DTI report concluded that the rules did not automatically provide the investor with all the information he needed at an early stage to make an informed investment decision.

The consequent retail review accepted the concern that the disclosure arrangements were "still failing to highlight the essential points and are instead contributing to "information overload"". ⁹⁰ It proposed substantial changes to both the presentation of the information and the timing of its provision, which represented a policy change on the nature of the information to be given and for greater precision in the rules. The result was that the timing of the information provision remained the same, but the rules indicated with far more precision what information was to be given. The Key Features document, which is the information given at point of sale is short, its format and the information which it is to contain are prescribed by the regulators in a pro forma document, with the aim that it must aid comprehension and product comparison by the investor, and relate only to that product being advised upon. It requires information on the nature of financial commitment, a description of benefits payable and whether guaranteed, an indication of the risks, the consequences of early surrender, an indication of charges and expenses and signposting to more detailed information to follow.

The second tier, "important information" is to contain more details on product particulars, ultimately in a client specific form. The third tier, "useful information" is to comprise full details of the total range of funds available under unit linked contract, the with profits guide and the scheme particulars in the case of a collective investment scheme: to be available to investors and others on request and signposted in the Key Features. The audience for the latter is not just the

⁸⁸ April 1990, paras 4.13-4.16, and 4.19.

⁸⁹ Ibid., para 4.16.

⁹⁰ SIB, April 1991, para 7.

ordinary investor, but those who can filter the information for that person's use: advisers, financial journalists and the regulators feel it can therefore usefully be more technical as it will be interpreted by others.

The Contents of Disclosure

MIBOC defined the broad parameters of the type of information that should be given: the nature of the product and the investment purpose (long or short term); the financial and tax implications of the investment: the investor's financial commitment, the consequences of early surrender, an indication of ultimate benefits taking into account the effect of inflation; and the charges "where identifiable". To be useful to the investor, this information had to be readily understandable, manageable in quantity, relevant and factual or based on realistic (or stated) assumptions and given before the investor made his or her investment decision, with a "sharply focused summary" being provided before the end of the cancellation period.⁹¹

The issue of what information should be disclosed has been one of the more technical, and debate has occurred at a very detailed level. The rules in this area are again precise, for two reasons. Firstly, the debates have involved such technical matters as the costing structures of different types of policies and become embroiled in actuarial debates over the most accurate method of reflecting these complicated structures. Secondly, there has been a very strong concern on the part of the regulators, particularly SIB, that the disclosures required should not be capable of being manipulated by the product companies for their own ends. This has resulted in detailed rules which prescribe the basis for calculations and a strong aversion on the part of SIB to using illustrations of future benefits to indicate either the effect of charges or long term surrender values. The regulation has again been directed principally at life products, and has focused on three issues: illustrations of future benefits, surrender values and product costs. These will be discussed in turn, examining the course and nature of the rule changes and the debates surrounding them.

⁹¹ April 1986, paras 42-52.

Illustrations

The principle concern in the issue of allowing companies to give illustrations of future benefits is the balancing between a need to indicate to the consumer the nature of his/her ultimate return on the investment, and the danger that as these figures are purely conjectural they will be falsely inflated by companies which will use them as a basis of competition between products. This is a very real danger, and one of the problems of the pre-FSA (and to an extent post-FSA) era was the extreme use of projections for competitive purposes.

MIBOC and SIB have shared the same concerns over the use of illustrations. These are that projections are of a subjective and conjectural nature which makes it "inappropriate" for them to be used as a basis for selection between product companies.⁹² Further, they may easily be manipulated, with companies competing for business on the basis of escalating and unrealistic projections of future performance, projections which may be taken by the investor to be actual statements of how much he or she will receive. However, despite these dangers, both SIB and MIBOC felt that the investor should have some indication of further prospects and so projections should not be prohibited.⁹³ Moreover as salesmen or IFAs will give them regardless, it is thought better to control them than leave them to the "back of the envelope" calculations of the seller.

The solution which was arrived at was to permit illustrations but to prescribe the basis of their calculation, requiring them to be given on the basis of two prescribed rates of investment return, and be accompanied by an indication of the effect of inflation.⁹⁴ The costs of the product are deducted from the illustration, but these are also prescribed by the regulators. The subsequent debate has been whether these costs should be those of the office, particularly now the company is required to disclose these in the same document (see below). Although SIB stated in its discussion paper that it favoured moving to an "own charges" basis, in the final consultative paper

⁹² SIB CP 30 and 60.

⁹³ April 1986, para 51.

⁹⁴ July 1986, paras 6-21.

it rejected this idea, again arguing that the charges are too open to manipulation, would be misleading as they represent current not future costs and create an impression that current differences would determine future performance, and that undue weight could be put on them by the investor in making the decision.⁹⁵

The OFT for the first time ruled this basis of calculation to be anti-competitive in March 1993.⁹⁶ It shares SIB's concern at the marketing use companies may make of illustrations, which it feels is a justification for illustrations being on the basis of standardised assumptions. However, with Fimbra, the DGFT is opposed to using standardised charges. He stated that they prevent the investor from assessing the effects of the life office's level of costs, and competition between firms will then be limited to premiums. Companies with low premiums would be at a competitive advantage, but could simply raise their charges. Further, charges rarely change significantly over the life of a policy, particularly due to the practice of front end loading. Finally, the combination of own charges for expenses and standard charges for illustrations could be confusing. In a theme common to the debates on disclosure, the objective is shared: that the investor should receive as much information as he or she needs to make an informed decision. The dispute concerns what information the investor can understand, and what information would be misinterpreted or would otherwise mislead.

Surrender Values

The charging structure of most products is such that the majority of charges are taken out of the first few years' premiums, a practice known as "front end loading". The consequence is that if the policy is surrendered in the first few years the investor is likely to receive less than he or she has paid in premiums. Disclosure of surrender values has always been required under the regulation, but it has not always been clear. The Retail Review, in this as in other aspects of the

⁹⁵ CP 60, para 39.

⁹⁶ March 1993, paras 4.31-4.43.

Key Features document, used consumer research to inform policy on disclosure. This led the regulators to emphasise that withdrawal even after 5 years could be disadvantageous and SIB's proposed rules provide that surrender values should be shown for the first five years of the policy, but no longer.

These rules have not received the approval of the new DGFT, who stated that preventing disclosures of surrender values in the later years of a policy masks the differences which may exist between policies and so limit the investor's ability to make an informed decision. He concluded that the rules were likely to restrict and distort competition to a significant extent.⁹⁷ In addition, a report commissioned by SIB recommended that surrender values should be given for the full term of the policy.⁹⁸ However, these proposals clash with SIB's policy on illustrations. A requirement to have surrender values shown to the end of the policy would institutionalise the provision of illustrations in a manner of which SIB is not favour, as it feels it would place too much emphasis on conjectural amounts which should not be used for competition, and which the investor may take to be guaranteed sums and use them to base his or her investment decision.

Product Costs

The disclosure of costs arising from the management and other expenses incurred during the life of the investment is the last issue which we will look at, and that which has been one of the greatest areas of controversy. The issue is highly technical, and as the nature of the products varies, it is also very complex. The debate, again, centres around life products. Most life assurance products fall into one of three types: without profits, with profits and unit linked.⁹⁹ The charging structure of each varies. Briefly, the charges on unit-linked products are separately

⁹⁷ OFT, *The Marketing and Sale of Investment Linked Insurance Products: The Rules of the Securities and Investments Board and the Life Assurance and Unit Trust Regulatory Organisation*, March 1993, paras 4.25-4.27.

⁹⁸ T. Miller, *Curbing the Sale of Unsuitable Products, A Report to the SIB*, SIB, May 1993.

⁹⁹ See Glossary of Terms.

identifiable to each policy holder, and by reducing the amount of money invested will affect the ultimate return. In relation to without profits policies, the return is fixed, so the amount of charges or expenses will not surprise the investor by reducing the amount he or she expects to receive. Disclosure of charges on the latter policies has therefore never been required. In the case of with profits policies, which are the majority of policies sold, the life office pays a fixed benefit, plus a share of profits which is at the discretion of the office. Expenses are not allocated to a particular policy. All premiums received on without profits as well as with profits policies, together with investment income, realised capital gains and other income are pooled in the company's life assurance fund, from which expenses and claims are met; expenses relating to a particular policy are not deducted from that policy's premiums.

The debate on disclosure was initially whether disclosure should be given, to which the initial regulatory answer was no, and subsequently how disclosure should be made: how should the effect of charges and expenses on with profits policies in particular be shown. MIBOC did not require disclosure for three reasons: that it was technically infeasible, the information could not be given accurately and consistently and so should not be given at all as simplifications would be misleading, that the information would not be understood and anyway was unnecessary,¹⁰⁰ and finally because it did not consider that it would be "appropriate" for it to seek to impose "a detailed system of classification and allocation of expenses that would be necessary to produce the required result."¹⁰¹ Detailed rules were again in this early period rejected on the grounds that it was technically impossible to draft them, and they represented an inappropriate role for the regulators.

This failure to provide for disclosure of expenses on life policies was strongly criticised in Parliament, and followed assurances from the Minister for Corporate and Consumer Affairs that

¹⁰⁰ SIB and MIBOC, *Product Disclosure: Illustrations, Surrender Values and Past Performance*, July 1986, paras 21-26, and *Life Assurance Companies, Disclosure of Expenses and Charges*, December 1986.

¹⁰¹ *Ibid.*, para 26.

a policy statement would be sought on the issue.¹⁰² The failure to make rules requiring disclosure of costs rules was also criticised by the DGFT. He considered that the failure to disclose "muted" competition¹⁰³ but to an extent which it was difficult to assess: the matter would be kept under review.¹⁰⁴

Following this pressure, SIB appointed the accountants Peat Marwick McLintock to examine methods by which charges and expenses could be disclosed.¹⁰⁵ The point in issue since then has been not whether these should be disclosed, but how they should be disclosed. The debate has been between giving information which is accurate and comprehensive, and giving information which the investor can understand. The method of disclosure recommended by PMM and supported by the life offices is reduction in yield (RIY), the percentage amount by which the ultimate benefits would be reduced by the charges and expenses. SIB initially rejected RIY as it felt it would not be understood by investors, and that investors in fact wanted to know how much of their money was being invested. It therefore favoured an alternative method of disclosure, reduction in premium. Despite its initial misgivings, however, SIB was swayed by the life offices' and actuaries' arguments that RIY disclosure was more accurate, emphasised the long term nature of the investment, enabled greater comparison between life assurance and competing products (bank and building society accounts) and that the short term impact of charges was shown in the disclosure of surrender values.¹⁰⁶

The disclosure of expenses for with-profits policies caused the greatest technical difficulty. PMM recommended disclosure on a specimen/standard basis across the industry. SIB rejected this on the grounds that comparisons with unit-linked policies would be difficult, but a year later had still not arrived at a firm conclusion as to what form the disclosure should take, and so had

¹⁰² See Chapter 3.

¹⁰³ March 1987, para 3.27.

¹⁰⁴ Ibid., para 5.11.

¹⁰⁵ May 1987.

