Making a success of Principles-based regulation

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The UK Financial Services Authority (FSA) leads the way in the development of Principles-based regulation of the financial services industry. It is proposing a significant shift towards reliance on broadly stated Principles rather than more detailed rules. The implications of a more Principles-based approach for regulators, those regulated by the FSA and those whose interests the regulatory regime is designed to protect are the subject of ongoing dialogue.

This article seeks to contribute to that dialogue by examining the following questions:

1. *What is really meant by "Principles-based regulation" in this context?*

The UK introduced Principles in financial services regulation in 1990. What is new or different about what the FSA now talks of as a "more Principles-based approach"? We suggest that the current debate often conflates a number of related but distinct approaches to regulation but that there is evidence of a radically different approach to regulation in some areas – most notably in the context of the FSA's Treating Customers Fairly (TCF) initiative.

2. *What are the main benefits and opportunities to be derived from a more Principles-based regime for the UK financial services industry?*

As the FSA seeks to shift the balance of its rulebook in favour of a more Principles-based approach, it is important to consider the benefits and opportunities that are presented to regulators, regulated entities and consumers and how a more Principles-based approach might assist in achieving the FSA's statutory objectives.

3. *What are the risks and challenges associated with regulating in this way?*

New approaches to regulation bring new challenges. Risks and challenges arise in a number of different areas, from "constitutional" issues over maintaining the accountability of regulators to practical issues such as the different skills and approaches required from supervisors, senior management, compliance staff, enforcers, tribunals, the courts and so on.

4. *What are the "critical success factors" for a more Principles-based approach?*

Based on discussion on the above questions, we want to advance thinking about what conditions are necessary in order to make Principles-based regulation a success. For example, how should decisions be made about what type of rule or standard is appropriate to achieve a particular outcome? What should be the role of industry guidance? What approach is required from supervision and enforcement staff? What can be done to address accountability concerns?

We have discussed these issues with stakeholders from across the regulated financial services industry, regulators and other groups. This article sets out our analysis of the key issues that have emerged.

A. What does Principles-based regulation mean?

In general terms, Principles-based regulation means moving away from reliance on detailed, prescriptive rules and relying more on high-level, broadly stated rules or Principles to set the standards by which regulated firms must conduct business.

However, a study of what the FSA has said and (in some areas) done in recent years reveals that there are a number of connected but distinct regulatory approaches working under the banner of "Principles-based regulation", some of them suggesting potentially radical developments in the relationship between the FSA and the industry it regulates.

At least three elements in the FSA's current thinking can be identified:

- broad-based standards in preference to detailed rules;
- outcomes-based regulation;
- increasing senior management responsibility.

These strategies may be related and may be used together, but they are different and, importantly, they are therefore likely to raise different practical issues for regulators and regulated.

1. Broad-based standards in preference to detailed rules

The term "principles" can be used simply to refer to general rules, or also to suggest that these rules are implicitly higher in the implicit or explicit hierarchy of norms than more detailed rules: they express the fundamental obligations that all should observe. In the FSA context, Principles refer to both the type of rule and its position in a hierarchy of rules. The eleven Principles for Business are general rules, which set out the main obligations on firms, and are those provisions from which the other rules and guidance in the FSA Handbook flow.[1]

The use of Principles, rather than reliance solely on more detailed and prescriptive rules, has been a feature of the regulatory regime for financial services since 1990.[2] The Principles have a number of characteristics:

- They are drafted at a high level of generality, with the intention that they should be overarching requirements that can be applied flexibly to a rapidly changing industry.
- They contain terms that are qualitative not quantitative: general, usually evaluative terms ("fair", "reasonable", "suitable") as opposed to "bright line" rules ("within two business days", "turnover of £20m").
- They are purposive, expressing the reason behind the rule.
- They have very broad application to a diverse range of circumstances.
- The Principles are largely behavioural standards – they are concerned with, for example, the "integrity", "skill care and diligence" and "reasonable care" with which authorised firms or approved persons conduct and organise their businesses and the fairness with which they treat customers and manage conflicts of interest.
- It follows that breach of a Principle must involve an element of fault.[3]
- Breach of the Principles can be sanctioned through public (but not private) enforcement action.[4]

Although the FSA always made clear that the Principles might apply "in situations where no rule or guidance *yet* exists" (emphasis added), "amplification" of the Principles through other provisions of the Handbook was integral to the model of the FSA's Handbook.[5] Indeed, the FSA sought to reassure the industry that the circumstances in which enforcement action would be taken on the basis of the Principles alone would be rare.[6] The Principles enable supervisors and enforcers to police the spirit of the rules as well as the letter, avoiding "creative compliance"[7] and the need for the rules to anticipate every possible situation.

More recently, the FSA has made plain its intention to place greater reliance on the Principles alone. The FSA no longer considers that enforcement on the basis of Principles alone should be regarded as exceptional.[8] The FSA also intends to rely increasingly on Principles alone (supported by formal and informal guidance) in setting and developing standards. This approach is illustrated in TCF and the FSA's decision not to resort to writing new rules in order to achieve changes in the behaviour of regulated firms.[9]

For example, in the context of TCF the FSA has concentrated a great deal of attention on the processes by which firms design financial products. This is a radical change of focus: outside the context of regulated funds, product design has traditionally received very little attention from regulators whose focus has primarily been on the sales and advice process. Nevertheless, the FSA proceeds not by making new rules but through a combination of exhortation (in discussion papers, speeches, examples of good and bad practice and other material), supervisory work and the threat of possible enforcement action.[10] In this way Principle 6 (fair treatment of customers) has been used to effect a significant change in regulatory policy.

2. Outcomes-based regulation

A different theme running through much of what the FSA says about Principles-based regulation is the focus on "outcomes". In a speech in December 2006 the FSA's Director of Retail Policy defined the move to a more Principles-based approach as "a shift of emphasis by the FSA away from looking at the processes carried out by firms, towards the outcomes we seek to achieve, for consumers, firms and markets".[11]

The logic of this strategy is compelling. It is based on the idea that firms and their management are better placed than regulators to determine what processes and actions are required within their businesses to achieve a given regulatory objective. So regulators, instead of focusing on prescribing the processes or actions that firms must take, should step back and define the outcomes that they require firms to achieve. Firms and their management will then be free to find the most efficient way of achieving the outcome required. Other regulators, such as the Financial Reporting Council, have also been adopting this type of approach.[12] Here the FSA seems to be talking about a strategy that is significantly different to the Principles-based approach practised in the UK since the early 1990s. The focus on outcomes, as described by the FSA, resembles a form of

Table 1. TCF outcomes

Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture
Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly
Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale
Where consumers receive advice, the advice is suitable and takes account of their circumstances
Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect
Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint

performance-based regulation. In contrast to the setting of behavioural standards or standards of conduct, performance standards specify the outcome required but leave the specific measures to achieve that outcome up to the discretion of the regulated firm.[13] The outcome or performance standard may be tightly defined (eg, where rail operators are required to meet quantitative performance targets in respect of delays to trains) or more loosely defined. The "outcomes" that the FSA seems to have in mind appear to be much more loosely defined. In its July 2006 paper on TCF the FSA seeks to define six outcomes, as listed in Table 1.

It remains unclear how the FSA will measure, or expects firms to measure, the achievement of these outcomes or what consequences flow (in terms of supervisory or enforcement responses) from failure to achieve these outcomes.

3. Increased senior management responsibility

Sir Callum McCarthy has made clear that he expects the move to a more Principles-based approach to result in "intensified reliance" on the senior management of regulated firms.[14]

However, it can be argued that through the TCF initiative the FSA is also increasing the focus on the activities of senior management in a different and novel way. Much of the progress that has been made has resulted from the "TCF programmes" that the FSA has encouraged, exhorted and, most recently, mandated firms to undertake, rather than the specification of outcomes or guidance on standards. Over time the TCF initiative has developed from gentle encouragement to a consideration of how firms treat their customers.[15] It now involves an analysis of the key stages of the "product life cycle"[16] and a framework for the steps that senior management must now take to assist them in ensuring that TCF is effectively embedded into a firm's values, culture and the way it conducts business:[17] In 2006 the FSA was set a "deadline" of the end of March 2007 for firms to get to the "implementing stage" of their TCF programmes.[18]

Table 2. Key elements of a TCF Programme

Defining what TCF means for the firm
Assessing current performance to identify gaps where the firm is not delivering TCF satisfactorily
Developing an action plan to close any identified gaps and to embed the concept of TCF into the firm's strategy, operations and culture
Implementing change through existing programmes or new initiatives
Monitoring the effectiveness of these programmes, using relevant management information

The cost of this process to the industry must be very significant. The benefits for consumers may be very great indeed. But all of this has been achieved without writing new rules or setting clear outcomes against which firms can easily measure their compliance or performance.

