Rethinking Conduct Regulation

***by Iain MacNeil**

Key Points:

The scale of misconduct in financial markets suggests that the current approach to conduct regulation in the UK and in the EU has failed.

Conduct regulation should be cut back so as to allow consumer law and fiduciary duty to play a more central role.

A reconfiguration along these lines would provide a better base for integrating ethical codes with the legal framework governing financial conduct.

Abstract:

Conduct regulation has evolved in a manner that lacks coherence. In this article, Professor Iain MacNeil identifies three fundamental characteristics that would need to be addressed in any wholesale reconfiguration.

INTRODUCTION

Recent years have seen a sharp rise in penalties and compensation associated with misconduct in financial markets. Financial penalties imposed by the Financial Conduct Authority (FCA) in each of the last two years for which data is available[1] exceed the cumulative total for all prior years of the Authority's existence and the total cost of compensation payments associated with the PPI mis-selling saga alone is around £22bn, broadly equivalent to the entire profits of the "big-five" UK banks in 2014.[2] The response in the UK has been dominated by a focus on more intense enforcement of conduct regulation characterised by the FCA as "credible deterrence" although there has also been a trend towards criminalisation and more focus on individual as opposed to entity responsibility. This stands in contrast with the more fundamental reappraisal of prudential regulation (at the global, EU and UK levels) which has led to a greater focus on systemic risk and the development (albeit not the elaboration) of the concept of macro-prudential regulation. This article proposes that a reappraisal of conduct regulation should start with an examination of three fundamental characteristics. The first is how law is taken into account in making regulatory rules and in particular its role in market-failure and cost-benefit analysis. That investigation is intended to determine whether conduct regulation overlaps unnecessarily with the general law. The second issue is the relationship between conduct regulation and ethics and the third is the degree of complexity within the system. It is unlikely that any

[1] See FCA, Enforcement Annual Performance Account 2014/14.
[2] See KPMG report at http://www.kpmg.com/uk/en/issuesandinsights/articlespublications/newsreleases/pages/uk-bank-profits-up-62-but-must-urgently-tackle-low-return-on-equity-says-kpmg-report.aspx.

fundamental reconfiguration of conduct regulation can be achieved without addressing these issues in the first instance.

THE OBJECTIVES AND PURPOSE OF CONDUCT REGULATION

The Financial Services and Markets Act 2000 (FSMA 2000) provides that the strategic objective of the FCA is to ensure that markets work well and that its operational objectives are consumer protection, market integrity and competition.[3] The broad statutory remit given to the FCA means that in principle it enjoys very wide discretion in determining whether regulatory intervention is necessary and if so how it should be framed. Since the entry into force of the EU's MiFID regime in 2007 the UK regulator's discretion has been constrained to some extent by the policy of maximum harmonisation applicable to MiFID's conduct regime which has the effect of "capping" the UK regime at the level set by MiFID.[4]

A key factor in understanding the evolution of conduct regulation in the UK is that it has no direct relationship with the statutory objectives in FSMA 2000 (above) and this remains true whether one considers the original objectives applicable to the old Financial Services Authority (FSA) or those that are now in place for the FCA. The reason for that disconnection is that the *purpose* of conduct regulation, as articulated by the FSA/FCA, is to solve the problem of market failure.[5] The primary sources of market failure are lack of competition, information asymmetry, conflicts of interest, externalities and misaligned incentives. Implicit in the concept of market failure is that the existing legal framework does not adequately resolve these issues. Conduct regulation is perceived to solve market failure by improving market outcomes and consumer welfare. While this approach has the ostensible attraction of being framed in a rigorous economic mode of analysis it creates two problems for the (FSMA 2000) legal framework governing conduct regulation: the first is that there is not and cannot be a simple causal link between the statutory objectives of the FCA and regulatory rules (at any level); and the second is that the lack of such a causal link damages the accountability framework because the exercise of regulatory discretion cannot be properly evaluated against the statutory objectives.