¹⁰⁶ CP 23, paras 42-44.

included standardised disclosures as a temporary provision.¹⁰⁷ SIB established a further advisory committee of representatives from SIB, Lautro, Fimbra, the ABI, actuaries and the Consumer's Association which was asked to look at practicable and cost effective ways of identifying expenses. Their arguments reveal a concern for cost effectiveness, but also a strong concern that the information should be accurate, should not mislead or display a "spurious sense of accuracy", and should not be open to manipulation by companies.¹⁰⁸ They recommended that the company should state the effect of expense assumptions as a percentage reduction in yield, and that the company should disclose quoted and actual expense rates in the company booklet to build up a picture over several years, and introduce some discipline into companies' estimates in the early years.¹⁰⁹ RIY disclosure was introduced in 1990.¹¹⁰

The DGFT criticised RIY disclosure for charges and expenses as anti-competitive on the grounds that although a "most useful" form of disclosure it would not be meaningful to the investor. Further, as disclosure of costs was made in terms of reduction in yield and IFA's commission disclosure as reduction in premium, the two could not be compared and IFAs could not put their commission in the context of overall expenses.¹¹¹ He also criticised the fact that the cost of the risk and investment elements were not distinguished, so preventing comparison with other investment products, but would keep this under review.¹¹²

SIB and Lautro decided to commission consumer research on the issue to discover what the consumer could and could not understand. This found that there was a relatively low awareness of the cost of fund management and confirmed that RIY was ill-understood by a large majority.¹¹³ Some interpreted the figures to be the amount that would actually be paid to them,

¹⁰⁷ CP 23, May 1989.

¹⁰⁸ See the summary of the report in CP 27.

¹⁰⁹ CP 27.

¹¹⁰ Financial Services (Conduct of Business) Rules 1990, Part 5, Appendix.

¹¹¹ April 1990, para 4.17.

¹¹² Ibid., para 4.15.

¹¹³ SIB, *Consumer Research by Taylor Nelson Financial*, Jan 1992, May 1992.

many misinterpreted the figures as indicating that a ten year policy was cheaper than a twenty five year one. These findings are supported by a 1990 Gallup survey which found that consumers could not understand the absolute figures, nor the significance of what appeared to be small differences between them. The survey found that 65% of consumers thought a 2% RIY sounded "reasonable" to "very low".¹¹⁴ However, on a £1,000 annual premium on a 25 year term pension plan, a 2% RIY reduces the value of the fund by over £26 in every £100 otherwise payable. A 1% difference in RIY can affect the final payment on such a policy by over £12 in every £100 otherwise payable. RIY statistics can thus in practice disguise to the investor the effect of different levels of charges and expenses over the period of compound growth.

In the Retail Review both SIB and Lautro felt that RIY had sufficient technical merit to support its retention but felt that it needed a supplement in order for it to be understood by the investor, although they differed over what they thought this should be.¹¹⁵ Both were in favour of reduction in maturity proceeds, but SIB preferred the disclosure to state that costs would lead to a reduction of £*n* in every £100 otherwise payable; Lautro preferred disclosure of costs over the full term of the policy based on projected cash values. The disclosures would be product and client specific, but based on a standard assumed investment return. SIB was against using projected cash values and reductions as although consumer research had found this to be a highly attractive method of presentation,¹¹⁶ it felt the investor would take the conjectural figures as guarantees of what would be paid, that further statements as to the effect of inflation would be necessary, and that it would magnify small differences in assumptions.¹¹⁷ In the end SIB decided to supplement RIY with a reduction in premium in cash terms, a proposal which has been approved by the DGFT.¹¹⁸

¹¹⁴ Business Performance Group, *Disclosure in the Retail Financial Products Market*, (LSE, 1991), p.13.

¹¹⁵ See Lautro, CB 11.

¹¹⁶ CP 60, para 28.

¹¹⁷ DP 3, paras 22-23 and CP 60 paras 21-33.

¹¹⁸ March 1993, para 4.20-22.

The Debates

The arguments over the form of disclosure have been highly technical, which has posed SIB, and consumer representatives, with a great deal of difficulty. As with every other area of the regulation the majority of respondents to its consultations are the market participants, here the life companies and their actuaries, and it has been an area where the consumer bodies, lacking the technical expertise, have been at a disadvantage as a detailed knowledge of the area is required before they can effectively participate in the process. The regulators are also faced with the problem of how to evaluate responses which may, or may not, be simply industry lobbying.

The arguments of the life offices have been that only accurate information should be given, otherwise the investor will be misled. The concern of the life offices for technical accuracy is illustrated in one respondent's reply to the retail review:

The use of cash expressions (14p in the £ in the SIB example) will lead some investors to believe that this represents actual cash deductions to meet expenses. They are most unlikely to understand that the figure is derived from accumulating premiums at interest net of expenses or charges to a projected date and comparing the result with the corresponding accumulation, totally hypothetical, without expenses or charges.

The concern for accuracy dominated the early phases of the regulation. MIBOC, as we have seen, saw the lack of methodology to calculate expenses and the complexities involved in giving accurate information as reason not to provide disclosure at all. SIB, though pressured by the OFT to require some form of disclosure, were persuaded by this view which informed their decision to have RIY without a further disclosure explaining this figure to the investor. Reliance instead was to be on journalists and financial advisers using the with-profits guide to inform the investor about the product.

In the debates in the Retail Review, the life offices criticised different proposals on the grounds that they were misleading as they did not accurately portray how costs arose or were charged. For example, reduction in maturity proceeds was criticised as it made it appear as if deductions were only made at maturity; reduction in premium on the grounds that expenses are not deducted from the premiums before investment but from the pooled life fund, and it did not

reflect the changing incidence of costs over the term of the policy¹¹⁹ and would give an illusion of accuracy by setting premiums which are known against expenses which are not. They were also concerned that some methods of disclosure would be suitable for some types of products, not others. For example, reduction in benefit (effect of charges and expenses is to reduce benefit by np in £) was felt to be satisfactory for investment contracts but not term assurance life cover contracts where the cover was shown with mortality risk and the amount is guaranteed at the end. Reduction in premium was not suitable for the long term nature of the investment, as it gave no indication of the effect on eventual benefits and was not suitable for lump sum investments.

Underlying these arguments is the industry's concern that their products should not be disadvantaged against their competitors whose products are not covered by the Act and who do not have to reveal their charges. This has been explicitly stated by the industry, and also informs many of their arguments against alternative proposals. Reduction in maturity proceeds was criticised on the grounds, for example, that it would place life assurance at a competitive disadvantage *vis a vis* other savings media. Life companies feel that regulatory requirements impose unfair restrictions on them, disabling them from competing effectively with savings accounts of banks and Building Societies. There is a feeling in the industry that life policies, particularly endowment policies, are victims of a bad press, and that the information which the offices have to provide the investor places the stress too much on the expenses and not on the benefits of policies. Anything which discloses expenses in too harsh a light have been openly resisted. Interviews conducted by one research body found that life office professionals "expressed concern that seeing the actual effect of current charges will put off investors from purchasing a product altogether."¹²⁰

This is an area where the force of the industry's arguments has been increasingly resisted by the regulators. SIB and Lautro worked closely particularly on this area of the Retail Review,

¹¹⁹ ABI responses the Retail Review 1990-91.

¹²⁰ Business Performance Group, *op.cit.*, p.15.

and SIB has increasingly stated that salesmen will undoubtedly redress any perceived imbalance between life policies and other products, and that the fact that other savings media do not have to disclose charges is no reason why SIB should not require it of those which fall under its jurisdiction.¹²¹ This is a contrast to the initial MIBOC position, and SIB's own position in the first year of regulation. Although the influence of the product companies remains strong, SIB has become more aware of the consumers' needs in this area. This change in stance is partly a result of increasing knowledge of the area and of consumer's knowledge, and is also attributed by some participants partly to a change in senior executives at SIB. The continuous revision of policy decisions has been a direct result, however, of assessments of the provisions by the OFT as anti-competitive and requests from the Secretary of State to review the rules. Whilst the last review went far wider than was necessary merely to respond to the Secretary of State's requests, the impetus for the continual rule making has come from this source.

Suitability and Best Advice

The final area of retail policy which the chapter will consider is the suitability and best advice rules. The issue here has not been what the rule should require, but whether it should be restructured to make its meaning clearer in an attempt to improve compliance.

All investment advisers are under a duty not to make a recommendation to a private customer¹²² unless the recommendation is suitable for him or her, having regard to the facts disclosed by the customer and others of which the firm is, or should reasonably be, aware.¹²³ Under Principle 4 a firm is under a duty to seek any information from its advisory or discretionary customers about their circumstances and objectives "which might reasonably be expected to be relevant in enabling it to fulfil its responsibilities to them." Intermediaries advising on polarised

¹²¹ CP 60, para 22.

¹²² And discretionary portfolio managers in relation to all customers (SIB and SFA) or private customers (IMRO). SIB CR 16.

¹²³ CR 16.1.

products are also under further rules governing the standard of advice which must be given. The "best advice" rule is an application to the retail sector of the best execution principle.¹²⁴ It requires the intermediary to inform itself on the products which it can sell (tied agent) or are generally available on the market "and on which it can advise" (IFA), and not to sell a product if there is another generally available product which would better meet the customer's needs.¹²⁵ IFAs which are part of a financial conglomerate which also markets its own products are under a more stringent requirement: they must not recommend one of the products of the group if there is another product on the market which would meet the investor's needs as well as the group's product. This rule makes it virtually impossible for the IFA to sell a group product, and this "better than best" requirement was assessed to be anti-competitive by the DGFT when he reviewed SIB's rules.¹²⁶ However, the Secretary of State did not require any changes in the rules and although the Review included proposals to drop the requirement, SIB feared that subsidiaries may come under too great a degree of pressure to recommend the products of group companies and the requirement remains,¹²⁷ despite objections by the bank and building society trade associations.¹²⁸

SIB has stressed the importance of the suitability rule, describing it as "a direct statement of one of the basic aims of investor protection - that if an investor puts his trust in the judgement of an investor firm... that firm should vindicate his trust by tailoring its advice to his needs..".¹²⁹ Considerations of revising the rule pre-dated the Retail Review, and have not been the results of requests from the Secretary of State, rather of the widespread non-compliance with the rules.

Non-compliance with the suitability and best advice rules is one of the largest problems

¹²⁴ CR 22. See MIBOC, December 1985, paras 15-17.

¹²⁵ CR 17.

¹²⁶ March 1987, para 3.49.

¹²⁷ CP 60, para 50. CR 17(5).

¹²⁸ Responses of the Building Society's Association and the British Banker's Association to DP 3.

¹²⁹ March 1990, para 3.3.

which the regulators have to face, and the investors suffer. SIB expressed its dissatisfaction with practitioner performance in the area of suitable advice, as evidenced by complaints from investors, internal company information and its own research, in the Retail Review. Its research indicated that one third of policies sold in 1990 were surrendered within the first two years. The highest surrender rates were in unit-linked life assurances (endowment policies), an average of 37.1%, and in sales from company representatives (32.5%).¹³⁰ Though SIB accepted that there were shortcomings with the methodology used to collate the figures, it maintained that "the message is clear": unsuitable policies were being sold to investors.¹³¹

Evidence from other research carried out by the Consumer's Association reinforces this view.¹³² The most prevalent non-compliance is the recommendation of endowment policies when straight repayment mortgages would be more suitable, and the experience of the home income plans is one of the most striking examples of non-compliance with the requirements.¹³³ Other sectors of the retail market also criticise the life assurance companies' behaviour in this context, although research finds the High Street banks to be equally guilty. The Unit Trust Association described the life assurance companies' sales abuses in unusually harsh terms and criticised the commission structure which it argued foisted unsuitable products on an unsophisticated public.¹³⁴ Resignations of membership by five large life companies caused it to

¹³⁰ The survey was of 61 life companies, calculating termination rates using information about premiums rather than policy values. The survey found that in unit linked life assurance the termination rate within the first two years was 37.2% for direct sales, 40.1% for company representatives, 30.3% for IFAs; for non-linked life assurance the rates were 24.7% for direct sales; 24.8% for company representatives and 22.1% for IFAs.