Another example of such an approach can be found in the FSA's rules and guidance on conflicts of interest, which require firms to review their businesses, assess where conflicts or potential conflicts arise and put in place measures to manage those conflicts.[19] Firms are thus left to develop their own internal policies or "rules" for addressing these issues (with the assistance of guidance from the regulator as to what those policies should typically include). This is a radically different form of regulation – a form of "management-based regulation".[20] In this mode of Principles-based regulation, the FSA does not prescribe the processes that firms should use in conducting their regulated business. Nor does the FSA specify the outcomes that should be achieved in anything but the most general of terms. Instead, the FSA encourages or requires management of regulated firms to undertake certain disciplined programmes of review that are designed to enable the firm's own management to identify what is the best way to organise the firm's business to achieve a broadly stated regulatory goal. The FSA sets out the key elements that any regulated firm should address, but gives the firm considerable latitude to determine what the outcome of its analysis should be.

B. What are the potential benefits of a more Principles-based approach?

Assessing the benefits and drawbacks of each of these three strategies in detail has merit, but is beyond the scope of this particular paper. Instead, we will focus mainly on the first type of strategy: using a particular type of rule to express required standards of behaviour. But we will also consider the extent to which there is a degree of "fit" or "misfit" between the three strategies.

The potential benefits claimed of using Principles are that they provide flexibility, are more likely to produce behaviour which fulfils the regulatory objectives, and are easier to comply with. Detailed rules, it is often claimed, provide certainty, a clear standard of behaviour and are easier to apply consistently and without retrospectivity. However, they can lead to gaps, inconsistencies, rigidity and are prone to "creative compliance", to the need for constant adjustment to new situations and to the ratchet syndrome, as more rules are created to address new problems or close new gaps, creating more gaps and so on.

Before we can assess the potential benefits of using Principles as opposed to detailed rules, however, we need to bear in mind four inherent limitations of rules and rule-making.

1. The "golden rules" of rules

Rules are an integral part of regulation, but they are not a perfect regulatory instrument. All written rules, Principles or standards have the following limitations:

- Rules are just a "best guess" as to the future. The rule-maker has to anticipate how the rule will be applied in the future: new situations may arise that were not

expected/known about when the rule was written, and the rule may be interpreted and applied in ways that were not intended or anticipated by the writer.
- Rules are never perfectly congruent with their purpose – they are always over-inclusive and under-inclusive. Rules are inevitably either under-inclusive, failing to catch things that the rule-maker might want to catch, and/or over-inclusive, catching things that the rule-maker might not want to catch when applied to particular sets of circumstances. The question is how to minimise (rather than avoid) these problems, and whether it is preferable to exclude conduct that should be included if the objectives are to be served, or to include conduct that should be excluded.
- Whether a rule is clear or certain depends on shared understandings. Just looking at a rule does not tell us whether it is certain. Saying that a contract requires "consideration" may be clear to a lawyer, but is far from clear to a non-lawyer. Whether or not a rule is "certain" depends not so much on whether it is detailed or general, but whether all those applying the rule (regulator, regulated firm, court/tribunal) agree on what the rule means.
- How a rule affects behaviour does not depend solely on the rule. We will explore the issue of how rules affect behaviour in more detail below, suffice to note here that whether a rule has the desired effect on behaviour depends only partly on whether it is a precise, detailed rule or whether it is a principle. The firm's own attitude to regulation, the incentive structures for compliance and non-compliance, the levels of trust within the regulatory regime and the approach taken to enforcement, are also critical.

2. What we want from rules and what we can get

Most of us want three things from rules (whether principles or more detailed rules): simplicity and ease of application, clarity or certainty as to what we have to do to comply, and congruence with their purpose – achievement of what it is they are intended to achieve. Related to congruence is a fourth aim of regulators: to reduce the scope for creative compliance.

These first three qualities are what the FSA promises of Principles. That they will be outcome based, which at least in one sense suggests that they should be in line with the purposes of the regulatory regime; that they will facilitate compliance as they will be easier to apply; and that they will be predictable in their application – everyone will know what is expected of them. Unfortunately, rules, be they principles or more detailed rules, can never meet all of these demands. Instead, they can only ever score three out of four, at best, as Tables 3 and Table 4 illustrate. Table 3 shows a hypothetical example of three different types of rules which could be used (with paraphrasing) to communicate the requirements with respect to timely execution.[21]

The Type 1 rule is a "bright line" rule: it sets out a single criterion which has to be satisfied for the rule to apply, expressed as a quantitative measure. It is clear and straightforward to apply, but, as is well recognised, can fail to achieve its purpose (fair treatment of customers) as there may be circumstances in which customers' interests would be better served by executing orders of under 10,000 securities over a longer period. It is easy to manipulate or "creatively comply" with (orders could be aggregated to avoid the rule) and indeed the rule may be missing the point completely as volume amount is not necessarily a good measure by which to identify which customers are in need of this requirement of firms.

The Type 2 rule, the "Principle", is quite different in nature. It expresses the aim of the rule – to apply to those who are in practice exercising control. It is focused on the substantive objective. However, whether or not it is certain depends on whether both regulated firms and the regulator agree on what constitutes "paying due regard" and "treating customers fairly". Moreover, whilst it looks simple to apply

Table 3. Rule types illustrated

Type 1: Bright line rule	Type 2: Principle	Type 3: Complex/detailed rule
A firm must execute all orders of under 10,000 securities within one business day	A firm must pay due regard to the interests of its customers and treat them fairly	A firm must execute all orders for customers within one business day in the following circumstances: [definition of customer, definition of order, restriction as to whether discretionary dealing or execution only, definition of one business day, circumstances where large orders may be worked over a longer period, etc]

Table 4. Tradeoffs between different types of rules

Rule type	Ease of application	Congruence	Certainty	Scope for creative compliance
Type 1: Bright line	High	Low	High	High
Type 2: Principle	Depends	High	Depends	Low
Type 3: Complex standard	Low	High	High	High

(there is just one condition to meet), in practice a whole range of factors will have to be considered, which may make it as complex to apply as a Type 3 rule.

Type 3 is a detailed or complex rule. The list of conditions that have to be met for the rule to apply or be complied with can mean it has a higher congruence than a Type 1, bright line rule, but only if they are the appropriate criteria. It can thus potentially have the congruence of a Principle but provide more certainty than a Principle as it elaborates on what the conditions/factors are that have to be taken into account. That elaboration makes it complex to apply, however (more information is necessary, more factors have to be taken into account), and the creation of a list will inevitably leave gaps and again give scope for manipulation or creative compliance.

Principles thus have the benefit of congruence: of communicating the regulatory objectives and promoting behaviour that will achieve those objectives, and of minimising the scope for "creative compliance". Whether they are certain depends on the extent to which there is a shared understanding as to their meaning and application between regulator and regulated and any court or tribunal called upon to make a determination. Whether they are simple to apply depends on the number and type of factors to be considered in assessing their application. The type of rule which is used matters not least because it affects people's behaviour.[22] Research in tax, accounting, auditing, financial services, health and safety, and criminal law shows that whether a rule is detailed or general (a principle), combined with the consequences of breaching the rule, has a significant effect on how people respond to the rule.[23]

Nonetheless, Principles can potentially enhance compliance by promoting behaviour which is congruent with the objectives of regulation, particularly in a supervisory and enforcement context that is predictable and non-aggressive.

In particular:

- Principles can *engage senior management* in the regulatory process, and can require internal compliance divisions to develop a more strategic role.
- Principles *focus on the purpose behind the rule* rather than just on the detailed provisions.
- Principles offer *flexibility* for regulated firm and regulator in determining how to comply with the rule, facilitating the development of new business models, products, strategies and internal processes.
- Principles *enhance responsiveness* of the regulation to market innovation and other developments, increasing the durability of the Principles and reducing the need for constant amendment, thereby "future proofing" the regulatory requirements.
- Principles are *hard to manipulate*, making creative compliance difficult.
- Principles can lead to a *decluttering of the Handbook*, focusing attention on the important rules.
- Principles can lead to a greater degree of *substantive compliance* with the purpose of the rule, rather than a "box-ticking" approach, as they require firms to think through how to comply; as such they can be directly linked to management-based regulation.
- A smaller number of Principles can r*educe complexity.* Complexity can impede compliance as very few of those regulated can absorb, and remember, the information that detailed rules are trying to communicate. In contrast, a smaller number of Principles can be easier to remember and reduce the complexity of compliance. However, Principles also require greater judgement in their application, which can result in a different form of complexity.
- Principles can provide a *basis for open dialogue* between regulator and regulated firm, facilitating a co-operative and educative approach to supervision, particularly with respect to firms who are well intentioned, but either ill informed, or simply confused as to what the regulatory provisions require.[24]

