

Implementing Financial Regulation

Theory and Practice

Joanna Gray and Jenny Hamilton



John Wiley & Sons, Ltd

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To Our Families

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Preface

One of the main motivations for writing this book has been the desire to think through the implications of some of the insights provided by recent scholarly work that theorises about regulation and about risk, and to try to apply and “test” these insights, albeit in an admittedly non-scientific fashion, in the practical operating environment of the regulation of the UK financial services sector.

Although there is much written about the application of the risk based supervisory framework in UK financial services, there is little independent consideration of that framework, and its attendant shift in focus from rules to risks. This book attempts to address that shortfall. Against the background of some of this literature we consider how the regulator has extended its reach downwards into the level of the regulated entity to impose direct and specific responsibilities on individuals within firms, especially senior management and individual senior managers. In so doing we analyse this trend against some of the key theoretical literature on regulation and compliance as well as against the notion of “responsibility” within complex organizations, and present a critique of much of the rhetoric surrounding notions of compliance/ethical culture as well as the recent sharpening of mechanisms of management and manager accountability within UK financial regulation. We also present a critique of the impact of some of the ‘consumer protection’ regulation, such as information disclosure, in the light of the growing literature on, for example, consumer decision making.

We are conscious that in attempting to apply the insights of the theoretical literature to the practice of financial regulation some might suggest that this book is neither one thing nor the other – neither a rigorous theoretical analysis nor a rigorous explanation of the operational detail of the regime. However, we would respond that we believe there should be more cross-over between regulatory theorists and those familiar with the operational detail of various regulated business sectors. Unless scholarship has an explanatory power it is open to the classic (and often unfair) charge that it looks inward and speaks to itself rather than having any interest, much less relevance, to the world beyond. Attempts to marry theory and practice are few and far between in legal scholarship, but the value of any theory must ultimately be its ability to explain.

Inevitably we were selective in those aspects of the regulatory regime that we have chosen to analyse. We have chosen to confine our analysis primarily to the impact of the policy and actions of the Financial Services Authority itself, but we acknowledge that there are some significant other areas of the regulatory framework, in the broader sense, that have the potential to impact on the downward reach of regulation – such as the Financial Ombudsman Service and which would also benefit from analysis, but these remain for future research.

As ever with any attempt to write in an area of substantive law and regulation that is subject to constant change and reformulation there are parts of this work that will look out of date on the literal content of the law and FSA Handbook once this work appears. The content of these chapters reflects the state of play in October 2005 and so subsequent developments which would otherwise have been incorporated into this work do not appear. These include the publication as a House of Lords Bill in November 2005 of the Company Law Reform Bill at the start of what is likely to be its lengthy Parliamentary progress. Chapter 2 of that Bill contains provisions which govern the general duties of directors and provides a statutory statement thereof. No sooner had the Company Law Reform Bill been published than the Chancellor of the Exchequer announced, in the December 2005 Pre-Budget Report the Government's intention to do away with the new requirement for quoted companies to produce an Operating and Financial Review

in which they address and report on some of the broader “stakeholder oriented” issues beyond shareholder value that, as the discussion in Chapter 5 points out, are indicative of a desire to effect a degree of cultural or “mindset” change within companies. However, the reason given by the Chancellor for this decision simply reflects that these concerns and issues will be addressed elsewhere for many companies as they produce Business Reviews in order to comply with the EU Accounts Modernisation Directive (2003/51/EC).

Another development announced in that same Pre-Budget Report was the Government’s intention to produce a Regulatory Reform Order in order to implement those changes recommended by the N2 + 2 Review of FSMA 2000. One of those changes is to remove the need for the FSA Board to give formal approval to all general guidance issued by FSA, so that delegation of this function will be possible in some circumstances, to a committee or even individual staff member at FSA. This might be thought to go some way to meeting the concerns of firms expressed in the most recent Financial Services Practitioner Panel survey discussed in chapter 4 and again in the critique of the operation of regulatory enrolment in chapter 7. However, we would argue that this is unlikely, for the strong concerns expressed therein by firms related to the willingness of FSA to issue guidance in the first place and are more likely to relate to individual guidance than general.

