



## Regulation for grown-ups

UK financial services regulation has become over-elaborate. The high-level regulatory principles of the early 1990s setting out how firms should behave have developed into a shelf-breaking heap of manuals regulating every aspect of the sector. Firms have learnt to live with all this, and even draw comfort from it. Having lots of rules covering every part of a business – from the way investments are sold to avoiding conflicts of interest – can make life easier. Everyone knows what is required and can develop systems to comply that tick all the right boxes.

But it also has a regulatory risk. The market is too large and sophisticated for a regulator to spew out effective rules for every outcome. And if firms only concentrate on complying with detailed rules they can lose the broader perspective. It is costly too, among other things, impeding attempts to close the savings gap.

Principles based regulation (PBR) is the regulatory response – an attempt to cut out many of the detailed rules leaving a framework of high-level standards for firms to meet. Firms are left to apply these to individual circumstances and risk regulatory sanction if they get it wrong. The industry is already grappling with PBR in the form of the Financial Services Authority's (FSA) initiative to get firms to ensure that they 'treat their customers fairly', but the publication earlier this month of the FSA's plans to take the scalpel to its key rule-book covering dealings between firms and customers represents a significant step forward.

The change may have been forced on the FSA. Financial services regulation increasingly comes from Brussels and imposing additional FSA rules could undermine competitiveness. There is also an element of regulatory outsourcing – a transfer of regulatory responsibility to the private sector.

Yet, whatever its provenance, the move is constructive. It offers the prospect of market-driven solutions to meeting regulatory objectives with a subtlety and efficiency that the current regime cannot provide – in short, regulation for grown-ups.

However, dangers also need to be addressed to realise these benefits. The most important concerns how firms will know when they have got it right.

In trying to comply, firms will need to set their own detailed standards of conduct, but FSA regulatory sanctions will be based on the more general principles. With only principles to work with, how will firms know if the FSA agrees with the lines they have drawn? In this context, there is a growing tendency for every FSA communication to be scrutinised for some indication of the FSA's likely approach. This sort of 'soft regulation' by speech, case study and letter risks creating uncertainty. The FSA needs to find ways of communicating in an accessible and coherent manner.

It is not just the FSA's views that will count. PBR potentially replaces coercion with community. Firms will need to talk to each other in assessing how to

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comply with the principles. This is already happening. The FSA is looking towards the industry associations to act as a focal point to capture at any given time the standards that their members consider are an appropriate expression of the FSA's principles. Does this mean a return to Self Regulatory Organisations? The industry associations will be reluctant, not least because they do not enjoy statutory immunity, but some move in that direction seems inevitable with the increased use of 'statements of good practice'. If so, this process must be carefully managed to avoid duplication and inconsistency, particularly for institutions involved in several trade bodies.

The role of the Financial Ombudsman could take on a new significance – one it was never meant to have and is unlikely to want. Its determination of what is 'fair and reasonable' in individual cases could begin to have wider implications in the context of the sort of interpretive dialogue the FSA contemplates. The approach of the FSA to Ombudsman decisions needs greater clarification if the Ombudsman is not to develop into a new arbiter of regulatory standards.

And then there is the FSA's enforcement role. Concern remains that PBR leaves greater scope for the operation of hindsight and the policy concerns of the day. You cannot eradicate hindsight, but more detailed FSA rules give firms something to point at as regulatory benchmarks for behaviour. If these are now to be reduced, clearer assurance of objectivity is needed. Maybe this can only develop over time as firms see how FSA enforces the new regime. If so, the FSA will need the sensitivity of an equity judge and it must ensure that it employs the right people.

The early signs are encouraging. The FSA seems to recognise some of these dangers. But that is only part of the solution; the financial community needs to engage actively to ensure that they are adequately addressed avoiding the uncertainty and cost of a regulatory jumble.

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