Principles can promote compliance where "creative compliance" would otherwise be possible, and can prompt more substantively compliant behaviour, particularly if the penalties for non-compliance are high.[25] Where Principles are used, regulated firms are more concerned about error costs ("getting it wrong") than where rules are more precise. They are less likely to attempt to "creatively comply". However, this may have a "chilling effect" on their behaviour, prompting them to be more conservative in their interpretation as to what conduct is allowed (this is discussed further below). There is also less recourse by management to legal or other expert advice, as the scope for argument as to the proper interpretation is seen as far greater.[26] Research suggests that whether or not Principles enhance compliance depends on the broader context, in particular the incentive structures the firm has for compliance or non-compliance, and its attitude towards the regulatory regime.[27]

There is a danger, however, in thinking that "one size fits all": that the advantages and disadvantages of certain types of rules will be the same for all actors in the regulatory regime. Instead, different types of rules can help or hinder the supervision and compliance activities of regulators and others in different ways. For example, detailed, precise rules can help regulators (and gatekeepers such as auditors) discourage non-compliant behaviour when the opportunities for creative compliance are not available or clients are unaware of the precise rules.[28] Detailed rules can also be used more effectively than Principles to persuade recalcitrant or sceptical firms (or internal management) that they should change their behaviour. Detailed rules can thus empower supervisors, and indeed internal compliance officers, in certain circumstances, whereas Principles will not, as debates can always be had about their interpretation.[29] One consequence of moving to a more Principles-based approach may mean, therefore, that the compliance role will need additional senior management support, particularly when seeking to engage the business in a discussion of whether a proposed behaviour or strategy will be principle-compliant. Similarly, detailed rules are more useful for regulators dealing with ill-intentioned and ill-informed firms than more general rules.[30] Finally, detailed rules can be useful for regulators themselves, facilitating quick processing of a large number of cases, and ensuring consistency of interpretation and application by a large number of officials, particularly where they are geographically dispersed.[31]

Further, whether or not Principles enhance compliance depends on the broader regulatory context, in particular the incentive structures the firm has for compliance or non-compliance, and its attitude towards the regulatory regime.[32] In short, whether either the positive or negative effects of Principles are realised depends on more than just the principle. These issues will be addressed further below when we consider the conditions required to make Principles-based regulation a success.

3. Principles-based regulation, management- based regulation and outcome-based regulation – fit or misfit?

It was proposed at the outset of this paper that Principles-based regulation is being used by the FSA to refer not only to basing regulation on a particular type of rule, but to "outcome-based" regulation and "management-based" regulation as well. Both strategies have potential advantages which are in line with those of using Principles. Outcome-based regulation, at least to the extent that it involves a focus on substantive achievement of regulatory objectives, is compatible with using Principles. A focus on senior management responsibilities is an inherent part of Principles-based regulation in that a significant amount of responsibility for interpreting and applying the rules is devolved to the firm itself. This can have the benefit of enhancing compliance as firms take responsibility for compliance, and are better suited to knowing how their internal processes need to be structured in order to achieve compliance and to monitor them appropriately.[33]

However, there is no reason analytically why the duties of firms in outcome-based regulation and management-based regulation have to be communicated in Principles. Both outcome-based regulation and management-based regulation are also compatible with using rules which are more detailed and precise. They are thus potentially prey to the same weaknesses, and offer the same strengths, as detailed rules. All three strategies have limitations and drawbacks, however, as the next section will discuss.

C. The risks and challenges of a more Principles-based approach

There are clearly risks and challenges associated with a move to more Principles-based regulation, both for the regulator and the regulated community.

We consider these under the following headings:

- legal obstacles;
- lack of certainty;
- proliferation of guidance;
- regulatory creep and blurring of the distinction between minimum standards and best practice;
- an increasing gap between internal guidance and published Principles, rules and guidance;
- accountability issues;
- unpredictability and the risk of over-zealous/hindsight-driven enforcement;
- inappropriate skills and mindset of regulators and regulated.

1. Legal obstacles

The key legal limitation on the FSA's use of its rule-making power is EC law. Unusually for a UK regulator, the FSA has extensive rule-making powers, but its ability to use these is necessarily constrained by EC provisions. The interaction between the Principles and EC law remains unclear, but the FSA appears to envisage that firms should acquaint and advise themselves as to how the FSA's high-level Principles fit together with EC law rules.[34]

Undoubtedly the prescriptive terms of some of the rules required to be adopted pursuant to EC directives such as the Markets in Financial Instruments Directive (MiFID) will hamper a move towards Principles-based regulation. Moreover, when faced with "maximum harmonisation" measures, the FSA's ability to impose broad Principles in addition to EC requirements will also be restricted.

However, as the FSA points out, as a result of the Lamfalussy process, EC Directives increasingly include high-level requirements which are similar to Principles. For example, Article 19 of MiFID imposes a broad obligation on MiFID firms to act in the best interests of their customers. This has the same general structure as a principle, but is contained as a rule in the handbook.[35] It could be argued that the move to more broadly based standards is to be welcomed; and indeed that MiFID is in many places too detailed. But here the age-old dilemma of EU harmonisation returns – how to ensure equivalent interpretations and implementation in each Member State whilst allowing each the flexibility to develop rules for its own contexts. For example, it seems likely that the FSA might take the view that the breadth of the obligation in Article 19 of MiFID is such that all MiFID firms may still be required to meet the demands of the TCF initiative – demands that will not be made in many other EU Member States. The risk of Principles-based regulation in the EU context is thus simply the risk of implementation of Principles at the national level moved up to the supranational level: the risk that divergent interpretations of EC Principles will be adopted by regulators in different member states, thereby frustrating the harmonisation which those Principles were intended to achieve.

2. Lack of certainty

One of the criticisms usually raised against Principles-based regimes is that they do not give the industry the comfort of knowing where it stands because the meaning of the Principles is not sufficiently certain. The FSA has recognised that it must be possible to predict, at the time of the action concerned, whether or not it would be a breach of a Principle.[36] There is a distinction, however, between predictability and certainty. Certainty with respect to rules means that there is a shared understanding between those applying the rule as to its meaning and application in particular instances. Predictability refers instead to the regulatory response – that regulators will always respond to similar situations in similar ways, and so the regulated firms know what the supervisory and enforcement response will be. A degree of uncertainty can be accepted if firms know that the regulator will allow them a certain "margin of appreciation" in their interpretations, and will respect due efforts to construct a reasonable interpretation and act accordingly. Moreover, uncertainty will increase if the regulator has developed internal understandings on the application of rules that are not reflected in its published statements.[37] However, what underlies the concerns about lack of certainty is often lack of predictability: we (firms, professional advisors) may get it wrong, but will we be prosecuted/fined/sued as a result? Regulation is prospective, it aims to guide future conduct. Firms require as part of certainty confirmation from the regulator that both their current behaviour and their proposed courses of action are on one side of the line or the other, and that if the supervisor accepts that conduct now, that no enforcement action will ensue further down the track. The question is how to provide both certainty and predictability whilst giving firms the flexibility and space to innovate that Principles can create.

There may be other legal obstacles to a more Principles-based approach. For example, some of the concerns we outline below in relation to "regulatory creep" and accountability issues could be framed as legal challenges if the FSA were thought to be using the flexibility of the Principles effectively to impose new regulatory requirements without going through the statutory process of consultation and cost–benefit analysis that attaches to the promulgation of new rules or guidance.[38]

3. Proliferation of guidance

One of the principal means by which it is often suggested that sufficient certainty can be delivered is through the provision of guidance in various forms. Guidance can be provided in a number of different ways, formal and informal:

- more detailed rules;
- formal guidance from the regulator;
- informal guidance from the regulator including speeches, "Dear CEO" letters, FAQs, etc;
- guidance given by supervisors in discussions with regulated firms;
- worked examples;
- industry guidance (with or without confirmation from the regulator);
- public enforcement actions – both contested and settled;
- decisions of the Financial Ombudsman Service (FOS);
- ongoing dialogue between regulator and regulated, including individual guidance, risk mitigation plans, risk assessments.

In both financial services and tax regulation, there is a growing consensus that the most appropriate response is to combine Principles with elaboration in the form of guidance rather than more detailed rules. Indeed this is the basis on which the TCF initiative proceeds. TCF is not contained in the handbook, rather its requirements are elaborated in a series of "statements", "cluster reports", self-assessment questionnaires, fact sheets and worked examples.