¹³¹ Colette Bowe, Retail Division Policy Director, letter to the *Financial Times*, 30.1.92.

¹³² *Which?*, February 1992 and May 1993.

¹³³ Life assurance companies made products which entailed the taking out of a second mortgage to raise money for investment. Customers, predominantly retired people, were told that the investment would cover the second mortgage, and give them some money left over which they could spend as they wished. Many of the investments failed to raise sufficient amounts to meet the repayments, leading to repossession orders on the homes.

¹³⁴ Initial response to DP 2.

revise its submission to reflect these companies' views,¹³⁵ but the incident indicated the depth of feeling and resentment of the commercial success, and political lobbying power, of the life companies.

Both the suitability and best advice rules have been the subject of considerable confusion as to their scope and meaning, particularly on two issues. Firstly, the range of products which the IFA has to survey to satisfy the rule, and secondly, what conduct the suitability rule is actually requiring. The issue in relation to the latter has been whether it requires that only the most suitable product be recommended, or whether recommending a product which is suitable (though not perhaps the most suitable) complies; further, does the rule prohibit advising on products which are unsuitable. The initial rule provided simply that what was recommended must be suitable. An accompanying Practice Note indicated that this could mean that it was not possible to invest in anything which the firm has to offer.¹³⁶ In the first draft of the core rules SIB split the duty, imposing a positive obligation on those advising private customers or acting in discretion for any customer to advise or deal only in products which were suitable, and imposing an obligation not to advise "any other customer" if it has reason to believe that the deal would be unsuitable.¹³⁷ In March 1990 the Review Committee concerned with the regulation of marketing of investment products and services stated that it felt that a second proposition should also be regarded as flowing from the suitability rule: "that it cannot be suitable to recommend one type of investment when another type of investment would plainly be more appropriate for the customer in question."¹³⁸ SIB endorsed this statement, and in the Review stated that it was "disposed to spell out the obligation more fully.." and sought consultation on whether the rule should be made more

¹³⁵ Prudential, Legal and General, Guardian Royal Exchange, Scottish Provident and Allied Dunbar resigned in December 1992, cutting the UTA's revenues by 10%.

¹³⁶ SIB 1987 Rules, r.5.01, Practice Note.

¹³⁷ SIB, *Regulation of the Conduct of Investment Business: A Proposal*, August 1989, Annex C, Draft Designated Rules, r.8.

¹³⁸ March 1990, para 3.7.

sharp and comprehensive, or the matter left to SRO guidance.¹³⁹

SIB ultimately concluded that any elaboration of the requirement should be made specific to particular types of business, rather than formulated in the "abstract", and that the SROs were better placed to formulate this. The Law Society in particular, however, remain concerned that it does not sufficiently indicate that non-FSA products should be included when making the suitability assessment.¹⁴⁰

SIB did propose two amendments, however. First, that customers should be required to sign the statement containing the information about them given to the adviser (the "fact find"), which should apply wherever Principle 4 applied. Second, the customer must be given written reasons for the recommendation given. The scope of the latter is confined to long term products, as yet undefined;¹⁴¹ the amendment is directed principally at life assurance products, in line with most of the rules in this area, but SIB is unsure whether its scope should be confined to these. The giving of written reasons was proposed by the Consumers' Association.¹⁴² The aim of the amendments is to provide a discipline which would encourage "wholehearted compliance" with the rule, as well as foster a "spirit of personal responsibility on the part of investors".¹⁴³ SIB hoped to improve compliance by requiring some form of visible conduct which could be monitored, and which might also influence the behaviour of the adviser.

The rules imposing standards of advice in relation to packaged products are a second source of confusion as to what conduct they require. SIB expressed concern that the widely differing interpretations meant practitioners could not understand their responsibilities to their clients in this area, producing an "uncertainty and lack of clarity in a vital area of investor

¹³⁹ DP 2, para 26.

¹⁴⁰ Response by the Law Society to SIB's CP 60, May 1992.

¹⁴¹ CP 60, paras 70-76.

¹⁴² Consumer's Association response to April 1991.

¹⁴³ CP 60, para 75.

protection" which in the interests of investors could not be allowed to continue.¹⁴⁴ Two issues have arisen in relation to, particularly, the "best advice" rule. The first concerns the scope of inquiry independent advisers must make as to products available on the market. The second is whether "best advice" is in fact a feasible requirement. In studying the responses to the Review and SIB's documents it is clear that there is a tension between avoiding imposing obligations which cannot be fulfilled, and lowering the standard of advice to something meaningless. There is also a tension between wanting to provide for niche or specialist players, but not wanting to legitimate incompetence or failure to explore the market fully.

Criticisms of the rule have focused in part on its label, "best advice". The rule does not contain the phrase, requiring that the adviser only recommend a product if it is not aware of another which would "better meet [the customer's] needs". The label, however, has been criticised on the grounds that it was inaccurate and thus misleading, implying that one product above all others could be identified as the "best buy", whereas in fact several products could be qualify, especially given the uncertainties of future performance.¹⁴⁵ It was also argued that the label had become simply a marketing device which had been so exploited that it should be decently buried. Moreover, the rule's relationship with the suitability rule was felt to be confusing, and some argued that it was simply a restatement of that rule and so should be scrapped or at least reformulated. There was also concern that any subsuming of the rule into the suitability requirement or altering of the wording to "good advice" would signal a dilution of the obligation that the regulation could ill afford. Ultimately SIB decided the rule did not need reformulating but it did need elaborating, which in the New Settlement rule structure would be most appropriately done in the SRO rules and guidance.

The second issue, confusion over the IFA's duty, has prevailed since the rules have been in force. The issue was whether an IFA had to investigate every single product on the market,

¹⁴⁴ DP 2, para 28.

¹⁴⁵ Views taken from some of the responses to the Retail Review.

a requirement with which IFAs said they could not feasibly comply. MIBOC and SIB used informal guidance to indicate that a survey of all products was not necessary, in fact an IFA could deal with just one company for a particular sector of their business and still conform with the requirements, provided they had chosen the company on merit and carefully reviewed their choice.¹⁴⁶ SIB sought to address the problem in the Review by proposing an alteration in the best advice rule, and reformulating it in relation to tied agents to require the agent, having already established the most suitable type of product, to take reasonable steps to recommend a product "from within his competence that will, in his professional judgement, best meet the customer's needs."¹⁴⁷ In relation to an IFA, the IFA would be required to offer impartial advice "on the basis of access to a reasonably wide selection of packaged products and product companies."¹⁴⁸ The Core Rule provides that an IFA must take steps to inform itself of products available generally on the market and "on which it can advise". The reason was to permit IFAs to develop market niches, but the danger remains that without further elaboration in guidance the rule could in fact permit IFAs to conduct only rudimentary market surveillance.

Analysis and Conclusion

Rule formation in the retail sector has involved considerations both as to the structure and substance of the rule, and indicated the impact of the rule making procedures on the rules, particularly their substance. Five aspects of this rule formation process may be focused on: firstly, what the objectives of the regulators have been and their impact, secondly the perceptions of those involved of the nature of the issues, including the investor and market, thirdly the impact of the information gathered, fourthly, compliance considerations and finally the nature and limits of rules

¹⁴⁶ *FT*, 20.1.89; *Economist*, 18.2.89.

¹⁴⁷ DP 2, para 29.

¹⁴⁸ *Ibid.*, para 30.

used in this area.

The rationales behind the regulation have been that given the opacity of the products involved the regulation should aim to ensure that investors are not confused when making the decision either about the nature of the advice which they are receiving, or about the product which they are being advised on. The imposition of structural regulation, polarisation, is the extreme regulatory response to the problems of product opacity, information failure and the reliance of the investor on the advice of the intermediary. The main regulatory concern subsequently has been to avoid policies which would undermine the structural market division between tied and independent intermediaries either by imposing regulatory requirements inconsistent with it (multi-tying or badging, for example) or by so structuring the market that polarisation ceases to be a commercial reality.

The regulators here face a fundamental tension between regulation and competition. Although the initial intention may have been to create a competitive balance between the two poles through the rules, commercial developments have been such that the tied sector is stronger than the independent sector, and is used by the majority of investors.¹⁴⁹ The tying of all the High Street banks and the major building societies to life assurance firms, and the banks' development of their own in-house products, has severely limited the range of investment advice available. Although banks may operate an IFA firm, most customers will not be referred there. The principle of equivalency of treatment clearly guided the architects of the polarisation regime, but it seems to have been purely retrospective: to what extent should each sector of the market be limited in continuing its commercial practices as they existed in 1985. Little rigorous thought seems to have been given to the prospective effects of the regulation. It is doubtful whether the two poles received formal equality of treatment from the regulation; what is clear is that it was not substantive. Those who chose independent status were to feel a greater impact from the regulation

¹⁴⁹ IFAs account for just over 30% of the value of sales, but they tend to deal more with those consumers seeking higher value policies so only 25% of consumers use them. OFT, *Fair Trading and Life Insurance Savings Products*, March 1993, para 6.3.

on their business operations than those who did not: they were to be subject to licensing, maximum commission levels, and best advice obligations. Those who chose tied status had none of these impediments. In addition because the rules regulating the life offices' appointment of tied agents as appointed representatives were initially so lax, mainly because Lautro believed that as they were responsible for the representative's actions the offices would conduct financial and fit and proper reviews on their representatives without being required to do so by the rules, it was much easier to tie than to be independent and go through Fimbra's membership process.

Given the market developments, this principle of equivalency of treatment decreased in importance, to be replaced by one of maintaining the independent sector. Debates on the rules have been strongly influenced by perceptions firstly, as to whether the independent sector is a valuable source of investor protection per se, and secondly what the effect of different rules would be. As we have seen, SIB's view that the independent sector should be maintained and that hard commission disclosure would lead to its significant erosion have led it to form rules requiring soft disclosure, the OFT's view that hard disclosure would not have this effect, and its changing view that the IFA sector is not necessarily deserving of regulatory support, have led it to require hard disclosure.

The OFT's view on the issue of competition has been influenced strongly by its perception of the market. The OFT believes there is not one market but two: one for advice, in which IFAs compete between themselves, and one for sales, in which IFAs and tied agents compete. Hard commission disclosure is necessary to introduce competition in the quality of advice given and limit commission driven advice, leading ultimately to a fee structure, although the latter has not been pushed in the more recent OFT reports. SIB and Lautro feel that there is one market, for advice. Both IFAs and tied agents give advice, the difference lies in the range of products over which they can advise.

Polarisation has been accompanied by rules on disclosure. In forming these rules, three factors have been influential: the perception the regulators have of the person at whom the

information is directed, the nature of the issue in relation to which the rules are being formed, and the concern to form rules which cannot be easily avoided. In relation to the first, it has become apparent that the OFT has a slightly different conception of the investor than the FSA regulators. It tends to see the investor as a rational being who will be capable of seeking out information and using that which he or she is given. Again, these differences in perceptions have only emerged slowly over the course of the rules' formation. The FSA regulators, particularly since their research into consumer understanding, are now more concerned than they ever have been to ensure that the information is comprehensible to the investor, and due to that research have a more focused view of what the nature of that information has to be. The result has been a change from the detailed and complex information which was given before, to a much more simplified version of point of sale disclosure.