The statutory framework does, however, link indirectly to market failure analysis through the requirement that any rule-making proposal made by the FCA must be accompanied by a

[3] See generally FSMA 2000, Part 1A, and Chapter 1.
[4] The impact has to some extent been mitigated by the UK's use of the exceptions procedure within that regime to impose stricter requirements (e.g. in the case of the retention by the UK of its more onerous regulatory rules for the sale of packaged products in the retail market): see article 4 of the MiFID Implementing Directive 2006/73 [2006] OJ L241/26.
[5] FSA, Reasonable Expectations: Regulation in a non-zero failure world (2003).

cost-benefit analysis (CBA).[6] This creates the impression that regulatory intervention is located within a framework of economic analysis that has the capacity to measure both the costs and the benefits that will flow from a particular rule or set of rules. However, that impression is open to serious doubt. On the cost side, consideration is required of the impact of rules and that is difficult to estimate in advance. On the benefits side, the conclusion is often simply that regulation will mitigate consumer detriment and promote investor protection to such an extent that the (un-quantified) benefits exceed the costs. Despite being framed in a quasi-scientific methodology, the justification for regulatory rules through CBA is largely qualitative and judgemental because the impact of regulation is hard to predict and the comparison of costs and benefits is so complex that the reasoning often reverts to simple assertion that the (uncertain) costs are justified by reference to the high-level investor protection objective.[7] Thus, any perceived superiority implicit in such "technocratic" regulation as opposed to more general legal rules dealing with consumer and investor protection may be illusory.

The missing link between the statutory objectives and market failure analysis is risk. FSMA 2000 requires the FCA to consider the differing degrees of risk involved in different kinds of investment or other transaction.[8] While market failure may lead to consumer detriment and create a *prima facie* case for regulatory intervention, it will only happen if the risk of detriment meets the prevailing view of the regulator as to the degree of risk that can be tolerated within the system. But the statutory framework has no explicit or implicit risk preference: again that is a matter that is left to the regulator's discretion. Thus, it is not just rule-making that lies within regulatory discretion but also the setting of risk tolerance and the ranking of potentially competing regulatory objectives such as consumer protection, competition and innovation.[9]

THE PROBLEMS WITH CONDUCT REGULATION

In its current configuration conduct regulation has three fundamental problems. One is that its relationship with law is not appropriately calibrated. In essence, conduct regulation is now trying to do too much of the work that could be done by the general law, especially when

[6] FSMA 2000, s138I(2)(a).

[7] For a good example of the difficulties, see the FSA's CBA analysis of the implementation of MiFID in Consultation Paper 06/19, 'Reforming Conduct of Business Regulation' at Annex 1. The general approach is one whereby quantified costs (based on projections of impact) are compared with a qualitative assessment of benefits. There was no CBA for MiFID at the EU level and in any case estimation of (variable) impact across all the member States (as well as for the inter-state business that would supposedly grow as a result of MiFID) would have been virtually impossible: see the Commission's original proposal at COM(2002) 625 final.

[8] FSMA 2000, s 1C(2).

[9] See for example FSA, 'The Turner Review, A regulatory response to the global banking crisis' (2009) which noted (at 89) that the FSA had focused too much on its role as a conduct regulator and had not given sufficient attention to systemic risk.

account is taken of the expansion of EU consumer protection law since the FSMA 2000 regime took effect. A second is that its relationship with ethics is unclear. In particular, it is not self-evident that an ethics-focused set of high-level principles can or should map clearly on to a set of detailed conduct rules that are derived from market failure analysis which is driven by efficiency considerations rather than ethical values. And the third is that conduct regulation has evolved into a system which is too complex to meet its objectives. Complexity is present in the scope and application of the conduct regime by reference to markets, products and customers and leads to an outcome in which compliance is narrow and technical in its focus rather than being informed by an over-arching sense of proper conduct. While there are also other factors that are associated with the failure of conduct regulation in recent years, it is unlikely that any significant improvement can come about without addressing these fundamental issues.