However, the elaboration of Principles in different forms of guidance can itself lead to problems:

- Increasing prescription, complexity and inaccessibility can occur if Principles are elaborated in a multitude of mandatory or quasi-mandatory provisions stemming from a range of different sources. Unless great care is taken in the formulation of guidance it could simply reintroduce detail and prescription in a much less transparent and accessible way. The practical reality is that most firms currently treat most FSA guidance as though it were binding.[39] If poorly used, guidance therefore threatens the objective of giving greater freedom for firms to develop their own approaches that Principles-based regulation promises. For that objective to be achieved, there needs to be space within which firms have the freedom to manoeuvre and the confidence to exercise that freedom.
- The risk of inconsistency, as each new piece of guidance expresses another "good idea" but the overall sum of guidance is never assessed, simply because it is expressed in so many disparate sources. Further, at present, the Principles-based initiative is being pushed forward through speeches and reports, and there are issues about the internal consistency of the messages being given as to the status of different communications from FSA (eg, "Dear CEO" letters), which enhances the sense of unpredictability.
- A body of "case law" which could become increasingly complex and inaccessible and prescriptive could be generated, over time, if reliance is placed on decided cases as precedents for the interpretation of the Principles. The law of negligence has been developed through case law and through the detailed and sophisticated explanations of the application of the principles which emerge from the judgments in decided cases. However, this process proceeds according to strict rules of precedent, resulting in a complex "sedimentation" of case law[40] that requires considerable legal training to decipher, and is not necessarily a model that regulators want to follow.
- There is a particular cause for concern about the risk of inconsistent decisions taken by the FOS, which can award compensation to customers on the basis of its own opinion as to what would be fair and reasonable in the circumstances. Although Principles-based regulation does not change this position, there would clearly be cause for concern if the FOS's conception as to what is "fair and reasonable" were to depart from the FSA's views as to what the Principles require: firms may comply with the Principles and yet fall foul of the FOS.
- Individual Financial Services and Markets Tribunal ("Tribunal") decisions may assume an degree of undue significance. Cases taken to the Tribunal are relatively small in number and generated principally by those issues that involve individuals and questions of integrity. It has, with respect, to be open to some doubt as to whether the Tribunal is really the body best placed to be giving final determinations on the meaning of the Principles. For

good reasons, the Tribunal is isolated from the FSA and is not party to the regular debate that the FSA enjoys with the industry about the issues it faces and how these might be dealt with. Nor does the Tribunal system provide the sense of practitioners judging their peers that might be regarded as an important feature of other systems of professional self-regulation based on broad standards of ethical conduct. The practical consequence may be that the interpretation of the Principles is sometimes determined through the "battle of the experts" that is seen in civil litigation.
- Reliance on settled cases as authoritative interpretations of the Principles presents additional concerns: the FSA asserts that settlements have "precedent value".[41] It is impossible, however, to escape the fact that they represent a compromise on both sides. This is accentuated by the plea-bargaining that evidently takes place. The dynamics of a settlement negotiation are not conducive to a pure and objective interpretation and application of the Principles. Whilst this may not be a criticism – at all – on the facts of the particular case, it does present real difficulties in knowing how far that interpretation is applicable in other factual situations, whether directly or by analogy.
- The regulator risks depriving itself of the benefits of a Principles-based approach by an over-proliferation of guidance, creating expectations as to its own conduct in the future which may be legally binding, and infusing guidance with a sense of obligation that it does not intend guidance to have, but which firms nonetheless treat it as having.
- Uncertainty is increased as firms are never sure if they have observed every piece of guidance, statement, settlement or enforcement decision that might be relevant.

Ultimate certainty is an impossible goal. It is possible to have too much guidance in a Principles-based regime such that it becomes rule-based regulation by the back door – in a way that avoids the usual checks and balances which apply to the promulgation of formal rules. Thus although both the regulator and the industry may gain initial benefits from a Principles-based regime, as the body of informal and formal guidance grows and ossifies, those benefits will be lost unless the regulator can give firms the room in which to develop the flexibility in compliance that will allow them truly to innovate.

4. An increasing gap between internal regulatory guidance and published Principles and rules

There is a danger that in an attempt to ensure internal consistency of interpretation and application of Principles that internal guidance will proliferate which is increasingly at odds with the published Principles, rules or guidance. This increases uncertainty and unpredictability, and raises key issues of accountability.[42] For example, despite the FSA's public commitment to moving away from prescription and the "tick box" approach to supervision, some firms continue to find that supervisors have some very specific expectations as to what firms should be doing in order to comply with the requirements of TCF. Certain practices, such as the use of customer focus groups in product design or the use of "mystery shopping" to test the customer's experience of using the firm's services, are gradually becoming viewed as regulatory requirements. There is clearly a danger that the FSA's own internal guidance to supervisors, issued in an attempt to ensure consistency of approach, becomes used in practice as a set of requirements that are far from transparent to the regulated community.

5. "Regulatory creep" and the blurring of the distinction between minimum standards and best practice

Linked to the proliferation of guidance is a risk that Principles-based regulation can give rise to charges of "regulatory creep".[43] As we have seen, in the context of TCF, high-level Principles have been used to extend the FSA's scrutiny into areas such as "product design", which had not previously been thought to be the subject of regulatory requirements. "Mystery shopping" exercises have now become a routine feature of firm's TCF programmes, although they are not mandated by the FSA. The FSA might seek to extend its regulatory remit into other areas in this way under the banner of Principles-based regulation. This could result in the FSA pushing the boundaries of its statutory jurisdiction as well as raising questions as to whether it is an appropriate way to develop regulatory policy.

The reluctance to identify a bright line between what is acceptable or unacceptable may result in a blurring of the distinction between minimum standards and best practice. Firms are to be left to work out standards for themselves and there must be a risk that they will set them either uncomfortably high or too low:

- As firms develop their own "rules" in the form of internal policies and procedures, there is a risk that these become a stick with which to beat them. The FSA may hold a firm to a standard which it voluntarily adopted but which was not necessary for it to achieve compliance.[44] A more Principles-based regime might, therefore, actually operate as a disincentive to strive for higher standards.
- Conversely, it might be that the blurring of the line between minimum standards and best practice leads to a tendency for firms to adopt overly cautious approaches. This is particularly likely to be the case where they regard the standard as unclear, the stance that the regulator will take as unpredictable, or the expected cost of non-compliance as high (because of the probability of high sanctions and/or a high risk of detection and the fact that a public finding of breach of Principles is regarded as particularly damaging to reputation). This could inhibit rather than encourage innovation.

6. Accountability

This leads us into the question of accountability. Accountability is crucial to public, industry and consumer confidence in the regulatory regime. The move to more Principles-based regulation could result in concerns over accountability in a number of ways.

- As noted above, the TCF initiative has demonstrated that it is possible for the FSA to effect quite significant shifts in regulatory policy by promulgating a new interpretation of a Principle through discussion papers and the like. The requirement on firms to undertake a "TCF programme" has been imposed without any specific rule being made. TCF has been developed quite independently from the handbook. TCF is based on the Principles for Businesses, but it reaches much further into the deeper recesses of firms' activities, and indeed those of the retail product supply and distribution chain, than the handbook ever did. However, its elaboration has not been subject to the consultation processes that the FSA is obliged to go through when making rules. Although the FSA has begun to consult more formally on TCF initiatives, there is concern that Principles-based regulation could effectively be used to bypass the key statutory requirements to which the FSA is subject when it issues formal rules and guidance,[45] namely that it must consult publicly (and in particular with representatives of the industry and consumers) and must subject rules and general guidance to cost–benefit analysis.
- The FSA's proposals to "confirm" industry guidance give rise to similar issues. In its November 2006 discussion paper,[46] the FSA proposed provisions that the guidance provider demonstrate that the impacts on consumers and other market participants had been considered, and the FSA reserved the right to require them to consult with particular groups. There is to be no separate consultation requirement, however, nor will the guidance be subject to cost–benefit analysis. As the guidance is meant to be linked directly to particular handbook provisions, the FSA argues in effect that it can rely on the consultation and cost-benefit processes that attended the formation of those provisions – in other words, on a chain of accountability from the FSA through to the guidance. However, there is a need to afford adequate consultation on a more consistent basis to ensure the process does not become dominated by narrow self-interest. There are also risks for the trade associations themselves that they may fall into a role that involves them being gradually co-opted into the regulator's role in standard setting – a role that sits uncomfortably with their role as advocates for the industry.

7. Unpredictability and the risk of overzealous/hindsight-driven enforcement

It was noted above that certainty and predictability are related but separate concerns. The regulator's response to regulatory non-compliance should be predictable, rational and consistent. Principles can facilitate a co-operative and educative approach to compliance, which can help firms that are well intentioned and disposed to comply. However, compliance-based, educative approaches based on Principles and guidance are open to abuse by other, less well-intentioned firms, for whom enforcement action based on more detailed rules is more appropriate.[47] Although heavy sanctioning can act as a deterrent to non-compliance in many cases,[48] the anticipated error costs for firms of "getting it wrong" are higher with respect to Principles than detailed rules (assuming that the approach to enforcement is otherwise the same), and firms will structure their behaviour accordingly. There is a potential danger that this will lead to "over-compliance", with firms adopting overly conservative courses of action thinking that to do otherwise will be considered by the FSA to constitute non-compliance.