By contrast, the OFT is moving in a different direction, preferring more information to be given even though SIB has finally produced a disclosure regime more or less in line with what have been the OFT's requirements since 1987. The DGFT has recently assessed the product disclosure rules under the Fair Trading Act 1973 for the first time.¹⁵⁰ The DGFT recommended a client and product specific disclosure statement should be given to the investor before they had taken the policy. In addition to the information already given, the disclosure should contain itemised charges and the company's policy on the allocation of their investment earnings. It should show how the projected returns to consumers would accrue by accumulating premiums paid, less expenses incurred, at particular rates of investment return. It should also show surrender values up until the end of the policy, and provide information on persistency rates: how long a policy of this type is kept for before it is surrendered. The view of SIB's staff is that the investor would be swamped by this volume of information, and that given the unsophistication of the investor and the consequent dangers of information overload, the proposals do not distinguish sharply enough between information which is essential, and that which is interesting.

¹⁵⁰ March 1993, *op.cit.*, FTA s.2, powers under s.125(4).

The regulator's difficulty in determining forming rules on disclosure is exacerbated as this is an area of technical complexity, as we have seen in relation to charges and expenses disclosure. Here the balance between information which is accurate and comprehensive and that which is comprehensible has been one which the regulators have found hard to strike, tending initially towards concerns for accuracy over comprehensibility. The information on which the rule making decisions has been based has not aided resolution of the problem, as it has come predominantly from the industry and its actuaries and its technical nature has disbarred most consumers from participating. Experiments to include more representatives than the Consumer's Association, who have invested a considerable amount of resources in reviewing the FSA rules, have failed due to this complexity. In this area, the regulators have had actively to seek alternative sources of information, turning to consumer research. Despite the strong influence this had in forming the rules, however, SIB do not propose to maintain such research, principally on the grounds of cost.¹⁵¹

The rules on information provision have generally been highly precise and complex, with one exception. That exception was the second phase of the disclosure requirements in 1990, which required only that sufficient information be given prior to sale to enable an informed investment decision.¹⁵² It was non-compliance, as well as anti-competitive reviews by the OFT which caused the regulators to revise these rules. The tendency to prescribe in the rules on information provision every last item of information apart from that which is particular to the company or the investor is in marked contrast to the rules on all other forms of customer agreements, the detail of which SIB and SFA have substantially reduced, even in relation to private customers.

Detailed rules can themselves, however, lead to avoidance and non-compliance. In seeking to achieve compliance through more detailed rules the risk is encountered of a formalistic approach

¹⁵¹ Trade and Industry Select Committee, The Securities and Investments Board, Minutes of Evidence, 18.12.91., HC paper no.162-i, Colette Bowe, paras 56-64.

¹⁵² Financial Services (Conduct of Business) Rules 1990, r.5.12A.

being adopted,¹⁵³ and yet the regulators feel that the regulated cannot be trusted to act according to the required standards in the absence of the control that detailed rules bring. The concern to write rules which do not lead to information being given that cannot firstly, mislead or be misused, and secondly, be avoided has influenced the rule making process. Disclosure may actually be misleading in providing information which can be mis-interpreted by the consumer. Although life offices' concern for accuracy may be misplaced with respect to charges, information on illustrations does need to be complemented by other information putting it in context, principally surrender values and inflation and disclosure may also itself be misleading as customers may not appreciate the conjectural nature of the figures.

The rules also encounter the difficulty that they may prescribe the giving of information in such a manner that it can be misused, or give rise to spurious competition. The potential for companies to use illustrations for promotional and competitive purposes has been a key factor in forming the rules on product disclosure. Moreover, there is a danger that the scope of the rules may be drawn in such a manner that companies will exploit the provisions and compete on disclosed matters, altering those aspects of their product which are not covered by the rules. A recent study for SIB found that companies who had a poor ratio of surrender values to maturity values, which is not required to be disclosed had actually inflated their maturity values so as to be included in the top ten companies of several financial press rankings by maturity values, although the penalties for surrender remained high right up until the end of the policy.¹⁵⁴

Compliance considerations also have affected the substance and structure of the rules. In order to improve compliance with the rule, the regulators have sought to tailor its substance to the incentives of those subject to the rule. Several surveys have shown that over a third of all advisers

¹⁵³ See Chapter 1.

¹⁵⁴ "1992 With Profits Survey", *Money Marketing*, cited in OFT, *Fair Trading*, op.cit., paras 3.15-3.16.

do not inform their customers of their status, and the figures are worse for tied agents than IFAs.¹⁵⁵ Lautro and SIB had different approaches: Lautro argued that the status should be on the business card, as this would always be given, and people usually read it. SIB felt the Guide should be maintained, however, but agreed that it should be in the company's own format, even though its research found that investors preferred a Guide in an "official" format. The basis for the decision was that its appearance as an official document may discourage its use, and representatives would be more likely to hand over the guide if it was in the company's own style.¹⁵⁶ The rule was thus a compromise between considerations of clarity of disclosure and an attempt to achieve compliance.

Altering the structure of the suitability and best advice rules was also considered as a means by which compliance with these rules could be achieved. The more general statement, with greater room for interpretation, was felt to be insufficient in providing control. In this area, in contrast to the context in which the regulators envisaged the soft commission rule applying, the investor or other market participants are not relied upon by the regulators to monitor conduct, which has led to regulators considering detailing the rule in the third tier to set out what would be reasonable grounds for a recommendation or factors to be taken into account in giving advice. This was an attempt to use more detailed rules to facilitate compliance and control by communicating to the intermediary more clearly exactly what type of behaviour is required. Requiring conduct which can be monitored, by requiring written reasons for recommendations, is also an attempt to use the structure and substance of the rule to improve its enforceability.

The suitability and best advice rules indicate two of the problems which rules and rule makers face. Firstly, particularly in relation to the best advice rule, there is a question of whether it is requiring something which is impossible to achieve. Secondly, the conduct required by these

¹⁵⁵ For example, Gallup research in November and December 1991 showed that 35% of advisers did not disclose their status; the figure was higher for company representatives than independent financial advisers (quoted in H. McRae, *Developments in the Retail Savings Markets* (Business Performance Group, LSE, 1992).

¹⁵⁶ CP 60, para 60.

rules is not mechanical, such as that required by reporting requirements or even precise disclosure rules. It requires the exercise of judgement on the part of the adviser. Rules cannot create informed judgement where none exists, however. They rely for their operation on the judgement of those subject to them; where that judgement is lacking the rule itself cannot provide it. The rule can perhaps provide guidelines and leave less to the discretion of the addressee, but it cannot do more. So the regulatory aim must be realised through using techniques other than rules, here training and improving the competence of advisers. Changing the rules has gone a long way to address the regulatory concerns raised by the retail market, but it will not solve all the problems which arise. It is a highly complex area which indicates that rules alone, of whatever type, are not enough: they need to work in tandem not just with enforcement but with more indirect techniques of training and education of those who apply the rules, and of those for whose benefit they are written.

Conclusion: Regulators as Rule Makers

This thesis has taken a different approach to the study of regulatory agencies than has been conducted hitherto in the UK. As a study of a system of regulatory agencies it forms part of the UK literature on these bodies, which began with Baldwin's study of the Civil Aviation Authority¹ and was continued in Baldwin and McCrudden's *Regulation and Public Law*,² but which still remains in a nascent form in comparison with the attention regulatory agencies have received in the US. It has focused, however, on an area of agency activity which has not previously been the subject of in-depth study, rule making.

The financial services regulators differ from other UK regulatory agencies in several respects. The regulation is formed and administered not by a single agency but by a network of agencies each of which performs a range of regulatory tasks under the same statute, but in relation to different market areas. The structure combines agencies operating on a different legal basis: SIB exercises statutory powers, the SROs operate contractually. Despite the latter's company status and contractual powers they are still public bodies, however, and are subject to judicial review.³ The range of rule making powers delegated to SIB, the extent of its rule making function and the presumption that rule making would be the *modus operandi* of the regulation is unparalleled in nature and extent in other agencies. SIB also has the power to issue a range of different rule types. Such legislative provision of a hierarchy of rule types is rare, matched principally in the Health and Safety at Work Act 1974. Finally, SIB's rule making powers are also unusual because neither Parliament nor a Secretary of State has the power to veto the rules, except on the grounds of anti-competitiveness.

¹ R. Baldwin, *Regulating the Airlines* (Oxford, 1985).

² R. Baldwin and C. McCrudden, *Regulation and Public Law* (London, 1987).

³ See *Bank of Scotland v. IMRO* 1989 SLT 432, *R v. AFBD ex p. Mordens Ltd*, *The Times* 6.9.90, *R v. Fimbra*, ex p. *Cochrane*, *The Times* 23.6.89 (CA), *R v. Lautro*, ex p. *Ross* [1993] 1 All ER 545 (CA), [1992] 1 All ER 422.

The thesis has focused on rule making for several reasons. Firstly, the regulation is rule based and one of the main functions of the agencies has been rule formation. Studying why regulators have formed the rules that they have facilitates an understanding of how regulators have carried out a key part of their regulatory function. This is of interest to both area specialists and public lawyers, and yet it is an issue which has been little explored. SIB's rule making powers are unusual, as noted above, but where other agencies have rule making powers few studies have been conducted on their exercise. Only Baldwin has begun to look at issue of the choice of rule type,⁴ but this has not as yet been in depth and has been with an eye mainly on enforcement. Other studies of agencies have focused solely on enforcement, and whilst the rules which the officials have to apply have been criticised, no consideration has yet been given as to why the rules were formed in the way that they were.⁵

Secondly, there has been little attention paid by those concerned with studying agency or law making activities to the concept of rules. Whilst the issue of discretion in rule application has been subject of quite sophisticated theoretical and empirical study,⁶ rules and rule making in the context of administrative agencies are all too often only considered in a well rehearsed and increasingly sterile debate between rule making and adjudication, or rules and discretion. The aim of the thesis has been to move that debate on by analysing what rules are in order to understand the nature of the rule making decision, and what factors influence it. This enables us to understand the rules which have been made and the reasons for them.

In Chapter 1 an analytical framework of rules was proposed which can be applied to an individual rule and / or a system of rules, and which identified four dimensions of rules: substance, status, character and structure. The dimension of structure has four elements: scope,

⁴ R. Baldwin, "Why Rules Don't Work", (1990) 53 MLR 321.

⁵ K. Hawkins, *Environment and Enforcement* (Oxford, 1984), G. Richardson *et.al.*, *Policing Pollution* (Oxford, 1983), B.M. Hutter, *The Reasonable Arm of the Law?* (Oxford, 1988).

⁶ See for example, D. Galligan, *Discretionary Powers* (Oxford, 1987) and K. Hawkins (ed), *The Uses of Discretion* (Oxford, 1992).

simplicity/complexity, clarity/opacity and precision/vagueness, which are interrelated. It was argued that in making rules decisions have to be made as to each of these dimensions, and that the dimensions interact, so that decisions on, for example, the substance or status of a rule may affect decisions on its structure and vice versa. The nature of these decisions was explored in the light of the nature of rules themselves. Rules are general and prospective, and in attempting to achieve a policy objective focus on those aspects of a situation which are perceived to increase the likelihood of causing a harm sought be prevented, or promoting a situation sought to be achieved. In their formation the rule maker is therefore required to anticipate and identify the circumstances which should activate the rule. The rule may be over-inclusive, including situations in which application of the rule does not further its purpose, or under-inclusive. The rule maker's ability to predict may be dependent on the heterogeneity, technicality or complexity of the subject matter of the rule, the volatility of conditions in which it operates and the knowledge of the rule maker.