Another important development which is likely to emerge before publication is the FSA’s final response to its Consultation Paper 05/10. This feedback is likely to impact on the operation of the regime of “individualised” responsibility for senior managers and other individuals performing key functions within regulated firms discussed in chapter 3. Some initial response was given by the FSA in its “Better Regulation Action Plan” of 2 December 2005 but final feedback will not be given until the position of the Approved Persons regime in Chapter V FSMA under the implementation framework for the Markets in Financial Instruments Directive becomes clearer.

Joanna Gray and Jenny Hamilton
31 January 2006

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1

Regulation in context

Financial services regulation has matured considerably in the past 25 years. The current regulator, the Financial Services Authority (hereafter “FSA”), has developed a sophisticated, comprehensive and potentially far-reaching regulatory tool kit through which to implement its objectives.¹ This reflects the fact that the “art” of regulation is now understood to be far more diverse and intricate than when regulation first began to attract academic interest. While it operates within the statutory framework imposed by the Financial Services and Markets Act 2000 (hereafter “FSMA”), there are three aspects of this regulatory toolkit developed by the regulator that we believe are of particular importance and significance. These are the subject of this book, rather than the structure of the regulatory environment for financial services,² which needs little explanation and has been extensively described and analysed elsewhere.³

¹See J Black, *Mapping the Contours of Financial Services Regulation* (Centre for Analysis of Risk and Regulation, LSE: London, 2003).

²This structure has undergone significant change since the 1980s – from one of little or no regulation of different sectors within financial services industry to “self-regulation under a statutory umbrella” – to full statutory regulation under one “super-regulator”.

³See, for example, G McMeel and J Virgo, *Financial Advice and Financial Products: Law and Liability* (Oxford University Press: Oxford, 2001); J Hamilton, *Financial Services*

The first aspect of central importance is the adoption by the FSA of risk-based regulation, and the concomitant development of its risk-based operating framework for supervision. This is of fundamental significance, and provides the context within which analysis and discussion of the two further aspects are carried out. The first of these two further aspects is the trend towards greater regulatory incursion into the internal business management processes and strategies of regulated firms through regulatory tools which address the role of senior managements of firms, and directly regulate individuals within firms, especially senior managers. The second further aspect is the change in regulatory rhetoric and action over the last 20 years to mirror the re-drawing of the boundary between collective and personal responsibility. This has led to an increasing emphasis on financial citizenship and personal financial autonomy.

The centrality of these aspects is in stark contrast to the situation in the early days of the precursor of the FSA, the Securities and Investment Board (hereafter “SIB”). At that time regulation was viewed simply in terms of command and control. Its effectiveness was judged against compliance with prescriptive and detailed rules, and regulators in the financial services sector were left to determine their own broad regulatory objectives.

The rise of risk

In one sense the adoption of risk as the basis of regulation by the financial services regulator is neither particularly unique nor unusual. Discourses around risk have now become commonplace within executive government in the UK.⁴ As Fisher⁵ has commented:

Regulation, in L Macgregor, T Prosser and C Villiers (eds) *Regulation and Markets Beyond 2000* (Ashgate: Aldershot, 2000), p 243; M Blair, L Minghella, M Taylor, M Threpiland and G Walker, *Blackstone's Guide to the Financial Services and Markets Act 2000* (Blackstone Press: London, 2000).

⁴Although as Black identifies, risk-based regulation has two distinct meanings, one refers to the implementation of internal risk management systems, the other refers to risk-based regulation where sources of risk are regarded as external to the organisation – J Black, *The Emergence of Risk-based Regulation and the New Public Risk Management in the UK*, *Public Law*, 512–548.

⁵E Fisher, *The Rise of the Risk Commonwealth and the Challenge for Administrative Law*, *Public Law*, 2003, 455–478 at 455.

One of the central tasks of the UK executive state is now perceived to be the handling of risk... The task of public decision makers is increasingly characterised in terms of the identification and assessment and management of risk and the legitimacy of public decision-making is also being evaluated on such a basis.