On the other hand, there is a strong concern that decisions about the interpretation of broadly stated Principles will be enforced after the event, sometimes in a politically charged environment. Over-zealous enforcement action is likely to lead to a deterioration of the relationship between regulator and regulated firm,[49] particularly if the firm thinks the regulator is acting with the benefit of hindsight. Reliance on reports or statements which are not issued as formal guidance, as for example in the Nationwide case[50] where the decision was based on non-compliance with an FSA Information Security Report issued in 2004 which did not constitute formal guidance, enhances both uncertainty and unpredictability, and makes it more likely that firms will treat all communications from the FSA as in effect binding rules.

Further, it is unclear at present to what extent the FSA intends that a failure to achieve the "outcomes" to which it refers should have direct regulatory consequences (eg, enforcement action) or should only be a consideration in the exercise of the FSA's discretion as to where to focus its supervisory or enforcement resources. There are a number of problems with moving to a fully outcomes-based model in which the primary, enforceable obligation imposed on firms is to achieve a specified "outcome":

- The Principles are not currently framed as outcome-based standards and would require significant amendment.
- Enforcing a rule that specifies an outcome (but not the manner in which that outcome should be achieved) is dependent on reaching a fair and objective measure as to whether or not a firm has achieved a particular outcome. This is very difficult to achieve: quantitative measures are only ever proxies for quality of behaviour, can skew activities away from the achievement of the substantive objectives, and are themselves open to creative compliance.[51] As a result, organisations can "hit the target but miss the point".[52]
- It would also require that the FSA have power to take enforcement action on the basis of failure to achieve outcomes even where there is no element of fault. This is because as soon as the element of fault is introduced, responsibility for determining what steps it is reasonable for firms to take to achieve the outcome moves from the regulated firm to the FSA and, ultimately, the Tribunal. A "no fault" enforcement regime combined with ill-defined outcomes and unreliable measures would be likely to result in stifling over-regulation and over-compliance.

It is also unclear what the FSA considers to be the enforcement consequences of its more management-based strategies. Does the FSA consider that compliance with its "deadline" for the implementation of firms' TCF programmes is required by Principle 6 or is it simply an exhortation which may, if it is not heeded, result in intensified supervisory attention? It is only recently that the FSA has confirmed, again through informal guidance, that it is the latter.[53] Enshrining management-based standards (eg, the requirement to have a TCF programme) in rules is one option. However, management-based regulation can degenerate into process-based regulation when both managers and supervisors place an emphasis on demonstrating compliance with processes, which are again easier to monitor, over demonstrating achievement of outcomes, which are far harder to assess[54] (eg, "going through the motions" of a TCF programme for the sake of satisfying the FSA). This may put management-based regulation in tension with outcome-based regulation and with the use of Principles.

Finally, it is unclear what the relationship is between Principles-based regulation and the FSA's risk framework of supervision, Arrow II. There is little discussion in the FSA's various publications as to how these will interact. Will Arrow II be in practice the supervisory face of Principles-based regulation? If so, then to what extent is the refashioning of the handbook linked into the risk factors identified in the Arrow II regime? If not, how are Arrow II and Principles-based regulation going to interact in practice? Moreover, Arrow II categorisations drive the allocation of supervisory resources. For most firms, this means that their main route for interacting with the FSA is through a call centre. Fostering a positive relationship and ensuring consistency of approach between supervisors, without the creation of a considerable body of internal FSA guidance, is a particular challenge.

8. Inappropriate skills and mindset of regulators and regulated

There is a significant risk that Principles-based regulation will fail due to an inappropriate set of skills in both the FSA and regulated firms, and a relationship that is characterised by mistrust on both sides. A more Principles-based regime will require a revolution in the relationship between firms and the FSA. It may well be that this would be a change significantly for the better, but it will only work if attitudes change correspondingly. The challenges here are twofold:

- A substantial change in the skills, judgement and mindset of supervisors is required. The FSA needs to carve out a space in which firms can innovate. This is particularly true if all reasonable efforts have been made by firms to comply. The FSA will have to demonstrate sensitivity in deploying its enforcement resources in a Principles-based regime, particularly because the reputational damage in the wake of a breach of Principle is perceived to be greater. This demands in turn a more sophisticated dialogue between firms and their supervisory officers. At present, the industry perceives a significant gap between the attitude and ability of those working in the strategy and policy division of the FSA to those working in supervision and enforcement. The former are far more willing to engage with firms than the latter. However, firms are going to have to be able to debate with supervisors the issues which they have with the application of the Principles in a way which is constructive and timely. Supervisors will have to accept that consistency of practice between different firms is not necessarily a goal in itself. Rather, what needs to be assessed is whether a particular firm's method of doing business is appropriate to enable that firm to meet the Principles, which in turn demands a good level of understanding of the reasons why the firm has decided to do business in that particular way. These judgements will also have to be backed up by the enforcement division, to reduce the risk of retrospective actions.
- A significant change in the skills, judgement and mindset of firms is equally important. The transition from prescription to Principles is not an easy one for firms. Principles-based regulation, particularly if it takes the form of the TCF initiative, requires senior management to engage with regulatory issues at the highest level, and not regard these as things that can be delegated to compliance. In turn, compliance divisions will have to develop a more strategic role, and find ways of inculcating compliance in the absence of detailed regulatory rules. The burden on compliance teams and senior management to consider issues such as those arising under the TCF initiative will thus be significant and likely to increase under a more Principles-based regime. These areas need to be staffed and resourced in such a way as to enable firms to do an effective job, bearing in mind the different skills and mindset required.

D. The "critical success factors" for a more Principles-based approach

Principles are necessary for a Principles-based regime to work, but they are not sufficient. The issue thus arises as to the conditions in which Principles-based regulation will "work" to deliver the potential benefits outlined above, to ensure synergy between the three strands of the FSA's own articulation of "Principles-based regulation" and also to maintain an appropriate degree of consumer protection and of accountability of the regulatory regime as a whole.

We propose eight key preconditions for making Principles-based regulation work for regulators, firms and investors, based on four main themes: the elaboration of Principles; supervision and enforcement; accountability; and regulatory relationships:

1. Developing criteria to identify the appropriate balance between Principles and other types of rules

In a regime of the scope and complexity of the FSA regulatory regime it is not possible simply to have Principles and guidance. Some "fixed points" are needed: rules that set out in more detailed form what conduct is required, and thus provide, in effect, safe harbours from subsequent charges of non-compliance in a more concrete way than compliance with guidance can. What is this balance, and how can we identify where more detailed rules, guidance or "fixed points" are needed? The FSA has made general statements that detailed rules will be used where necessary, and as noted, may be needed to implement EC requirements. However, there has been very little sustained attention paid to this question to date by either the FSA or industry. Some key questions, when devising criteria as to when more detailed rules (as opposed to guidance) may be needed, may include:

- Where is uniformity/standardisation or at least comparability of means (not just ends) required, by whom and for what reason? For example, there may be good reasons for providing detailed rules on how information on products and charges should be communicated to retail investors to facilitate comparability between products. Or there may be good reasons for providing common definitions of capital. Identifying where uniformity or standardisation of means or processes would be desirable requires analysis at a much greater degree of granularity than has been undertaken to date.
- Where is it more cost-effective to have a "bright line" rule, a detailed rule or a Principle, and for whom? There is an economic dimension to the issue of the appropriate balance between rules and Principles. There are three main types of cost involved in rule-making and application to be borne in mind which can be differently distributed between the regulator, the regulated and the beneficiary of the regulation depending on the type of rule adopted:
  - *the costs of rule making*: initial information costs and subsequent costs of elaboration through guidance, enforcement decisions, waivers and so on; Principles have low initial formation costs but potentially higher elaboration costs for both regulator and regulated than detailed rules
  - *the costs of rule application*: interpretation costs (in accumulating all aspects of the rule, including additional guidance, elaboration in enforcement actions and obtaining legal advice); application costs (in gathering and interpreting all relevant information to ascertain whether the rule applies); and dynamic costs (keeping up with changes in rules). These fall on both regulator and regulated, and can arise in both detailed rules and Principles. However, for regulators, the issue is where more resources are going to be invested: in elaborating requirements mainly in rules, thus investing in policy and legal divisions, or elaborating requirements expressed in Principles mainly through the supervisory process, which requires a different internal distribution of skills and resources
  - *the social and economic costs of over-inclusion or under-inclusion in particular instances.* The potential "chilling effect" on behaviour of Principles when combined with an aggressive and/or unpredictable enforcement regime was noted above. However, there is almost no work done in financial regulation as to where it would be more costly or beneficial to err on the side of making a potentially over-inclusive rule or a potentially under-inclusive rule
- Where are the incentives of firms not to comply such that more detailed rules may be needed? As noted above, one size does not fit all – detailed rules may be necessary in order to deal with certain types of firms, or at least likely responses in certain situations. Moreover, detailed rules can provide leverage from compliance divisions within firms trying to persuade senior management to develop particular processes or refrain from certain conduct on the basis of a general principle. It may be that guidance is sufficient in most cases, but rules may be necessary for particularly significant issues, notably significant market failures or where particular types of conduct poses high risks to regulatory objectives and/or where the commercial incentives for firms to get it right are weak. In the FSA context, this would mean a closer tie-in between Principles-based regulation and the risk-based regulation of Arrow II.
- Should a private right of action be available? This is a question that is specific to the FSA context, as the FSA can attach the private right of action to rules.[55] Historically, no private right of action has been attached to Principles on the basis that it would be inappropriate to subject such broadly stated obligations to private enforcement. However, some of the rules to which the private right of action attaches are themselves very broadly based (such as suitability). It is unclear what the FSA considers the implications of the move to more Principles-based regulation on the private right of action to be; or whether it considers that redress via the FOS is sufficient. The desire to provide a private right of action could, however, be a criterion for retaining or developing a rule rather than relying on a Principle in particular instances.
- What is the degree of trust between regulators and regulated firms as to whether the rule will be interpreted and applied appropriately in particular circumstances, and therefore whether Principles or more detailed rules are required? This is fundamental to the decision, but is the hardest to evaluate. This relationship is in part constituted by the rules themselves, so firms and the FSA will be unable to prejudge this issue – rather, both sides will need to work together to establish trust in the newly created regulatory context.