The rule making decision was explored in greater depth, and it was suggested that different types of rules have different implications. These related principally to the amount of discretion or decisional jurisdiction a person applying the rule has, the interpretation which that person may give the rule and the amount of predictability which the rule provides. Other implications relate to the costs of formation and application, compliance with the rule and enforcement considerations. It was suggested that these might affect decisions on the rule's status, character and structure. In addition, rule making was viewed as one form of decision making, and so a broader range of factors was identified as potentially affecting rule making decisions. These were firstly, the substantive framework, which refers both to the terms and objectives of the enabling legislation and the area of social and economic activity which the rules are to regulate; secondly, political considerations, including the history of the agency and the perceptions and expectations which the political community have of the regulation; thirdly, organisational factors, which include both inter- and intra-organisational considerations, fourthly, the decision making process and finally the

norms and perceptions of officials and the regulated and wider community of the agency's role and purpose. These factors overlap, and several may operate at any one time.

This concluding chapter will examine the influence each factor has had on the rule making decision, identifying which dimension of the rule it has most affected: have institutional factors had an influence, for example, on the structure of the rule? It will then examine the use which the rule makers have made of different types of rules by examining the extent to which they have considered the implications of using rules of different status, character and structure. Finally it will indicate the manner in which decisions on one dimension can affect decisions on another, before indicating the issues which future research of this nature should address.

Factors influencing rule making

Substantive Framework

This has three elements: the substantive area in which the rules operate, the requirements of the legislation and the objectives of the regulation. As we saw in Chapter 2, the substantive context in which the rules operate and have to regulate is highly complex, heterogeneous and fluid. The rules have to regulate conduct of all investment business, which is widely defined, and the patterns of business and the nature of the products are subject to continual innovation and change. Such a complex subject matter poses difficulties for rule making due simply to the nature of rules themselves. They are prospective and general, and require the rule maker to identify what is the mischief, how it arises, and therefore how it should be prevented. For this the rule maker needs information. Absence of information was one of the problems SIB encountered in drafting the initial rules, and the result was a highly complex rule structure as the rule maker tried to exclude or extend application of rule on an incremental basis to situations not initially thought of. The inexperience of the UK to such regulation meant that drafters were drafting without a UK precedent to use, and the rapidly changing market situation meant the rules were shooting at a

moving target. Practitioner experience and drafting skills proved hard to marry: the experience and techniques of each were so different, and practitioners were too concerned to exclude their business from the rule or to have their duties specified more clearly to offer any overarching viewpoint. As the rule makers become more experienced not just in the issues involved but in drafting rules to deal with them, or in the words of the regulators and their observers, as the system "beds down", a move to more general rules may be possible as rule makers feel able to make the "generalisations" or abstractions which rules require. There is evidence that this is occurring. However, the sheer complexity of the subject matter, the range of products, business practices and arrangements and investors which the rules have to cover suggests that even with good information, detailed rules are necessary to regulate the area, and as we have seen in Chapter 5 they still form a significant part of the rule system.

The requirements of legislation have had a direct affect on the substance of rules in that SIB had to fulfil its legislative requirements. However the principles to which SIB's rules must conform and the issues for which they may make provision are generally phrased and do not appear to have acted as an impediment to rule making by requiring inappropriate or impracticable rules. The Act does constrict, however, developments in the institutional system and SIB's ability to "stand back" from rule making in all areas. SIB is granted rule making powers which it alone can exercise as they involve alteration of common law (client money rules and Chinese walls).⁷ The statute also provides that only compliance with SIB's rules enables unsolicited calls to be made,⁸ and EC firms to issue advertisements in compliance with the Act.⁹ SIB is also responsible for the authorisation, recognition and regulation of collective investment schemes.¹⁰ Any provision, in short, which confers rights on third parties has to be made by SIB as the SROs' rules are purely contractual. Finally, SIB has a statutory role as a direct regulator of firms, and

⁷ FSA 1986 Ss.55 and 48(2)(h).

⁸ S.56.

⁹ S.58(1)(c).

¹⁰ Part IIX.

does not have the power to refuse the applications of any UK or EC firm which otherwise fulfils the membership requirements. It therefore has to have rules to regulate these firms' activities.

The provisions of the legislation have impacted on the structure of the conduct of business rules to a significant extent. The statutory provision for a right of action for a person who suffered loss as a consequence of a firm breaching the rules, s.62, was one of the principal causes of the highly specific and complex rules which characterised the initial rule books. Firms were fearful of litigation, and so wanted to minimise uncertainty as to what the rule required and in what situations; their demands for specification stemmed directly from this provision.¹¹ It was a pre-requisite of the move towards the 10 Principles that the right of action did not apply to them, and its limitation to private customers enabled SROs to feel that they could afford to be less specific in their rules (see below).

The objectives of the regulation have impacted directly on both decisions as to substance and to the choice of rule type. In Chapter 3 the formation of the Act and the different aims of the regulation sought by the key participants were discussed. It was argued that as far as the objectives of the legislation can be discerned they combine investor protection, the prevention and detection of fraud and market manipulation, raising the standards of business in the market place, the provision of confidence in the markets, the importance of competition, the facilitation of market efficiency and the promotion of London as a financial centre. Given the range of objectives and the heterogeneity of the industry it is clear that they cannot all be met simultaneously or through the same means and the regulators have to perform the inevitable balancing act. Moreover, it is not immediately clear what the objectives require in any particular circumstance. What is "protection" and to whom should it be given? Does investor protection require paternalistic measures, or is it served by a competitive market place in which the investor has freedom to choose between different products or courses of action? How does "market efficiency" relate to competition? Should the rules aim to treat different sectors of the market

¹¹ See Chapters 4 and 5.

equivalently, or impose requirements which might give an advantage to one sector of the market over another?

This factor therefore combines with another, the perceptions of the regulators, as it is their interpretation of objectives which has been significant. The interpretations of objectives have affected decisions as to the substance of the rule, particularly the regulatory technique to adopt, to a significant extent, and consideration of the impact of the rule has been an important factor in the decision. Disclosure is the most widely used regulatory tool, not only to provide information but to absolve firms from conflicts of interest. The thesis indicates that the regulators have favoured regulation which is more intrusive into business operations in the retail sector than the wholesale. They have been reluctant to re-impose structural regulation in the wholesale markets, preferring instead to use disclosure and conduct regulation.¹² In the retail sector, by contrast, structural regulation is the dominant feature, although again conduct regulation has been used where disclosure either alone or in combination with structural regulation, was felt to be insufficient.¹³

Part of the reason for the different approaches regulators have taken between the two market sectors is based on a perception that different types of investors require different forms and levels of protection, and that the objectives of investor protection and market efficiency can be met by providing different levels and types of regulation to each. As we saw in Chapter 2, the types of investors involved in the two markets are quite different. So different regulatory techniques have been used, and the scope of the rules has been affected to exclude duties from being owed to professional investors. The interpretation of the objectives has been that market operations should be affected only to the extent necessary to provide investor protection. Examining the rule making decisions which have been made suggest that one overriding factor has been of significance: the extent to which London's position as a leading international financial centre

¹² See Chapters 2, 3 and 6.

¹³ See Chapter 7.

would be affected by regulation. Regulators have made it clear that they regard the greater susceptibility of the wholesale markets to international competition as the main motivation for imposing less regulation in that area than in the retail markets, which are still fairly insulated from international competition.¹⁴

However, whilst the objectives have affected rule substance, they have not always been determinative, as it has not always been clear which substantive requirements promote, for example, market efficiency or competition. Moreover, the ability of regulation to affect market structure and the conditions of market operation raises questions of the proper nature of the regulators' role: should they impose regulation which could give one sector of the market a competitive advantage over another. As we saw in Chapter 6 and 7 both these considerations have had a significant impact on the decision of whether to form a rule, and what the substance of that rule should require.

Finally, the study of the formation of the conduct of business rules indicates that whilst the history and provisions of the Act are a principal source of the regulation's objectives, taking only these to be the regulatory goals ignores the dynamic element of regulation. As regulation is formed, it can create its own objectives, including the preservation, or attainment, of coherence in the regulatory requirements. Regulation creates new norms and rationales which regulators do not want to be undermined by developments elsewhere in the regulatory system, a factor in decisions in both the retail and soft commissions rules.¹⁵

The objectives of the regulation have also affected decisions as to the type of rule to use, in other words decisions as to the status, character and structure of the rule. We saw in Chapter 3 that in the debates surrounding the formation of the Act different rule types were associated with different objectives. For example, it was felt by many, particularly the Bank of England, that

¹⁴ For example, see Treasury and Civil Service Select Committee, Financial Services Regulation, Minutes of Evidence, 14.6.93., HC Paper no.733-i, Mr Andrew Large, para 70.

¹⁵ See Chapters 6 and 7.

regulation which would facilitate market efficiency required a particular type of rule, one which was not didactic but which set general aims and principles which firms should follow in their own manner, which was flexibly applied, but could in the last resort be used for disciplinary purposes. Again, it was the objective of securing London's position as a leading financial centre which was one of the principal reasons why the Bank of England, the Government and other prominent actors in the City felt that the rule system had to change.

Political factors

The institutional structure and rule making procedure are such that political actors have little opportunity for direct influence. The Government has only two opportunities to influence the rules directly, firstly before SIB was recognised, and secondly under the competition review, both of which it has used to affect the rule making decisions, as Chapters 4 and 7 indicate. The impact of political factors has otherwise been less tangible and it has been political expectations rather than direct actions which have exerted an influence. Politicians established the objectives of the regulation and the institutional structure, both of which have themselves had a significant impact on rule formation. The requirement of speed which has exacerbated the rule making difficulties encountered in both the initial rules and the formation of the Principles and Core Rules was a political imperative. The appointment of David Walker to replace Sir Kenneth Berrill when the latter had made clear his wish to continue as Chairman of SIB was a clear indication that the Government, and Bank of England, expected a change of approach; the Government's own change in objectives required and facilitated the change in rule structure which was subsequently introduced. As the widening of SIB's rule making powers and the introduction of a range of different rule types required legislative changes, the Government's attitude was crucial in enabling these to be effected.

It is notable that the New Settlement rule system required legislative change, and that if such a system had been introduced initially, as many of the regulation's critics believed it should,

it is the opinion of many key participants that the DTI would not have accepted rules akin to the Principles and Core Rules as sufficient to grant SIB designated agency status. It was a change in Government attitude which enabled the change in rule system, but also the Government's own concerns and priorities which limited its scope. The non-designation of the Core Rules to RPBs is attributed by more than one key participant to their lobbying power; it was the Government's, not SIB's decision that they be excluded, and this position was recently described by SIB's chairman as "anomalous".¹⁶ The Government's use of the opportunities it has had for direct influence suggest that if the structure or rule making procedures were different, requiring for example approval of all rules, both the content of the rules and the time it took for them to be produced would be significantly affected, not least as it would provide industry groups with another lobbying point.

Rule Making Procedures

Rule making procedures raise important public law issues for two reasons. Firstly, it is frequently the route through which control and accountability is sought, and secondly it may or may not involve broad participation, which can be a further source of accountability and legitimacy for an agency. However, they are also significant as they indicate the nature of the information which the agency will be receiving as inputs to its rule making decisions.