Furthermore, risk has become the dominant concept across a range of regulatory spheres from environmental protection and health and safety to other diverse arenas such as health, penology, and child protection,⁶ as well as public sector management and finance. It has become the dominant concept in the regulatory reform process itself where regulation has to be proportionate to the risks.⁷ As Fisher notes, in some of these spheres a concern for risk has always been implicit, as, for example, in environmental protection, food safety and occupational health and safety. In other regulatory spheres a focus on the concept of risk is relatively recent. Increasingly, however, regulators are required to engage in formal risk assessment and risk management.⁸ It is clear now that the language of risk has permeated most areas of executive government. This is so much so that HM Treasury's *Management of Risk: Principles and Concepts*⁹ states that "it can now be presumed that all existing [government] organisations have basic risk management processes in place"¹⁰ and further that "every organisation which wants to maximize its success in delivering its objectives needs to have a risk management strategy, led from the very top of the organisation, which is then implemented by managers at every level... and embedded in the normal working routines and activities of the organisation".¹¹

⁶See, e.g., J Braithwaite, *The New Regulatory State and the Transformation of Criminology*, in D Garland and R Sparks (eds) *Criminology and Social Theory* (OUP: Oxford, 2000), and P O'Malley, *Risk, Uncertainty and Government* (Glasshouse Press: London, 2004), M Power, *The Risk Management of Everything: Rethinking the Politics of Uncertainty* (Demos: London, 2004).

⁷Better Regulation Action Plan, 24 May 2005, available at http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2005/press_50_05.cfm. See also *Transforming the Regulatory Landscape – Launch of Consultation on Bill for Better Regulation*, Cabinet Office, 24 July 2005.

⁸E Fisher, *supra*, n 5.

⁹Consultation Draft, May 2004 (HMSO, 2004).

¹⁰*Ibid.*, para 1.3.

¹¹*Supra*, n 9, para. 2.6.

As Fisher observes, however, the notion that risk is now embedded in public decision-making is not a simple case of rebranding past practices with new buzzwords. Instead, risk represents a new way of conceptualising what “public administration” and regulation do. She suggests it is not simply a tool for decision-making, but in fact represents a new way of governing, and adds that “the end result has seemingly been a dramatic evolution in what public administration does and what it is perceived that it should do”.¹² This evolution, she believes, has a number of fundamental implications for what is understood to be the role and the nature of the administrative state and the role of non-legal modes of regulating public administration, as well as how to identify good and bad public decision-making. It raises not only questions about the meaning of risk but also questions relating to the ways it is deployed by regulators and administrators, and its implications for citizens.

But it is recognised that the way risk has been embedded varies across public bodies and agencies.¹³ Consequently, it cannot be analysed as if it were a uniform and unifying development across administrative and regulatory spheres. Rather each sphere needs to be examined for its specific implications. But in the call for more site specific examination of the embedding of risk it is important not to lose sight of the fact that this embedding is taking place within the context of an embedding of risk generally across a whole range of administrative and regulatory spheres. To ignore this wider context would be to overlook more subtle and broad-based implications of this development, and it is worth therefore analysing why risk has become so central in administrative and regulatory spheres generally. At the same time, risk is a concept that may be taken for granted by those involved in the everyday practices associated with it, and requires to be unpacked before looking at it further in the context of financial services regulation.

¹²E Fisher, *supra*, p 2, n 5.

¹³See, for example, C Hood, H Rothstein and R Baldwin, *The Government of Risk: Understanding Risk Regulation Regimes* (Oxford University Press: Oxford, 2001), P O'Malley, *supra*, p 7, n 6.

Why risk has become central

Very different explanations are given for why risk has come to be central across government and regulatory spheres.¹⁴ These explanations are, in part, influenced by the different approaches to what risk is, discussed below.

In attempting to account for the emergence of risk as a strategic organising principle in the public sector some commentators have simply pointed towards the particular needs of government. They highlight the need to restore confidence in the aftermath of mismanaged crises (especially responding to particular stimuli such as the collapse of the Barings banking group and BSE), and the need to improve communication with the public, in order to better manage public expectations.¹⁵

Political scientists, however, convincingly suggest that the adoption of the language and practices of risk reflects a deeper, more complex process, that of “political isomorphism”.¹⁶ This is a process of policy transmission such that bodies will adapt to or adopt governance strategies that have a common currency and will alter their practices so as to become more like those around them. In other words, as a strategy or operating principle risk becomes accepted and embedded in one organisation or institution, and so it acquires a currency within other organisations or institutions.