CONDUCT REGULATION AND THE GENERAL LAW

While the underlying premise of the FSMA 2000 regulatory regime is that the general law is not capable of delivering an adequate degree of consumer protection in the financial sector, it provides little guidance as to whether, and if so how, the general law is to be taken into account in the framing of regulatory rules. Several issues arise in this context.

The market without regulation

The starting point for market-failure analysis is the identification of some form of market failure. At the next stage "The focus is on comparing market outcome with regulation against the counterfactual of a market with no regulation in which market failure may take the form of asymmetric information, externalities and market power."[10] However, further investigation of that approach reveals that it does not adequately take account of the manner in which markets and transactions are already regulated by the general law. For example, with regard to financial advice, analysis of the manner in which the requirement for a suitability letter (explaining why the firm has concluded that the transaction is suitable for the customer) can solve the principal-agent problem makes no reference to the capacity of agency/fiduciary law to solve the problem in the absence of regulatory intervention.[11] Thus, the underlying problem is that the baseline against which the benefits of regulatory intervention are measured is not adequately specified and the outcome of such an approach over time is likely to be that conduct regulation expands so as to overlap unnecessarily with the role of the general law. This was evident in the FSA's approach to the implementation of

[10] FSA, Oxera Report, A Framework for assessing the benefits of financial regulation (2006).
[11] See FSA, Consultation Paper 06/19, 'Reforming Conduct of Business Regulation' at Annex 1 par 7.30 where the FSA indicates that its impact assessment of MiFID's suitability requirement takes account of market practice but does not question whether such practice conforms to fiduciary duty.

the Unfair Commercial Practices Directive (UCPD)[12], which relied on an inverted form of market failure analysis whereby the FSA concluded that "We consider that our Handbook and our regulatory approach already address any unfair commercial practices in the area of financial services"[13]: thus, instead of concluding that the UCPD would permit conduct regulation (in the form of the FSA Handbook) to be cut back since a source of market failure had been removed, the FSA chose instead to preserve overlapping conduct regulation.

Consumer law

A more sophisticated analysis of the market without regulation requires consideration to be given to several aspects of the general law that are relevant for financial markets. This is particularly the case with respect to consumer law, which has expanded both in scope and control techniques since the introduction of FSMA 2000. In principle it would seem that consumer law could do much of the work of conduct regulation while the integration of financial services into mainstream consumer law would align standards of conduct in financial services with other commercial activity. As far as the wholesale financial markets are concerned, the fact that they fall outside the scope of general consumer laws[14] is of less significance because categorisation as professional investors or eligible counterparties means in any case that much of the conduct regulation regime will not apply. For that segment of the market, general contract and tort law, supplemented in appropriate situations by fiduciary law, are more important considerations.

So far as consumer law is concerned it is important to take stock of developments that have occurred since FSMA 2000 took effect since they suggest that the underlying premise that consumer law cannot be relied on to provide effective protection for retail clients requires reappraisal. This issue can be approached from the perspective of a timeline of protective provisions that apply through the process of financial contracting in the retail sector. That timeline can be drawn in summary form as follows:

Marketing → Pre-contractual disclosure → Advice → Cancellation → Fairness → Performance standards

[12] Directive 2005/29/EC, [2005] OJ L149/22.
[13] See FSA Consultation Paper 06/19, Reforming Conduct of Business Regulation at par 28.8.
[14] Although it should be noted that the Unfair Commercial Practices Regulations 2008 (CPRs) have the potential to cover conduct in the wholesale market when it affects consumers: see regulation 2 (defining a commercial practice in broad terms to include conduct directly connected with the promotion sale or supply of a product or service to a consumer) and par 4.3 of the OFT Guidance on the UK Regulations implementing the Unfair Commercial Practices Directive (2008). Since the CPRs also provide that the core prohibitions are criminal offences, they would appear to offer scope for criminal convictions in cases such as LIBOR manipulation which had direct effect on mortgage costs in the retail market. It is not clear why that enforcement option has been ignored.