We have noted above that the DTI's direct involvement in SIB's rulemaking has been limited to its initial rulebook, but was a significant factor in the substance and structure of those rules. The involvement of Government or other agencies is otherwise restricted to the competition review. As this applies to all rules issued by SIB and the SROs it has had no effect on the type of rule used, nor which agency has issued it. This may be contrasted to the US where statutory requirements as to rule making procedure and the existence of executive reviews for certain rules

¹⁶ A. Large, *Financial Services Regulation: Making the Two Tier System Work* (SIB, May 1993) (hereafter Large Report), para 4.15.

has had a significant impact on the types of rules issued by agencies.¹⁷

The involvement of the OFT in the competition review has had a significant impact on the substance of the rules, however. This is most evident in the area of retail regulation, although even the informal expression of its views has influenced SIB's decisions in relation to soft commissions.¹⁸ It has also delayed the rule making process and contributed to uncertainty as the OFT has criticised SIB's rules, and then the regulators and regulated have had to wait for the Government to make a determination on the issue. The Government's involvement has had less impact on the rules' substance measured in terms of the number of rules which have been affected, although it has not always followed the OFT's advice, and has recently called for stronger measures than even the OFT contemplated.¹⁹

The other element of the statutory rule making procedures is consultation. SIB is required by statute to follow consultation procedures prior to the issue of new rules. SIB's approach has been increasingly not simply to send out draft rules for consultation but to set out proposed policy options. The opening of the Retail Review with an "Issues Paper" was particularly well received by those who responded to it. Proposed policy options only go to consultation once the regulators have themselves engaged in an information finding and evaluation process, and have formed a view as to what course or courses of action should be adopted. Researches conducted for the thesis indicated that consultation was not a hollow exercise, however, and that the responses are carefully considered before a rule is made. However, whilst the responses can provide information as to the potential impact and operation of the proposed policy or rule, their usefulness varies for three reasons. Firstly, some issues generate more responses than others: Lautro, for example, had less than five responses to its consultation paper on professional indemnity rules. Secondly, even

¹⁷ The literature is extensive. For a collection of recent articles on the issue, see the Symposium (1991) 41 *Duke LJ* (Winter issue). See also M.A. Asimov, "Nonlegislative Rulemaking and Regulatory Reform", (1985) 35 *Duke LJ* 381 and of the impact of executive analysis requirements, see T.O. McGarity, "Regulatory Analysis and Regulatory Reform", (1987) 65 *Texas LR* 1243.

¹⁸ See Chapter 6.

¹⁹ See Chapter 7.

where the issue generates a high response, as was the case in the rules considered in the thesis, these are principally from larger regulated firms and trade associations. Regulators comment that those who respond usually have a "hobby horse", an argument or view which they always maintain, and that tapping into the "apathetic majority" can be difficult.

Finally, consumer representation is confined to the Consumers' Association and the independent Board members, although both Sir David Walker and Andrew Large have emphasised that the role of SIB's Board is to act in the public interest, not be representative of industry.²⁰ The Consumers' Association finds itself very stretched to monitor all rules, and has focused on those relating to the retail sector, where it has done a number of surveys into selling practices. The lack of information on the comprehension of consumers or their views prompted Lautro and SIB to commission market research on these issues, the results of which were very influential in forming the product disclosure rules. Other, more informal, attempts to involve consumers have been less fruitful due to the technical nature of the issues involved. SIB's current chairman, Andrew Large, has stated that the consultation process does not provide adequate focus or information and has suggested the formation of advisory groups,²¹ however despite its evident contribution to rule making in the retail review SIB does not anticipate future consumer research along similar lines on the grounds of cost.²²

Finally, the process of negotiation which was adopted for the formation of the Principles and Core Rules had an impact on the substance and structure of the rules. In relation to the substance, the process highlighted differences between regulators and their functional division of responsibility meant that disputes between different parts of the market as to what duties the rule should impose and on whom became institutionalised in debates between the different bodies, on

²⁰ Trade and Industry Select Committee, The Securities and Investments Board, Minutes of Evidence, 19.12.90, HC Paper no.131, Mr David Walker, paras 23 and 64; Large Report, para 12.4.

²¹ Large Report, para 12.9.

²² Trade and Industry Select Committee, The Securities and Investments Board, Minutes of Evidence, 18.12.91, Colette Bowe, paras 56-64, HC Paper no.162-i.

which a compromise had to be reached. This compromise did not always result in a standard as opposed to a detailed rule, however, contrary to what some economic theories would predict.²³ The status of the Core Rules (applying to SRO members) meant that the Rules were the root of the third tier rules; the SROs could not alter the Rules' requirements unless a derogation (explicit or implicit) was granted. They therefore had to ensure that the Rule contained provisions they agreed with. This led on occasion to longer, more detailed and complex rules as different provisions were accommodated.²⁴

Institutional Factors

The thesis has not conducted an organisational study of each agency to show the impact of social or professional backgrounds and norms of officials, or organisational structure on rule making. It has however shown that inter-organisational factors, that is the interaction between regulators within an institutional structure, have played a significant role in the rule making decisions of the regulators. The structure is essentially federal, and exhibits consequent tensions between the role of the centre and the autonomy of the outlying bodies. It is the result of the compromises made between differing views of what the structure should be, views formed in the light of differing objectives of the regulation. Market efficiency claims pushed simultaneously for self-regulation (sensitivity, flexibility) and oversight (fears of cartels and restrictive practices). Investor protection claims pushed for public interest regulation with tough enforcement (central, statutory body) and awareness of market practices to ensure abuses were addressed (practitioner regulation). The result was a network of agencies whose relative roles were ill-defined.²⁵

The dynamics of this institutional structure and the relationship of the agencies has had a direct impact on the choice of rule type. The most difficult issue to resolve in the operation of

²³ See Chapter 1.

²⁴ See Chapter 5.

²⁵ See Chapter 3.

the system and the formation of the rules has been who should be primarily responsible for forming the rules. The extent to which SIB should prescribe the contents of the SROs' rule books was not indicated in the Act beyond the provision that the SROs' rules should provide equivalent investor protection to that provided by SIB's. The purpose of the New Settlement was to define the respective roles of the regulators through the development of different rule types. The development of a rule system combining rules of different status and structure was in part aimed at indicating and defining the position and role of the regulators within the structure.²⁶

Rule structure has thus been in a reflexive relationship with the function of the issuing body: it has had the function of defining, and has been defined by, the position of that agency in the institutional structure. In order to emphasise SIB's role as a central, relatively high level standard setter the Principles and Core Rules had to be relatively short, general and opaque, not subject to frequent amendments and not complex on their face; they had also to apply to all authorised persons.²⁷ The more detailed nature of the third tier rules indicates the role of their issuers, the SROs, as the "coal-face" regulators, regulating the day to day operations of their sector of the industry.

These considerations of agency role definition led to two structural elements in the Core Rules, the glossary and the provision of derogations. The role of the glossary was to contain the complexity of the Core Rules which for institutional, agency and political reasons could not appear on their face. The use of derogations is more complex. Their provision, and the limits they pose to the rules' function as a common core, reflects the tensions in the structure and the uneasy way in which the rhetoric of self-regulation fits with the reality of central definition of aims by statute, interpreted and enforced by a semi-statutory SIB. For whilst the rhetoric of self-regulation demands the free ability of practitioners to make rules to fit their circumstances, the reality is that these bodies are viewed uneasily by those who fear their degeneration into trade associations,

²⁶ See Chapter 4.

²⁷ On the exclusion of RPBs from the designated rules see above.

including SIB, and welcome the limitations imposed on them in the form of detailed standards or rules which their regulation has to meet. This applies to SIB's relations with the SROs as it did to the DTI's view of SIB in 1987, and the attitude of MPs and Lords in the formation of the Act.²⁸

This tension is manifested in the aims of successive chairmen for SIB, on the one hand, to cease detailed rule making and, on the other, their desire to maintain control over the SROs. In 1989 SIB indicated that the regulatory structure was "still insufficiently mature" for sufficient trust and good relationships between the regulators to be fully developed to enable SIB to take a more "hands off" approach to rule making.²⁹ Despite the stated aims of the New Settlement that SIB should "stand back" from third tier rule making,³⁰ SIB's participation in policy debates which concern third tier rule changes,³¹ indicate that although both sets of regulators agree that SIB should not become involved in the detail of the rules, differences lie over the definition of "detail".

In a more recent statement on SIB's role and relationship with the SROs, SIB's current chairman Andrew Large anticipated that it may be possible to "de-designate" some of the Core Rules, "where SIB felt confident that the necessary standards would be maintained by that SRO, through a combination of rules and other delivery mechanisms".³² His report envisaged that SIB should designate rules only where this was more efficient and effective for the system than rule making by individual bodies. However, this contrasts with the Report's emphasis on SIB's enforcement and monitoring role vis a vis the SROs. The Report envisages that SIB take a much more active and public role in enforcement and monitoring in relation to both the regulated and the regulators. In this context, Large stresses a willingness to use the designation power "to

²⁸ See Chapters 3 and 4.

²⁹ SIB, *A Forward Look*, October 1989, para 4.3.

³⁰ See Chapter 4.

³¹ See Chapters 6 and 7.

³² Large Report, para 6.11.

impose rules in the case of an SRO which is unable or unwilling to introduce new rules - or make rule changes - which SIB believes are necessary to meet standards set by SIB..",³³ and emphasises that SIB should retain a reserve power to designate rules in case it should need to de-recognise an SRO.³⁴ In addition, control over the substance of the SROs' rules is still envisaged, although its method of implementation is seen to be through detailed standards of investor protection set by SIB, but not in the form of rules.³⁵ So whilst on the one hand Large wants SIB to step out of rule making, on the other, in its role as "regulator of regulators" he wants SIB to maintain control over the core provisions of the SROs' rules, either through non-rule based standards, or designated rules, and to maintain the policy initiative in cross-regulatory border and systemic issues.³⁶

Norms and Perceptions of the Regulators and the Community

In the discussion of the impact of the institutional structure, as in that of the objectives of the regulation, it became clear that the regulators' perceptions of their own and each others' role has had a significant impact on the rule making decisions. The tensions inherent within the institutional structure have been exacerbated by the perceptions each regulator has had of the others, and of itself. These have been related to the role which each should be playing, the legitimacy of the others and their skills and competence. The SROs are culturally distinct (the world of merchant bankers is far removed from that of J. Bloggs, independent financial adviser) and can be critical of each others' performance and efficacy as regulators. SIB has been wary of the SROs acting as trade associations,³⁷ and of failing to monitor and discipline its members satisfactorily. The SROs are not convinced that SIB has the legitimate role, knowledge and

³³ Ibid., para 4.15.

³⁴ Ibid.

³⁵ Ibid., paras 3.13-3.20.

³⁶ Ibid., para 10.2.

³⁷ See, for example, *A Forward Look*.

experience to decide all policy issues, or that it has sufficient awareness of market operations. The tension between SIB and the SROs was clearly indicated in the operation of the equivalency requirement, which had an immediate and direct effect on the SROs' rules. Large aptly described the recognition of the SROs and the interpretation of the equivalency requirement as a "bruising experience".³⁸ SIB felt that as the central regulator it had to require the SROs to follow its rules very closely, and the SROs felt that as practitioner bodies their legitimate autonomy and role in policy formation was being denied. The result was a considerable amount of friction between the two tiers of regulators which the change in rule type, introduced as the New Settlement, aimed to address. However, SIB remained involved in ensuring that the third tier rules conformed to the Core Rules, leading some to question if this aspect of the New Settlement was a mirage.³⁹ Large also envisages a new approach to regulation, but as noted above, there are considerable tensions between his objectives.

SIB's perceptions of its legitimate regulatory role *vis a vis* the regulated has also influenced its rule making decisions. In considering soft commissions, for example, SIB did not impose disclosure or structural regulation in two areas as it felt these measures would be too drastic, requiring too great a change in the structure and business operations of integrated houses.⁴⁰ Differences in perceptions between the regulators have also led to differences in their rule making decisions. The different interpretations of "investor protection" by SIB and the SROs in considering whether duties should be owed to professionals not for their own sake but for the sake of their customers, led to differences in the treatment of indirect customers.⁴¹ Differences in perception of the nature of the investor, and of the market which regulation had created has led to quite different demands of rules between the OFT and the financial services regulators.⁴² The

³⁸ Large Report, para 1.20.

³⁹ See *ibid.*, para 1.16.