2. Discipline and restraint in the provision of general FSA or industry guidance

Great care will be needed to strike the right balance between the provision of guidance on the meaning of the Principles and the need to avoid the dangers inherent in the proliferation of guidance (whether from the FSA or from industry bodies).

There is substantial evidence that guidance can facilitate compliance if it the wording is kept short and concise. Worked examples can also be particularly beneficial. This is an approach that the FSA favours (both for its own and industry guidance) – the provision of case studies and examples to illustrate "good" and "bad" practice.[56] In situations of uncertainty, people make decisions by analogy. More particularly, people work out how to comply with imprecise rules by reasoning by analogy, and well-chosen examples can facilitate this process.[57] As the FSA has recognised, steps will need to be taken to ensure that the body of material available to regulated firms does not become overly complex, prescriptive and inaccessible. The problem of accessibility can be addressed in part by straightforward solutions, such as creating links in the handbook from the Principles and rules to all relevant guidance, "Dear CEO" letters, industry codes and so on. There is also a need for greater transparency of internal guidance given by the FSA to its own supervisors as to how they should test practical compliance with the Principles. But the real issue lies much deeper. All those involved in the regulatory regime have to recognise that complete certainty is rarely attainable; and moreover in seeking to provide certainty through an ever-increasing proliferation of guidance, not only can the benefits of flexibility that Principles afford be lost, but uncertainty increases as firms are never sure if they have followed all the guidance that the regulator might deem to be relevant. Both regulator and regulated firm therefore need to exercise self-restraint: on the firms' part in asking for ever greater predictability, and on the regulators' part for trying to provide it.

3. Meeting the needs of different firms

A frequent response to Principles-based regulation is that it is inappropriate for small firms who lack the resources and expertise to develop interpretations of imprecise rules, and would prefer to be simply told what to do. At the same time, most struggle to cope with the Handbook in its present form. To an extent, different firms can need different rules, with small firms relying more on regulator-produced guidance, examples and so on.[58] This is recognised in the approach employed in relation to capital requirements under the new Basle II/Capital Requirements Directive regime. This provides firms with the option of either complying with certain "bright line" rules in order to calculate their regulatory capital or developing and using their own risk models. Extension of this concept to other areas of the regulatory regime may help to address the problem that "one size does not fit all".

4. Ensuring an appropriate style of supervision and enforcement and a balance between the two

Great attention must be paid to the approach that will be taken to supervision and enforcement and the roles each will play in the Principles-based regime. There are five interrelated issues to consider here.

- Further work is needed to clarify how compliance with the Principles will be tested by the FSA and the Tribunal and what the enforcement consequences might be of failure to comply with Principles, outcomes or management-based standards. The FSA's enforcement responses need to be carefully calibrated so as not inhibit firms' willingness to develop their own solutions to compliance with the Principles. There may, for example, need to be adjustments to the level(s) of penalty, the way in which cases are chosen for enforcement, and the frequency of internal review of investigations to determine whether they should continue.
- Principles-based regulation may require a different constitution of the FSA's Regulatory Decisions Committee/the Tribunal. It may be that the "chilling" effect can be mitigated if firms are confident that they can be judged by their peers: adjudicators with a deep understanding of their business. On the other hand, a mixture of independence and experience may be a helpful safeguard against regulatory creep, and may enhance accountability: how that balance is struck is a difficult problem.
- Principles-based regulation will require a change in the FSA's approach to supervision. Predictability has to be developed through dialogue between regulated firms and the FSA. One of the key places where that dialogue occurs is in the supervisory process. The FSA needs to be prepared to offer predictability in that process by committing to judgements on the appropriateness or inappropriateness of firms' interpretations of the Principles in particular circumstances. This has particular implications for those firms who are ranked as low priorities in the FSA's risk-based supervisory regime (Arrow II). These firms do not have individual supervisors assigned to them but are referred to a call centre. Developing the appropriate dialogues and relationships of trust in this context will be particularly challenging.
- Enforcement of Principles-based regulation may require a "due diligence" defence or be based on a "range of reasonable interpretations". The FSA is currently proposing a change to its enforcement policy to apply a new test for determining whether to take enforcement action, namely whether, "had a reasonable firm in that position applied their mind to the question they would have realised the risks they faced".[59] It is questionable whether this is a sufficiently strong statement to give firms confidence to adopt diverse approaches to complying with the Principles. In contrast, due diligence defences can create incentives for managers to invest in improving their internal systems and controls, as they will be given recognition in enforcement actions.[60] There is also a strong argument for formalising their use in Principles-based regulation if the firm can show that it took all reasonable steps to interpret and apply the Principles in good faith. The question as to whether the firm should also need to show that it acted in accordance with published guidance is problematic if part of the objective of a more Principles-based approach is to encourage firms to develop their own approaches. It could be argued that, rather than strengthening the role of guidance in the enforcement process,[61] the FSA needs to do more to emphasise its non-binding nature.
- Clarification is needed on whether/when enforcement is to be based on processes or outcomes. How the proposed TCF "outcomes" will be assessed, for example, remains unclear. It is not clear what the enforcement consequences are of a failure to engage in a TCF programme.

5. Redefining the role of decided enforcement cases

Enforcement decisions will assume a particular prominence in a Principles-based regime. If we are to avoid a drift towards enforcement-led regulation – and the complexity and inaccessibility that comes with the accretion of "case law" – we need to reconsider the role enforcement plays in providing guidance to others. To date, the FSA has not always been very precise in its language and in phrasing the obligations which it determines firms are under. For example, in the Citigroup enforcement decision, the FSA interpreted Principle 2 (skill, care and diligence) as an obligation not to disrupt the efficient and orderly operation of the markets, a standard that may well have been difficult to get through a consultation process had it been issued as a rule or Principle or a provision in the FSA's Code of Market Conduct.[62] The FSA needs to recognise that it will need to be more careful in the wording of its enforcement decisions lest it develop over-reaching new provisions without going through the appropriate consultation processes. This is particularly necessary if enforcement decisions are to have the status of binding precedents.

The question still remains as to whether settlements and/or enforcement actions should in fact have formal precedent value, and, if so, what rules of precedent should be developed. Alternatively, whether settlements and/or enforcement actions should have the status of guidance or "real life" worked examples?

All public bodies are under an obligation to act reasonably, which includes a requirement to act consistently between regulatees; it is also clear that their conduct and statements can in certain circumstances give rise to legitimate expectations which can be legally enforced. Whether it is necessary to invest enforcement cases with any greater degree of precedence value than is necessary to fulfil the FSA's obligations under public law is doubtful. Given the particular circumstances in which they arise and the often limited information published as to the full circumstances surrounding them, settlements should not be seen as having any greater status than guidance. However, communication of each could be improved in simple ways, such as links from the handbook from Principles or rules to all relevant enforcement decisions and settlements, as well as to all relevant external guidance.

6. Ensuring that the accountability mechanisms in the FSA's rule-making process are not bypassed

Notwithstanding the practical benefits of using industry guidance, the FSA should also exercise self-restraint in the extent to which it relies on industry guidance, lest it become an effective outsourcing of the FSA's standard setting role. There is a strong argument that the FSA should adopt a clear policy that it will not seek to effect a significant change in industry behaviour on the basis of the Principles alone without undertaking (or ensuring that the industry body concerned undertakes) a consultation process and a cost–benefit analysis that meets the requirements of FSMA.