Conduct regulation (COBS) encompasses all these issues through its own specific provisions.[15] However, a functionally similar outcome could be achieved through reliance on the general framework of consumer law especially since the UCPD extended the scope of protection beyond contract terms to include unfair practices at any point on the above timeline. While the FSA's 2009 concordat with the OFT[16] largely sidelined the Unfair Commercial Practices Regulations 2008 (CPRs)[17] in favour of dealing with such practices through its own conduct rules there is scope for those regulations to act as a substitute for many aspects of conduct regulation, especially since the concept of "practice" covers a single incident and does not need to lead to a transaction.[18] Moreover, since the practices targeted by the CPRs include a broadly framed general prohibition against unfair commercial practices, they have the capacity to take on a role similar to the FCA Principles for Business. The capacity of the CPRs to perform that role is borne out by an EU study showing that the UCPD has been used in the member States to assess at least half of the cases dealing with unfair practices in financial services and immovable property.[19] Furthermore, the general availability of criminal sanctions within the CPR regime arguably creates more effective deterrence in respect of the most egregious misconduct by comparison with the counterparts of negotiated compliance or regulatory sanctions undertaken by the FCA.

In the case of marketing, COBS controls the process of accepting clients and their categorisation as a retail, professional or eligible counterparty. Following Principle 7 of the Principles for Businesses COBS requires firms to communicate with clients in a manner that is clear, fair and not misleading. For retail clients, much of the protection of the COBS may be encompassed by the CPRs which apply to marketing as well as to advice and performance of the contract. Broader issues related to market structure, such as the regime governing adviser status that was introduced in 2012 following the FSA's Retail Distribution Review[20], would now be more appropriately dealt with under the FCA's competition objective rather than as conduct measures related to the consumer protection objective.

As regards pre-contractual disclosure, COBS has detailed provisions about disclosure of services, fees and commission. Consumer contract law has no express equivalent of these provisions but there are two potential sources of protection. One is the misleading omissions provision of the CPRs (regulation 6) which encompasses omitting or concealing information

[15] The FCA COBS Handbook is used here for the purposes of comparison as it matches the timeline better than the other (more limited) FCA conduct rulebooks.
[16] See http://www.fsa.gov.uk/pubs/other/concordat_fsa_oft_08.pdf.
[17] SI 2008/1277, implementing the UCPD (above n 12).
[18] *R. v X Ltd [*2013] EWCA Crim 818.
[19] See the Commission Report on the operation of the UCPD, Com (2013) 139 Final at 25 and n114.
[20] See I MacNeil, *An Introduction to the Law on Financial Investment* (Hart 2nd ed, 2012) par 6.1.2 for relevant background.

that would lead the average consumer to take a different decision as a result.[21] Another is the obligation incumbent on a fiduciary to disclose commission and other remuneration.[22]

The conduct of business obligations relating to advice and product selection are principally the rules on suitability and appropriateness. The former focuses on ensuring that any personal recommendation to a client is suitable by reference to the financial situation and investment objectives of the client. It applies to most sales in the retail market. The latter applies in circumstances in which a personal recommendation is not made and requires that the firm determine that the client has the necessary experience and knowledge in order to understand the risks involved in the product or service. Both obligations are in principle covered by fiduciary duty but the regulatory rules have a broader scope than fiduciary duty since they cover direct selling in which there is no agency relationship in the legal sense. However, consumer protection in that market segment could be achieved through the application of the concept of misleading omissions in the CPRs, which includes the omission of material that the consumer requires to make an informed transactional decision. While that would have the effect of moving the suitability assessment more to the consumer (as opposed to the seller/adviser under COBS) it is not clear that the suitability assessment is in any case much more than a compliance obligation encompassed in the sales process that leaves the ultimate decision with the consumer.