⁴⁰ See Chapter 6.

⁴¹ See Chapter 5.

⁴² See Chapter 7.

regulators' rule drafting has also been affected by their perceptions of the practicability of the rule, as the differences between IMRO's and SFA's provisions on soft commissions indicate.⁴³

The regulators have been susceptible to the perceptions the regulated community have had of particular aspects of the regulation. Criticism of the rules led directly to rule changes, for example in the customer agreement requirements and the re-focusing of duties to exclude professional customers. One of the traditional criticisms of agencies is that they are too susceptible to the perceptions of the regulated community, "agency capture". In one area, however, that of SIB's rules relating to product disclosure, we appear to see "agency escape", albeit one prompted by the OFT and not regarded as complete by consumer bodies.

Finally, one of the more complicated aspects of the interaction between regulator and regulated has been the regulators' attempts to influence the perceptions of the regulated. The regulators have used the structure of the rules in an attempt to revert to the traditional City culture of regulation, forming Principles to encourage a purposive approach and to emphasise that technical compliance could not be a substitute for management integrity. The change in rule types under the New Settlement was in part an attempt to alter attitudes by presenting the regulation as a code of good market conduct whose essential aims and requirements could be easily understood and flexibly applied.⁴⁴

Cost and Enforcement considerations

Costs are relevant to both the regulator and regulated. Both general and detailed rules can impose costs on the regulator. Costs arise from general rules as there is a demand from the regulated for their interpretation, from detailed rules as they may need to be changed more frequently and because there may be an increased demand for waivers. The substantive context of the regulation affects these costs. The regulators have not formed detailed rules with the

⁴³ See Chapter 6.

⁴⁴ See Chapters 4 and 5.

intention of using waivers extensively to mitigate their effects, however SFA, for example, do intend to grant waivers less frequently now that the rules are less detailed. Detailed rules have on occasion not been used because of the need for more frequent changes.⁴⁵ It was anticipated by the SROs that the introduction of more general rules would impose greater costs on them as there would be more demands for interpretation, and IMRO, for example, increased the number of staff in its legal division. These costs were outweighed by the factors which led to the more general rules, indicated above. There is little indication that if general or detailed rules have different costs for the regulator in their formation and application that this has been on its own a determinative consideration.⁴⁶

In relation to the costs of the rules for the regulated, SIB is statutorily required to have satisfactory arrangements for taking account of the costs of compliance with its provisions when forming rules.⁴⁷ However these do not have appeared to have had a significant, or even partial, effect on decisions either as to the substance or the type of rule. The Board is advised by the staff of the relative compliance costs of each policy option proposed, but detailed evaluation is rarely undertaken. An exception was the costing of the enhanced product disclosure rules. Transitional provisions (delaying the implementation of new provisions) and the granting of waivers appear to be the principal mechanisms used to reduce costs, and these are mainly costs associated with any system changes within a firm which compliance with the rules may necessitate. This lack of rigorous consideration of costs has been recently criticised by SIB's current chairman, who proposed that the regulators should begin to collect information on the practical effects of the rules and begin to develop the methodology to be able to quantify the relative costs and benefits of rule making initiatives.⁴⁸

Enforcement considerations have had a general influence on decisions on the substance

⁴⁵ See Chapter 6

⁴⁶ See Chapter 1, although for areas where it has been a partial consideration, see Chapter 6.

⁴⁷ Schedule 7, para 2A FSA 1986, inserted by s.204 CA 1989.

⁴⁸ Large Report, paras 7.14-7.23.

of the rules, and the enforcement and legal divisions of SFA and Lautro particularly co-operate on rule interpretation and amendments. The regulators state that they have been concerned not to promulgate rules which do not understand the practices of the industry, and so which cannot be sensibly enforced, as this would bring the regulation itself into disrepute. Enforceability has also prompted the formation of rules which make conduct visible or measurable, as the amendments to the suitability rule and the role of price in assessing best execution show.⁴⁹

The rule making decisions have thus been influenced by a wide range of factors, a number of which interact. They have affected both the substance of the rule and the type of rule used. Indeed, a striking aspect of rule formation in this area has been the extent to which rule type has been a policy issue in its own right, with rule structure and status particularly seen as an important elements in achieving the rule maker's objectives. The next section will explore the rule making decisions in more depth, looking at how rule makers have recognised and used the implications of rule type to achieve their different aims.

Implications of rule type

In Chapter 1 it was suggested that different decisions as to rule structure and status would have different implications for the discretion afforded the rule's applier, for interpretation and compliance, for the predictability and flexibility afforded by the rule and for the costs of formation and application. Bearing in mind the general factors indicated above, this section will examine why the regulators have used different types of rules, ie of differing character, status and structure, for different purposes, and how the function of the rule has had a significant impact on the type of rule used. The recognition and use of these implications illustrates that rule making, and particularly the formation of the New Settlement rules, has to a significant degree been a self-

⁴⁹ See Chapters 6 and 7.

conscious and tactical exercise, one aimed at altering the way in which regulation is perceived.

Discretion or Decisional Jurisdiction

The implications of different types of rules for the conferral of discretion has been a significant factor which has influenced rule structure. The use of general rules to confer discretion has been the result of both a failure and unwillingness on the part of the rule maker to decide what the rule should apply to,⁵⁰ the rule maker's inability to articulate the requirements of the rule more clearly or precisely,⁵¹ and a deliberate policy to give the rule's applier a choice as to what conduct was necessary to comply with the rule. The use of rule structure in this last manner indicates the extent to which the regulator feels able to rely on the person applying the rule to use his or her decisional jurisdiction in a way which will further the rule's purpose. The type of rules drafted may therefore vary with their audience. The SFA rules relating to professionals, for example, are now less detailed than initially, and contrast with the more specific requirements of rules regulating the retail sector. Fimbra's draft rules take a direct approach, putting the rule in the second person, "you must", as opposed to the more impersonal third person, "a firm must". The regulators have explicitly linked their expectations of the regulated's conduct with the types of rules which are written, and indeed used rule structure to influence the behaviour of the regulated, as we saw above. Sir David Walker introduced his Principles as an implicit contract with the regulated: you comply with the spirit of the rules, and we will not impose detailed requirements on you. His successor, Andrew Large, has spoken explicitly of this contract and recently emphasised that the more SIB felt able to rely on rising standards of competence and business ethics of the regulated the less prescriptive the rules may be able to become.⁵²

⁵⁰ See the discussion on the Introduction to the Principles in Chapter 5.

⁵¹ In relation to conduct regulation, see below and Chapter 7.

⁵² Large Report, para 6.5.

Rule structure has also reflected the trust that the supervisory body has over the regulator which it supervises. The insistence by the DTI on detailed provisions in SIB's rules reflected an uncertainty and lack of trust as to how its rule making powers would be used, and its demands and sentiments echoed those of MPs in the formation of the enabling legislation.⁵³ SIB's strict interpretation of the equivalency requirement stemmed largely from similar concerns. The adoption of the New Settlement rule system was a deliberate attempt to distribute power and scope of action within the regulatory system. The retreat by SIB from the formation of detailed rules was intended to convey the impression that the SROs were to be relied upon to make these more detailed decisions. The rule structure of the Core Rules and third tier rules was designed to reflect the accompanying philosophy that SIB should "stand back" from the detail of regulation, and "hand the baton of innovation" to the third tier.⁵⁴ However, the change in rule structure was also accompanied by a change in status which to a significant extent denied the freedom that the new structure would suggest: in changing the status of the rules to apply to SRO members, SIB simultaneously maintained control over the SRO rules. Any change in the nature and number of the Core Rules will therefore reflect, and possibly prompt, a change in the relationship between SIB and the SROs, one in which SIB seeks control over SROs' rules and regulatory activities less through its own rules and more through an overall monitoring of the SRO's activities according to stipulated standards or "goalposts" of investor protection.⁵⁵ However, a reluctance to relinquish the control which comes through the Core Rules without being assured of the form the SROs' rules will take and some form of detailed standards to which they must comply can be expected.

Interpretation and Compliance

⁵³ See Chapters 3 and 4.

⁵⁴ See Chapters 4 and 5.

⁵⁵ See the Large Report and above.

The implication of rule structure for interpretation and compliance is linked to that of control and conferral of discretion, discussed above. The influence of a rule's anticipated or actual interpretation on decisions as to its structure is evident in cases where the rule maker has felt that general requirements would not be interpreted as the rule maker would like and so the rule needs to specify what is required more closely. This has been the case in the rules on information provision in the retail sector, where failure of firms to comply with the purpose of the general rule and anticipation of avoidance of the rules has led to more detailed rules. However detailed rules have also been deliberately not used in some cases on the grounds that they need constant updating and are too easy to avoid.⁵⁶ Legalistic interpretations of detailed rules prompted the introduction of the Principles.

A mass of detailed rules can also lead to greater difficulties in interpretation as they can obscure the purpose behind the rules, and paradoxically can confer greater discretion. The economic analyses of rules which stipulate when detailed rules should be used do not seem to give consideration to this point.⁵⁷ Uncertainty and unpredictability can result as it becomes uncertain how a firm should act in a situation which is not exactly covered by the rule as the rule's purpose is unclear. It was in recognition of this that the idea of the principles was born, although this role which they played in the New Approach rules was more limited (in significance rather than number) than the Statements of Principle which were eventually formed.⁵⁸

Predictability and flexibility

As the above discussion indicates, one of the problems of designing rules to provide predictability is that it is not immediately apparent which type of rule should be used. Although not its primary aim, the development of the three tier rule system has had considerable benefits

⁵⁶ See for example the definition of soft commissions in Chapter 6.

⁵⁷ See Chapter 1.

⁵⁸ See Chapter 5.

in addressing the issue of how the advantages of detailed rules (certainty and predictability) can be combined with the advantages of standards (flexibility, purposive interpretation) to minimise the disadvantage of both: uncertainty. This has been achieved through using the structure, status and character of the rules. The arrangement of the rules in a hierarchical rule system, with the Principles at the apex, has relieved some of the pressure for detailed rules which comes from the desire for control and predictability. The general, relatively simple and opaque structure of the Principles makes loophole hunting a fairly fruitless activity, and has thus reduced the scope for "creative compliance"⁵⁹ or technical avoidance of the provisions. It has also enabled SRO rule makers to draft rules which are less prescriptive. SFA, for example, feel that the Principles act as a safety net under the detailed rules, and mean that they do not have to try to include in the rule every situation which they wish the rule to cover, or define precisely the conduct or disclosures required or prohibited. The efficacy of the Principles in this respect has been illustrated by their successful use in disciplinary proceedings by the regulators, particularly SFA and Lautro. The use of guidance in the third tier rules was also aimed at combining predictability with flexibility: the guidance is largely suggestive or recommendatory in character,⁶⁰ indicating what conduct will constitute compliance, but provides that the rule may also be complied with in some other manner - the onus being on the firm to show compliance. Thus to an extent the rule system of Principles, third tier rules and guidance (though notably, not particularly the Core Rules) provides a synergy of different rule types albeit, as we saw in Chapter 5, at the expense of simplicity of the overall rule system.

Implications of decisions on one dimension for decisions on others

The study has also indicated that decisions on one dimension can affect decisions on other dimensions. It was the change in status of the Principles, for example, which enabled these rules

⁵⁹ See Chapter 1.