Elaboration of the Principles in settlement and enforcement actions also raises accountability concerns, particularly if either or both of these are to be considered binding. If the main forum in which Principles receive elaboration is enforcement proceedings, it is arguable that there should there be wider rights of access to those proceedings by interested parties, including the Consumer Panel, to put forward "Brandeis brief" type papers on their own understandings of the Principles and the implications of alternative interpretations.

7. Changing the skills and mindset of regulators and firms

A more Principles-based regime will require a significant change in the relationship between firms and the FSA. This requires a considerable shift in the mindset, attitudes and skills of both regulators and firms. The FSA needs a change in its supervisory and enforcement culture, and to improve its understanding amongst supervisors of the industry it regulates such that they can respond to the judgement calls that Principles-based regulation will require them to make. The FSA has to be in a position to provide firms with the certainty and predictability they need in order to develop their own responses to Principles-based regulation. This can only in part be provided by industry guidance. Industry guidance is helpful but ultimately does not issue from the FSA and so cannot be taken as expressing the FSA's view as to what conduct is or is not acceptable. Rather than adopting a punitive approach, the FSA needs to develop a more educative and advisory approach to supervision, and one in which it is prepared to validate firms' decisions in appropriate circumstances – in other words, to give straight answers to straight questions.

However, firms also need to adopt a more strategic approach to regulation. Senior management needs to be more closely involved in developing the firm's business objectives in the context of the regulatory requirements. Compliance staff need to develop the capacity to elaborate on and enforce Principles-based regulation within their own firms, without always having the support of detailed rules to bolster their internal position. This capacity has to be enhanced from board level, with the appointment of skilled non-executive directors, right down throughout the organisation. Firms need to develop the skills of their own internal compliance staff in such a way that they too are in a position to make key judgement calls.

8. Developing and maintaining a constructive dialogue between regulator and regulated firm as to the expectations and responsibilities of each in interpreting and applying the Principles

The most important point is left until last. There is a limit to what rules or guidance can do. What is key is the development of shared understandings between the FSA and regulated firms as to the role and purpose of Principles in the regulatory regime, understandings that can only be partially developed through more guidance. We suggest that Principles-based regulation will work only if there is on-going dialogue between the FSA and regulated firms which develops shared understandings of what conduct is required by the Principles. It is only through extensive regulatory conversations as to the objectives of the regulatory regime, to the respective roles and responsibilities of regulators and regulated firms in achieving those objectives, and to the interpretation and application of the regulatory requirements that any regulatory regime can operate, particularly one which is Principles-based, in all the FSA's meanings of the term.

There are a number of obstacles in the way of developing such a dialogue, however. In particular, there are mismatches and "mindset gaps" between firms and regulators, within firms between compliance and business divisions; within regulators between policy, supervision and enforcement divisions, and across firms – between the well- and ill-intentioned, and the well- and ill-resourced. These gaps create uncertainty and mistrust, and the difficulties they raise are not necessarily susceptible to the same remedy. Moreover, attitudes to the regulatory regime are critically shaped by the perceived fairness of the regime as a whole, which is in turn shaped not just by whether regulation is based on Principles or detailed rules, or even what they say, but the manner in which they are administered.

Being able to engage in such strategic and constructive dialogue, however, places significant demands both on regulatory culture and the capacities of all those involved in financial services regulation in both regulated firms and the FSA. Regulatory conversations have to be based on some "rules of engagement", but it is far from clear that either industry or the FSA have begun to work out what these could be. We propose that fundamental to those rules of engagement should be an understanding and acceptance of two key responsibilities by firms and the FSA. Firms have to accept responsibility for thinking through the application of the Principles or rules in their own particular context. The FSA has to support firms in exercising this responsibility by giving firm commitments to the acceptability or otherwise of the responses firms develop to the Principles as part of the supervisory process. If Principles-based regulation is to work, these different rules of engagement need to be developed.

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1 It is worth noting that there are other broadly based rules in the FSA handbook which have the same structure as Principles, but have the status of rules.

2 See J Black, *Rules and Regulators* (1997), 91-108 for a more detailed account of the New Settlement and the motivations behind the introduction of the SIB Principles.

3 See FSA handbook PRIN 1.1.7G "In determining whether a Principle has been breached it is necessary to look to the standard of conduct required by the Principle in question. Under each of the Principles the onus will be on the FSA to show that a firm has been at fault in some way."

4 It should be noted that Principles-based regulation does not necessarily require that Principles have legal force – Principles could have the status of guidance that informs the supervision of forms and/or enforcement policy. However, the FSA is currently more committed than ever to maintaining the position that the Principles can themselves form the basis of enforcement action. Also note that while the Principles themselves do not attract private rights of action under section 150 of the Financial Services and Markets Act 2000 ("FSMA") there are other rules in the FSA handbook that are also drafted in high-level, purposive terms (and which are therefore indistinguishable from "Principles") but which do attract statutory rights of action under s 150.

5 See FSA, *The FSA Principles for Businesses*, CP13 September 1998, at paras 9-10, which includes the statement "Thus routine supervisory monitoring will rest on the Principles coupled with amplificatory rules, evidential provisions and guidance, rather than on the Principles alone." See also FSA Press Notice 099/1999: "Beneath the Principles there will be binding rules, evidential provisions and guidance. Collectively these will be the flesh on the bones of the Principles themselves. The meaning and impact of the Principles will be clarified both in the supervisory dialogue between the FSA and regulated firms and in the more detailed material outlined in the handbook."

6 Letter from the then FSA Chairman Howard Davies to the London Investment Banking Association but contrast this with ENF 11.6 and the fact that in practice enforcement cases have often been founded on breaches of the Principles alone.

7 "Creative compliance" refers to the process by which firms can seek to structure their arrangements or activities in a way that complies with the detailed requirements of rules but which, while compliant, undermines or avoids their purpose.

8 "I want to emphasise today that we can and do take Enforcement action on the basis of Principles alone and it is our intention to go down this route. The FSA set out in an often-quoted letter to the London Investment Banking Association in 1999 . . . that we would expect the number of cases for a breach of a Principle alone to be small. This is not the position of the current FSA leadership or Board. The Principles are rules and we intend increasingly to take enforcement action on the basis of those Principles alone, where this is appropriate." J Tiner, FSA Enforcement conference, 16 June 2006.

9 "Meanwhile, we are keen not to reach for our rule-writing pen in order to interpret and illustrate our high level requirements where we do not currently have detailed rules. We recognise the need to provide a degree of predictability to firms, some of whom ask us to define the minimum standards we require. Our response is that the Principles and other high level rules are themselves minimum standards, and that we see these minimum standards primarily in terms of outcomes, not of prescribing detailed inputs and

processes." C Briault, FSA Summer School 24 July 2006, cf "Treating Customers Fairly – Towards Fair Outcomes for Consumers", July 2006, para 1.9.

10 C Briault, "Making a Real Difference to Consumers Through More Principles-Based Regulation", FSA TCF Conference, 7 November 2006.

11 "Implementing Principles-based Regulation", speech by D Waters, Director Retail Policy, FSA at the ABI Conference, London, 7 December 2006.

12 Draft Updated Regulatory Strategy and Plan & Budget 2007/8, December 2006.

13 Coglianese, Nash and Olmstead, "Performance-Based Regulation: Prospects and Limitations in Health, Safety and Environmental Protection" [2003] *Administrative Law Review* 705.

14 "Principles-Based Regulation – What Does it Mean for the Industry?" speech by C McCarthy, Chairman, FSA, Financial Services Skills Council 2nd Annual Conference, 31 October 2006.

15 "Treating Customers Fairly – Progress Report", June 2002.

16 "Treating Customers Fairly – Progress and Next Steps", July 2004.

17 "Treating Customers Fairly – Building on Progress", July 2005.

18 "Treating Customers Fairly – Towards Fair Outcomes for Consumers", July 2006.

19 See the FSA handbook, SYSC 10.1.1Rff.

20 See Coglianese and Lazer, "Management-Based Regulation: Prescribing Private Management to Achieve Public Goals", 2003 Regulatory Policy Program, John F Kennedy School of Government – see in particular the account here of the alternative regulatory strategy developed in relation to food safety – "Hazards and Critical Control Points" or "HACCP" – which bears a striking similarity to the FSA's approach on TCF in that it requires firms to assess for themselves the potential hazards associated with all stages of food processing, to assess the risks of these hazards occurring and to identify the best method for addressing the hazards by identifying those "critical control points" in the production process where hazards can best be eliminated or reduced.