With regard to cancellation rights, the EU Financial Services (Distance Marketing) Directive[23] makes provision for such rights in the case of distance marketing contracts (only) while the EU Consolidated Life Directive[24] makes provision for life assurance and associated products such as annuities and permanent health insurance. UK implementation was through the FCA Handbook[25] but COBS does not extend such rights to all retail financial services and might not be capable of amendment to do that as a result of the "capping" effect of MiFID. [26] However, the better view is that cancellation rights do not fall within the scope of MiFID's conduct of business regime and therefore the general consumer law on

[21] Reg 6.
[22] See the Law Commission 1995 Report No 236 *Fiduciary Duties and Regulatory Rules* (1995).
[23] Directive 2002/65/EC [2002] OJ L 271/16.
[24] Directive 2002/83/EC [2002] OJ L345/1, article 35.
[25] See COBS 15.
[26] That issue would turn on whether cancellation rights can be characterised as part of the conduct regime put in place by MiFID. While the FCA's implementation in COBS 15 appears to follow that approach, it is at least arguable that they are not since MiFID's conduct regime focuses on the pre-contractual phase of marketing, disclosure and advice whereas cancellation rights are an adjustment of substantive contract law (in effect an extension of the right to rescind a contract). That approach follows the framing of cancellation rights within the Consolidated Life Directive as part of chapter 4 which relates to "contract law and conditions of assurance" as well as the FSA's observation that "Cancellation rights are not prescribed in MiFID as a tool for consumer protection and are considered to fall outside the scope of Article 4." (FSA Consultation Paper 06/19, 'Reforming Conduct of Business Regulation', Annex 1 at par 13.3).

cancellation of distance contracts (itself largely derived from EU law) could in principle be applied to financial services.[27]

In the context of fairness of contract terms there is already a high degree of interaction between COBS and consumer law. The unfairness provisions of the 1999 Unfair Terms in Consumer Contracts Regulations (UTCCRs, now consolidated in the Consumer Rights Act 2015) are particularly important for financial services albeit that they do not include within their scope the main terms of the contract nor the appropriateness of price paid by comparison with the service supplied. The FCA has an enforcement role with respect to unfair terms through its power to seek undertakings that unfair terms will not be used and or to seek injunctions to prevent their use. While the Authority has indicated in its guidance[28] that it will in principle go beyond the directive's test of unfairness and include in its assessment regulatory rules (including the FCA Principles for Businesses) it is not clear that FCA regulatory rules have played an important role in enforcement by comparison with the UTCCRs. Thus, it would seem that not much would be lost by relying solely on the UTCCRs as the basis for enforcing fairness in contract terms in the retail financial market.[29]

So far as quality and performance standards are concerned, the COBS regime has potentially important safeguards in the form of the suitability and appropriateness standards that apply to advised and non-advised sales respectively. However, the prevalence of mis-selling suggests that these safeguards have not worked well as a form of consumer protection despite the considerable compliance obligations associated with their operation. Their role could be subsumed within fiduciary law (below) and the new (mandatory) term relating to skill and care in the provision of services that will be introduced by the Consumer Rights Act 2015.[30]

Fiduciary law

Fiduciary law is applicable to many financial services transactions and performs an important investor protection function. Its central focus is to ensure that a fiduciary acts in the best interests of his constituent and avoids conflicts of interest. It adopts a strict approach in pursuing that objective and (as recognised by the Law Commission in 1995)

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[27] See The Consumer Contracts (Information, Cancellation and Additional Payments) Regulations 2013, SI 2013/3134 implementing EU Directive 2011/83/EU on Consumer Rights [2011] L304/64. The Directive is a maximum harmonisation instrument but does not apply to a contract to the extent that it is a contract for services of a banking, credit, insurance, personal pension, investment or payment nature. It follows that cancellation rights in financial services are outside the scope of that directive also, leaving open to member States the option to apply it (or even more protective provisions) to financial services.

[28] See FSA Unfair contract terms: improving standards in consumer contracts (January 2012).

[29] Since unfair contract terms are not categorised as a distinct form of enforcement in the FCA Annual Report – Enforcement Activity it is difficult to be more precise about that issue. No reference was made to such cases in the 2013/14 Report.