⁶⁰ Although Chapter 5 noted some exceptions.

to adopt the structure of standards. This structure, it was felt, would not provide sufficient certainty and predictability for a firm if breach led to civil liability. However, if the firm knew that the Principles would be interpreted by the regulators not the courts, then the firm would feel that the Principles would be interpreted with greater understanding and sympathy, and so the lack of certainty would be mitigated. A similar line of thinking influenced SFA's formation of rules relating to professional customers. As these customers could no longer bring a civil action for a firm's breach, SFA felt that it could afford to write less precise and more opaque rules.⁶¹

Decisions on the substance of the rule can also affect its structure. The thesis has shown that the decision to impose conduct regulation can constrain the degree to which the rule can be precise or even clear, although this constraint does not appear to arise from disclosure or structural regulation, the rules in relation to which have been both simple and complex, vague and precise, clear and opaque.⁶² If the aim of the rule is to require actors to make judgements or assessments, then the rule has to have a structure which facilitates this. Such a structure is one which uses opaque terms such as "reasonable" or "suitable" which both require and allow that judgement to be exercised.⁶³ The rule maker may have chosen conduct regulation over more precise requirements due to the ease with which the latter could be avoided, or to avoid the more arbitrary implications which these rules could result in;⁶⁴ or the requirement may be such, as in the suitability rule, that the rule maker could not articulate the requirement more clearly in a rule of wide scope and application.⁶⁵ The rule maker has to rely on the judgement of the applier, but the rule itself cannot improve that judgement. Other approaches therefore have to be used: training and competence requirements for example, to improve the quality of the judgement made.

⁶¹ See Chapter 5.

⁶² See Chapters 5-7.

⁶³ See Chapter 1.

⁶⁴ See for example, Chapter 6 (proposals for rules on multiples and percentage of business were replaced by conduct requirements).

⁶⁵ See Chapter 7.

The Functions of Rules

This study of the formation of the conduct of business rules has shown that regulators have used rules not just for the direct and obvious purpose of regulating the practice and behaviour of those involved in investment business but for more complex functions. In making decisions on these rules, we have seen that the objectives of the regulation and the substantive area being regulated have been significant considerations. However, the reasons for using rules, and more particularly for using different types of rules, have also been more subtle. The attention paid to rule structure and status indicates that rule making, particularly of the New Settlement rules, has been to a significant extent a self-conscious and tactical exercise. Rules have been used as signals, to influence conduct, alter perceptions and communicate expectations. Rule structure has been used to communicate to other regulators what the role of each within the system should be, and with a wider community as to what the regulation is doing. It has also been used to communicate expectations in a complex context in which the regulators conceive of a contract or agreement between them and the regulated.

Rule structure and status has also been used to alter perceptions of the relative roles of the regulators. The Principles provide an example of rules acting as shields, but in a more sophisticated manner than Jowell's initial example suggested.⁶⁶ They enable SIB to justify its position within the regulatory system. The Principles act as SIB's flagship, and can be used to shield itself from criticisms of the regulated or political community of over-regulation and intrusion by offering evidence that SIB is simply setting essential standards of business integrity which the regulated and regulators should follow.⁶⁷

Conclusion

⁶⁶ J.L. Jowell, *Law and Bureaucracy* (New York, 1975), p.20.

⁶⁷ See, for example, HC Paper no.733-i, op.cit., Mr. Andrew Large, para 39.

This thesis has studied the rule making activities of financial services regulators with two principal aims in mind. Firstly, to understand how at least part of the regulation operates and the basis on which it is formed in this important area of economic life. The FSA subjected large sectors of the financial services industry, particularly the City, to regulation for the first time, and moreover it placed sectors of the market which had seen themselves as traditionally and culturally distinct in the same regulatory boat. Despite its presentation as "self regulation" the regulatory structure had a far greater statutory element than at least the City had ever experienced before, and the way in which the statute was implemented through the detailed rule books of SIB was, to adapt the words of SIB's current chairman, a cultural shock.⁶⁸ The origins of the regulation and its institutional structure provide a striking example of the manner and extent to which agencies are indeed "institutions of compromise",⁶⁹ and how that compromise is manifested not just in conflicting objectives but in the structure of the agency itself. The thesis has been interested in financial services regulation for its own sake, to consider how it evolved and how we can understand at least some of the rules which have been made.

Secondly, the rule making powers of SIB and the rule based nature of the regulation are unusual in the UK. The thesis therefore focused on this area of regulatory activity to understand through an empirical study how that important function has been carried out as part of the wider consideration of regulatory agencies in public law. Understanding rule making involved asking a more complicated question than what factors influenced the policy formation of the agency, however. The thesis aimed firstly to consider from a theoretical point of view what rule making consisted of, what type of issues fell to be decided when a rule was being formed, what the implications of different rule making decisions might be and what factors would influence that decision, and then to study rule making empirically with these considerations in mind in an

⁶⁸ In his Report, Large described the Act as "culturally unfamiliar", Summary, para 4.

⁶⁹ D.C. Hague, W.J.M. McKenzie and A. Barker, *Public Policy and Private Interests: The Institutions of Compromise* (London, 1975).

attempt to develop a more sophisticated, and conceptual, understanding of the operation of one part of the regulatory function.

The study also has practical implications. Where non-legislative rules have been considered by public lawyers it has traditionally been with concern for their status and legitimacy.⁷⁰ However, rule making is becoming seen at least in some academic writing as an inevitable, and indeed a preferable way for regulation to be formed.⁷¹ Political recognition of these views has so far been slow,⁷² but we may expect perhaps that in the future agencies may increasingly be endowed with rule making powers. A study of rule making by regulators who have these powers provides an indication of firstly, what such statutes should provide, and secondly, how we might expect the rule making function to be carried out. It provides information on the way in which the regulatory institutions operate so that we can fashion participation, accountability and control mechanisms accordingly. The use of agencies to write rules can combine the benefits of expertise, speed, flexibility, and of wider consultation and participation than accompanies the formation of statutory instruments. However, the traditional sources and forms of control which public lawyers seek, Parliament and/or the executive, conflict with the rationales for using regulatory agencies and endowing them with rule making powers. Government or Parliamentary involvement in the rule or policy formation is slow and not necessarily expert nor efficient. Judicial review as a form of accountability is at best imperfect: it is ad hoc, partial, and judicial decisions may not give full recognition to the functions and role of the agencies. This is not to say that it cannot be important; however it cannot be relied on as the principal form of accountability. Given these considerations, other forms of accountability have

⁷⁰ J. Beatson, "Legislative Control of Administrative Rule Making", (1979) 12 *Cornell Int'l LJ* 199; R. Baldwin and J. Houghton, "Circular Arguments: The Status and Legitimacy of Administrative Rules", 1986 *Public Law* 239; G. Ganz, *Quasi-Legislation* (London, 1987) and P.P. Craig, *Administrative Law*, (London, 1989) pp.191-5.

⁷¹ See for example, Baldwin and McCrudden, *op.cit.*, p.330; I. Harden and N. Lewis, *The Noble Lie* (London, 1986), chapter 8.

⁷² Although see the report of the Rippon Commission, *Making the Law*, (London, 1992), para 262 which recommended increased use of delegated legislation.

therefore to be sought.

The FSA provides some part of a model which other statutes granting rule making powers should follow. The statute sets out principles to which SIB's rules have to conform. SIB has to conduct consultation prior to the formation of its rules, and this applies to all rules and guidance. The experience of the US Administrative Procedure Act 1946 suggests that such consultation requirements and procedures should not distinguish between different rule types.⁷³ The effect of breach of each one of the different types of rule is specified in statute, thus removing an uncertainty of status which prevails over much delegated legislation.⁷⁴ The statute specifies that the Boards of both SIB and the SROs must have lay representatives. It also specifies what each supervisory body's powers are to amend or otherwise affect (by permitting derogations) the rules of its supervisee: the Government's in relation to SIB, SIB's in relation to the SROs.

In its rule making provisions the Act has failings, or potential failings, which should however be noted. One fundamental failing is the ambiguity of the exact nature of the relationship between the regulators and the lack of coherence of SIB's powers, which stems in part from the piecemeal and incremental alterations of the structure over the course of the initial legislative process and subsequent amendments to the Act. SIB acts as a direct regulator yet oversees the direct regulatory activities of SROs, its rule making powers are of a different scope to its enforcement powers, and it has no "system management" powers, ie it cannot require recognised bodies to re-form or firms to seek authorisation through particular SROs in the interests of the regulatory system as a whole. There is a dissonance between the scope of its rule making and enforcement powers. It can make rules which apply to members of SROs, but has no direct enforcement powers over them unless the SRO appears unwilling or unable to act. However, it is to SIB as main regulator that the public look for direct action in the event of a failure. Andrew Large has indicated that he may seek statutory changes to bring SIB's enforcement powers in line

⁷³ See above.

⁷⁴ See Baldwin and Houghton, *op.cit.*

with those on rule making. Further, the statute does not make it clear whether SIB's rules can override common law. Statutory consideration of this matter could have pre-empted the Law Commission's review, currently in its third year.⁷⁵ It does detail what matters the conduct of business rules may make provision for, but the power is permissive rather than mandatory. Given the general nature of the provisions, the power could arguably afford to be mandatory without compromising the flexibility of the agency's rules. The current chairman of SIB has also criticised the absence of detailed standards for assessing the operations of the regulators and stressed that the setting of specific standards of regulation and performance measures would be an urgent task for SIB.⁷⁶ More intractable problems are raised by the process of rule making and the participation that affected groups have in fact (as opposed to in law). Large organised groups will always have a louder voice than the disaggregated consumer interest.⁷⁷ Lay representation on the Boards and consultation requirements go some way to addressing this; funded advisory groups and select committee oversight could go further.

This study of regulatory rule making is not only of prospective value, its approach could be applied to other agencies which issue rules in the same area, the Takeover Panel, for example, or the US Securities and Exchange Commission, to other rules of SIB, or to non-financial regulators. The nature of the study could also be extended from understanding the rule making decisions made by regulators to examining their effectiveness. Do different types of rules improve compliance, for example? What effect do different rule types actually have on the enforcement activities of the agency? As it is the first examination of these agencies and one of the few UK studies of the rule making activities of any agency, the thesis has not been able to explore these issues. It has shown, however, that regulatory rule making is an important and profitable area of

⁷⁵ Law Commission, *Fiduciary Duties and Regulatory Rules*, CP No.124 (London, 1992), reference made in April 1990.

⁷⁶ Large Report, para 3.22.

⁷⁷ See M. Olson, *The Logic of Collective Action* (1971) and M. Trebilcock, "Winners and Losers in the Regulatory System: Must the Consumer Always Lose?" (1975) 13 *Osgoode Hall LR* 619.

study for both public lawyers and area specialists concerned to further their understanding of regulation.

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Richard Parrett, SFA
David Brewster, IMRO
Barbara Muston, SIB
Martin Howe, OFT
Bob Ferguson, SIB
David Severn, SIB
Richard Cockcroft, Fimbra
Sir Mark Weinberg, MIBOC Chairman 1985-87
Colin Hawtin, Lautro
Julia Leisching, Lautro
Colette Bowe, SIB
Glenda Davies, SFA
Jane Vass, Consumers' Association
Sir Kenneth Berrill, SIB Chairman 1985-88
Roy Croft, SIB
Professor Bob Jack, SFA Independent Board Member
John Morgan, IMRO Chief Executive 1986-1993
Philip Brown, IMRO
Dame Rachel Waterhouse, SIB Independent Board Member
Andrew Whittaker, SIB
Michael Blair, SIB
Richard Smethurst, IMRO Independent Board Member
Professor Jim Gower
Sir David Walker, SIB Chairman 1988-92
Stuart Willey, Lautro

List of Responses to the Retail Regulation Review

Association of British Insurers
Association of Investment Trust Companies
British Bankers' Association
British Insurance and Investment Brokers' Association
Building Societies' Association
Consumers' Association
Institute of Chartered Accountants
Law Society

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