However, given that risk has been conceptualised and utilised in different ways across organisations and institutions, a process of policy

¹⁴And the literature is extensive – see, for example, M Power, *supra*, n 6; D Vogel, *The New Politics of Risk Regulation in Europe*, Centre for Analysis of Risk and Regulation (LSE: London, 2001), and the references contained within.

¹⁵M Power, *supra*, n 6.

¹⁶P DiMaggio and W Powell, *The New Institutionalism in Organisational Analysis* (University of Chicago Press: Chicago, 1991). See also P Frumkin and J Galaskiewicz, Institutional Isomorphism and Public Sector Organisations, *Journal of Public Administration Research and Theory*, 2004, Issue 3, 283–307, M Lodge and K Wegrich, Control over Government: Institutional Isomorphism and Government Dynamics in Public Administration, *Policy Studies Journal*, 2005, Vol 33, No 2, 213, E Abrahamson, Managerial Fads and Fashions; The Diffusion and Rejection of Innovations, *Academy of Management Review*, 1991, 16, 586–612.

transmission cannot be the whole explanation.¹⁷ Other explanations, primarily from within the socio-cultural disciplines, suggest that the centrality of risk stems from issues connected with control, accountability, responsibility and blame in late modern society. Two prominent theoretical perspectives that address these issues are broadly termed “risk society” theory and “governmentality” theory. The former draws on the work of the sociologists Beck and Giddens.¹⁸ The latter draws on the work of the important French social thinker Foucault.¹⁹

At the risk of oversimplifying and caricaturing these important and extremely influential perspectives, the approach of “risk society” theorists such as Giddens and Beck is one that identifies what they believe to be broad socio-economic and political changes that have occurred in late modern societies. Among these changes they identify a loss of faith in institutions and authorities and a greater awareness of the limits and uncertainties associated with science and technology. This loss of faith, greater uncertainty and consequent anxiety about the future has arisen, they suggest, because of an increased awareness of the

¹⁷Some suggest that in fact the politics of risk has a long genealogy in government and that in fact what has changed is the way in which it is being deployed – see, e.g., P O'Malley, 2004, *supra*, p 27, n 13.

¹⁸See, e.g., the work of Ulrich Beck, and Anthony Giddens: U Beck, *Risk Society* (Sage: London, 1992), U Beck, *Risk Society Revisited: Theory, Politics and Research Programmes*, in B Adam, U Beck and J Van Loon (eds) *The Risk Society and Beyond: Critical Issues for Social Theory* (Sage: London, 2000), U Beck, *The Reinvention of Politics*, in U Beck, A Giddens and S Lash, *Reflexive Modernisation: Politics, Tradition and Aesthetics in the Modern Social Order* (Polity Press: Cambridge, 1994), A Giddens, *Risk Society: The Context of British Politics*, in J Franklin (ed) *The Politics of the Risk Society* (Cambridge: Polity Press, 1998), A Giddens, *Risk and Responsibility*, *Modern Law Review*, 1999, 62, 1.

¹⁹See, e.g., G Burchell, C Gordon and P Miller, *The Foucault Effect: Studies in Governmentality*, (Chicago University Press: Chicago, 1991); N Rose, *Governing the Soul: The Shaping of the Private Self* (Routledge: London, 1990); N Rose, *Powers of Freedom: Reframing Political Thought* (CUP: Cambridge, 1999); M Dean, *Governmentality: Power and Rule in Modern Society* (Sage: London, 1999). The Chair Foucault held at the College de France was in “The History of Systems of Thought”. This connects with his general concern with the way human beings are sought to be controlled. For an introduction to his work, see P Rabinow, *The Foucault Reader* (Random House: London, 1984); B Smart, *Michael Foucault* (revised ed) (Routledge: London, 2002).

larger scale of risks faced in the 20th and 21st centuries (the period of “late modernity”²⁰). This is encapsulated in what has been termed the “risk society” – a society in which most risk is “manufactured”, that is, generated by humans as part of the techno-economic development of industrialisation, modernisation and capitalism, rather than externally imposed by nature.