21 There are several different bases on which to distinguish rules, notably: the nature of their content, and their structure and their legal status. The latter is the most common (legal rules/guidance; hard law/soft law). However, rules are sometimes classified on a tripartite basis according to content: whether they are specification standards (setting the exact output/behaviour to be adopted); process standards (setting out procedures to be followed) or performance standards (identifying the outcome to be achieved): see eg A Ogus, *Regulation* (Oxford, 1994). Alternatively they may be classified according to variations in their linguistic structure, on which see CS Diver, "The Optimal Precision of Administrative Rules" (1983) 93 *Yale Law Journal* 65; Black, *supra* n 2. The latter classification is adopted here, as it is usual for "Principles" to refer to rules of a particular linguistic structure. It should be noted that the classifications on the basis of structure and content are not necessarily aligned; whilst specification standards do usually have a particular linguistic structure (precise language, often a high degree of complexity), outcome and process based standards can be expressed in either general or precise terms.

22 Different types of rules also involve different costs and benefits, which may be differently distributed between regulator, regulated firm and the beneficiaries of regulation, discussed further below, and for other, less direct reasons which can be related to defining the institutional position of the regulator: see Black, *supra* n 2.

23 Diver, *supra* n 21; R Baldwin, *Rules and Government* (Oxford, 1995); D McBarnet and C Whelan, "The Elusive Spirit of the Law: Formalism and the Spirit of Legal Control" (1991) 54 *Modern Law Review* 848.

24 Baldwin, *supra* n 23; Black, *supra* n 2.

25 MW Nelson, "Behavioural Evidence on the Effects of Principles- and Rules-Based Standards" (2003) 17(1) *American Accounting Association* 91.

26 *Ibid*. Principles-based regulation may thus be bad for lawyers!

27 V Braithwaite, K Murphy and M Reinhart, "Taxation Threat, Motivational Postures and Responsive Regulation" (2007) 29(1) *Law and Policy* 137.

28 Nelson, *supra* n 25.

29 *Ibid*.

30 Baldwin, *supra* n 23.

31 Diver, *supra* n 21.

32 Braithwaite *et al*, *supra* n 27.

33 C Parker, *The Open Corporation* (Oxford, 2000).

34 The FSA is proposing to insert a "perfect implementation" clause into the rules on the application of the Principles to MiFID business. This simply states that "A firm will not be subject to a Principle to the extent that it would be contrary to the UK's obligations under Single Market Directive". As a result the onus would be placed on firms to establish whether a Directive is a "maximum harmonisation" Directive or not and to what extent the Principles, as interpreted by them, are compatible with the requirements of the Directive. See DP 07/2 *Implementing the Markets in Financial Instruments Directive*, January 2007, Annex 3, PRIN 3.1.6.

35 Although it should be noted that the FSA is proposing to copy it into the Conduct of Business rules rather than amend the existing FSA Principles for Businesses.

36 John Tiner and Margaret Cole have spoken in nearly identical terms on this issue, which has crystallised into the draft text of EG, the Enforcement Guide, which was proposed recently as a replacement for ENF in Consultation Paper 07/2, "Reviewing the Enforcement and Decision Making Manuals", January 2007. Tiner said: "We also recognise that there is a legitimate concern that in order for consequences legitimately to be attached to the breach of a Principle it must be possible to predict, at the time of the action concerned, whether or not it would be in breach of a Principle. But as long as the action or actions in respect of which discipline is being brought could reasonably be predicted to be in breach of the Principle, we do not consider that there is anything unfair about taking Enforcement action for the breach of Principles. In other words, where the requirement of predictability is met it is legitimate for consequences to follow even though the Principle is expressed in general terms. This does not mean you must have known at the time of the conduct you were in breach but rather that had

you applied your mind to the question you would have realised the risks you faced." Keynote address, Enforcement Law Conference, 16 June 2006.

37 For discussion see J Black, "Talking about Regulation" [1998] Public Law 77-98.

38 There is judicial support for the notion that it would be unlawful for the regulator to purport to make new rules or guidance outside the statutory structures that have been put in place for promulgating such standards, both in the UK (*R v SIB ex parte IFAA* [1995] 2 BCLC 76 on the extent of the SIB's powers to enforce its "guidance" on the pensions review) and in the Canada (*Ainsley Financial Corporation v Ontario Securities Commission* (1994) 77 OAC 155 where the Ontario Court of Appeal held invalid a policy statement on the grounds that it represented an attempt to impose a de facto legislative scheme for which there was no statutory authority).

39 In fact the FSA makes clear that Guidance is not binding: "Whatever guidance is used for, it is not binding on those to whom the Act and rules apply, nor does it have 'evidential' effect. It need not be followed in order to achieve compliance with the relevant rule or other requirement. So a firm cannot incur disciplinary liability merely because it has not followed guidance. Nor is there any presumption that departing from guidance is indicative of a breach of the relevant rule" (*Reader's Guide*). But note the FSA is currently consulting on a change to its enforcement policy which would make clear that guidance (including informal guidance in speeches and "Dear CEO" letters) may be relevant and taken into account in enforcement actions.

40 T Murphy, *The Oldest Social Science?* (Oxford, 1997).

41 FSA draft Enforcement Guide, para 3.2 (introduced in CP 07/2).

42 For discussion, see Black, *supra* n 37.

43 Better Regulation Task Force, *Regulatory Creep* (London, 2004).

44 In the *Deutsche Bank* case the FSA imposed a penalty for breach of its stabilisation rules even though they did not apply on the basis that the bank had adopted an internal policy that it would comply with the FSA rules.

45 FSMA ss 157(3) and 155(7). It should be noted that HM Treasury recently consulted on proposals to relax the consultation requirements for guidance issued by the FSA.

46 FSA, *FSA Confirmation of Industry Guidance* DP06/5, November 2006.

47 Baldwin, *supra* n 23.

48 G Becker, "Crime and Punishment: An Economic Approach" (1968) 76 *Journal of Politics and Economics* 161; G Stigler, "The Optimum Enforcement of Laws" (1970) 78 *Journal of Politics and Economics* 526; but see T Makkai and J Braithwaite, "The Limits of the Economic Analysis of Regulation: An Empirical Case and a Case for Empiricism" (1993) 15(4) *Law and Policy* 271.

49 I Ayres and J Braithwaite, *Responsive Regulation* (Oxford, 1992).

50 *FSA Final Notice, Nationwide Building Society*, 14 February 2007.

51 One example from the public sector is the original target for local authorities' rubbish collection. The target required them to ensure that a certain proportion of the rubbish they collected was recyclable. The authorities complied, separating out recyclable from non-recyclable rubbish. They burnt the recyclable rubbish. When the Department for Environment, Transport and the Regions argued they had not complied they retorted that they had: the target required the rubbish to be recyclable, not recycled. The target was subsequently changed. National Audit Office, *Measuring the Performance of Government Departments*, HC301 Session 2000–2001 (London, 2001), 30 to focus on the outcome (recycling).

52 G Bevan and C Hood, "What's Measured Is What Matters: Targets and Gaming in the English Public Healthcare System" (2006) 84(3) *Public Administration* 517.

53 "Treating Customers Fairly – Progress and Next Steps", speech by Sarah Wilson, Director Retail Firms Division, FSA, 19 March 2007

54 J Braithwaite, "Meta Risk Management and Responsive Regulation for Tax System Integrity" (2003) 25(1) *Law and Policy* 1-16; C Coglianese and D Lazer, "Management Based Regulation: Prescribing Private Management to Achieve Public Goals" (2003) 37 *Law and Society Review* 691-730; P May, "Performance-based Regulation and Regulatory Regimes: The Saga of Leaky Buildings" (2003) 25(4) *Law & Policy* 381-401.

55 S 150 FSMA 2000.

56 C Briault, at the FSA summer school in July 2006: "where possible we would prefer to provide predictability under our Principles and other high-level rules through various forms of guidance to firms, in particular through statements of good and poor practice and through case studies illustrating ways in which firms have successfully met our requirements."

57 To an extent this is the common law method; however, in non-legal life the process is far less bounded by the strict interpretive norms that characterize and structure judicial reasoning.

58 Baldwin, *supra* n 23.

59 CP 07/2 *Review of the Enforcement and Decision Making Manuals*, January 2007.

60 Parker, *supra* n 33.

61 In CP 07/2 it is proposed to make clear that guidance (whether in the handbook or in the form of case studies or "Dear CEO" letters) is material that the decision maker may take into account in determining whether enforcement action should be taken. The FSA's earlier Discussion Paper, DP06/5, "FSA Confirmation of Industry Guidance", suggests that FSA confirmed guidance should be afforded "sturdy breakwater" status, but the subsequent release of CP 07/2 and more recent FSA pronouncements leaves the position far from certain.

62 *FSA Final Notice, Citigroup Global Markets Ltd*, 28 June 2005.