Giddens, for instance, suggests that concern with risk has become ubiquitous because of an increasing awareness of the potential scale of these “manufactured” risks, which are typically unseen, global and potentially catastrophic. There is increasing awareness, too, of the contingent nature of risk assessment and management techniques. Late modern society is not necessarily intrinsically more dangerous than before.²¹ Indeed, we now live longer, have better health etc. But for every scientific “breakthrough” there are new uncertainties and new risks to be faced. There is now an awareness at all levels of the “inherent indeterminacies and uncertainties of risk diagnosis” associated with manufactured risk.²² This contrasts with the position at an earlier period (which Beck calls “simple modernity”), where there was belief in the ability of experts to identify, measure and hence control risks, or at least a belief that with the advancement of science they would ultimately succeed in doing so.

In addition, attempts to try to confine and control these risks increases uncertainty and danger.²³ The near collapse in 1998 of Long Term Capital Management, an investment fund that traded in derivatives – the very instruments created to off-set modern risk – can be seen as a quintessential example of what Beck and Giddens would call modern manufactured risk. Had it not been for the bailout encouraged by US Federal Reserve Bank, its collapse had the potential to unravel the entire

²⁰Or what some would call “postmodernity”. See, for example, D Harvey, *The Condition of Postmodernity* (Blackwell: Oxford, 1989).

²¹Cf. Ulrich Beck – who believes society is facing potentially apocalyptic threats, see U Beck, *Risk Society* (Sage: London, 1992).

²²U Beck, *Risk Society Revisited: Theory, Politics and Research Programmes*, in B Adam, U Beck and J Van Loon, 2000, *supra*, p 219, n 18.

²³*Ibid.*, p 206.

banking system.²⁴ As a result, they suggest, we have entered a period of “reflexive modernisation” which involves questioning the outcomes of modernity, including the practices and procedures associated with industry and science.²⁵ “Risk society” theory suggests that the preoccupation with risk in government and regulatory circles is a response to a general recognition that there are limits to the ability to know or to control the uncertainties associated with late modernity, and to a public wanting to hold public decision-makers to account. Risk is now viewed as a political rather than a metaphysical phenomenon.²⁶ Giddens, who has been a formative intellectual influence on the development of Labour “third way” ideology, suggests that “[a] good deal of political decision-making is now about managing [these manufactured] risks – risks which do not originate in the political sphere, yet have to be politically managed”.²⁷ For the exponents of the “risk society” thesis, risk governance is not so much associated with control but with the absence of control. In Giddens’ phrase late modern society is a “runaway world”.²⁸

An alternative perspective on the centrality of risk is offered by “governmentality theory”. The term “governmentality” is used to refer to

²⁴The study of the collapse has generated much paper and ink and different reasons put forward for its collapse. See, e.g., F Partnoy, *The Politics of Greed* (Profile Books: London, 2003); M Stein, Unbounded Rationality: Risk and Organizational Narcissism at LTCM, *Human Relations*, 2003, Vol 56(5), 523–540; D MacKenzie, Long-Term Capital Management and the Sociology of Arbitrage, *Economy and Society*, 2003, 32, 349–380; D MacKenzie, Fear in the Markets, *London Review of Books*, 2000, Vol 22, No 8, accessed on-line at www.lrb.co.uk/v22/no8/mack01_.html

²⁵A Giddens, Risk and Responsibility, *supra*, p 6, n 18. Beck describes reflexive modernisation as “self-confrontation with the effects of risk society that cannot be dealt with and assimilated in the system of industrial society”: U Beck, in U Beck, A Giddens and S Lash, *Reflexive Modernisation* *supra*, p 6, n 18. For a discussion of the similarities and differences between Beck’s and Giddens’ concept of reflexive modernity, see S Lash, Reflexivity and its Doubles, also in U Beck, A Giddens and S Lash, *Reflexive Modernisation*.

²⁶D Lupton and J Tulloch, Risk is Part of Your Life; Risk Epistemologies Among a Group of Australians, *Sociology*, 2002, Vol 36(2), 317–334.

²⁷A Giddens, Risk and Responsibility, *supra*, p 5, n 18.

²⁸A Giddens, *Runaway World: How Globalization is Reshaping our Lives* (Profile Books: London, 1999).

specific modes of government that have emerged in modern societies in line with liberalist and neo-liberalist discourses.²⁹ Governmentality theorists are interested in examining the ways in which power is constituted and exercised in liberal and neo-liberal societies. Their interest in risk does not focus on the nature and scale of risks in late modern society, nor does it centre around identifying macro-level transformations in society (transformations governmentality scholars do not necessarily accept in any case³⁰). Rather it is centred around the exploration of how the identification of risks associated with certain behaviour or activities provide a means through which to exercise control over populations, groups or individuals in neo-liberal societies. In other words, governmentality theorists are interested in identifying how risk is used as a “tool of governance” to shape behaviours.³¹ One of the clearest examples of the use of risk as a tool of governance is in insurance.

The technologies of insurance (statistics, classification and frequency observation) are tools used to make risk calculable and, in making it calculable, it can be used as the basis on which to promote responsible behaviour on the part of the insured, for which the clumsy but apt term “responsibilisation” has been coined. This can be seen, for example, in relation to smoking and other hazardous activities whereby smokers or those who engage in such activities are required to pay higher premiums or denied insurance altogether. This allocation of responsibility in turn enables norms of behaviour to be established, which are then used to encourage voluntary self-regulation,³² such as, for instance, giving up

²⁹D Hodgson, “Know your Consumer”: Marketing, Governmentality and the “New Consumer” of Financial Services, *Management Decision*, 2002, Vol 40, No 4, 318–328.

³⁰See P O'Malley, 2004, *supra* p 26, n 6.

³¹P O'Malley, Risk, Power and Crime Prevention, *Economy and Society*, 1992, 252, and P O'Malley, Imagining Insurance: Risk, Thrift, and Life Insurance in Britain, in T Baker and J Simon (eds) *Embracing Risk: The Changing Culture of Insurance and Responsibility* (Chicago University Press: Chicago, 2002).

³²M Foucault, Governmentality, in G Burchell, C Gordon and P Miller (1991), *supra*, n 19, F Ewald, Insurance and Risk, in G Burchell C Gordon and P Miller, *supra* n 19; D Lupton, *Risk* (Routledge: London, 1999) at p 25, M Dean, *Sociology after Society*, in D Owen (ed) *Sociology after Postmodernism* (Sage: London, 1997), P O'Malley, *supra*, n 13; D Knights, Governmentality and Financial Services: Welfare Crises and the

smoking. Risk governance in this sense is about using the concept of risk as a means of governing individuals or groups in such a way as to (re)define responsibilities for the outcomes associated with particular phenomena or activities, consistent with an ethos of neo-liberalism which emphasises autonomy and self-help over state intervention.³³

Examples of this emphasis are not confined to the area of insurance. They can be found across a broad spectrum of fields where the state utilises risks governance in this sense. As O'Malley illustrates, in some jurisdictions drug addicts have been

recast as “responsible risk takers” who must govern the effects of their risks on themselves and on others. This new governmental image of the drug user no longer represents them as “addicts” enslaved by the drug and cursed with impaired rationality. Rather . . . they are considered rational choice subjects, free to make choices and to take responsibilities, albeit having a “relationship of dependence” with a drug.³⁴

In the context of environmental concerns on the other hand, the Australian government has sought to redefine drought to the category of “manageable risk” rather than a “natural disaster”, the responsibility for which has been transferred away from the state and on to farmers on the basis of their failure to respond adequately to risk managing deteriorating land conditions.³⁵ Within the health field Ruhl³⁶ has drawn attention to how pregnant women are “statistically graded” for risk on the basis of lifestyle and increasingly assigned responsibility for the health of the foetus. Similarly, in the context of criminal behaviour in the UK Batchelor demonstrates that despite their difficult familial and social circumstances young women who offend tend to reject the label of “victim”, preferring to focus instead on issues of personal choice and

Financially Self Disciplined Subject, in G Morgan and D Knights, *Regulation and Deregulation in European Financial Services* (Macmillan: Basingstoke, 1997).

³³D Lupton, *ibid.*, p 102.

³⁴P O'Malley, 2004, *supra* p 8, n 6.

³⁵V Higgins, Calculating Climate: “Advanced Liberalism” and the Governing of Risk in Australian Drought Policy, *Journal of Sociology*, 2001, 37, 299–316, referred to in P O'Malley, 2004, *supra*, p 9, n 6.

³⁶L Ruhl, Liberal Governance and Prenatal Care: Risk and Regulation in Pregnancy, *Economics & Society*, 1999, 28, 95.

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