[30] Consumer Rights Act 2015, s49, not yet in force.

often goes beyond the standards that are permitted by regulatory rules.[31] Why then has so much effort been invested in devising a regulatory scheme that implements a diluted form of fiduciary duty? There are probably three main reasons. One is that regulatory intervention does not take proper account of the role of law with the result that quasi-fiduciary conduct regulation becomes characterised as a solution to market failure. Another is that regulatory rules provide a form of *ex ante* guidance with which firms can comply whereas fiduciary duty is a broad standard that can only be definitively formulated in any particular context through *ex post* adjudication. A third reason is that fiduciary duty can be adjusted or excluded by contract whereas regulatory rules (at least in the retail sector) cannot.[32]

However, reverting to a system in which fiduciary law plays a more central role offers some advantages. One is that fiduciary law offers a relatively simple scheme that focuses on the requirement for ethical and contextual judgement in a way that is difficult to replicate in a complex regulatory scheme.[33] Another is that it offers a route towards more uniform and coherent standards of conduct across a wide range of financial transactions. Thus, while the current debate on long-term institutional investment is focused on fiduciary duty in the investment chain (and the Law Commission has developed guidance on fiduciary duty for pension trustees[34]) much of the relationship between institutional investors and their customers is subject to conduct regulation that may not always run parallel to fiduciary duty.[35] The fact that fiduciary duty is routinely excluded in many wholesale financial market transactions does not alter that argument since much of (quasi-fiduciary) conduct regulation can in any case be excluded in transactions with professional clients or eligible counterparties. Thus, the case for a more central role for fiduciary duty is not based on extending its scope but on permitting it to act as the primary standard of conduct within its existing field of application. Finally, a more central role for fiduciary duty would link standards of conduct in the financial sector more closely with other sectors, thereby providing an additional channel by which conduct might be benchmarked and improved.

Enforcement

[31] See n 11 above at 3. One prominent example is conflicts of interest where fiduciary duty adopts a strict proscriptive approach in contrast with the regulatory approach of "managing" such conflicts to avoid adverse impact on clients (e.g. compare MiFID articles 13(3) and 18 with the classic common law formulation in *Aberdeen Railway v Blaikie Bros* (1854) 1 MacQueen 461 (HL)).

[32] While the common law recognises that the content of fiduciary duty can be adjusted by contract (see e.g. *Kelly v Cooper* [1993] AC 205) COBS 2.1.2 prevents contacting out of regulatory rules applicable to retail clients.

[33] See e.g. P Hanrahan, 'Regulation, Ethics and Collective Investments' in I MacNeil and J O'Brien (eds) *The Future of Financial Regulation* (Hart, 2010), arguing that fiduciary duty can fill in the gaps between particular legal rules by reference to a particular ethical model (acting in the best interests of the investor).

[34] See http://lawcommission.justice.gov.uk/docs/lc350_fiduciary_duties_guidance.pdf.

[35] While occupational pensions are excluded from the FSMA 2000 regulatory perimeter and fall within the remit of the Pensions Act 1995, the sale of almost all savings and investment products targeted at the retail market fall within the scope of the FSMA 2000 conduct regime.

One potential objection to the argument that much of conduct regulation could be subsumed within the general law is that the role of the FCA in public enforcement would be compromised. However, that need not necessarily be the case. The FCA already plays a major role in enforcement linked to unfair terms and while it does not play a major role in relation to the CPRs as a result of a policy choice[36], it is formally designated as an enforcer[37] and so could change its approach. Furthermore, the FCA could well be empowered to undertake enforcement of fiduciary law within the regulatory perimeter. While that approach would be a departure from its traditional role in enforcing its own regulatory rules, the model of a public regulator with broad enforcement powers over all unlawful conduct is one that already exists in Australia. In that system the Australian Securities and Investment Commission (ASIC) devotes much of its attention to enforcement on behalf of investors and is able to take action with respect to breach of fiduciary duty falling within its (broad) regulatory mandate. [38] That approach also has the benefit of bringing public enforcement to bear in areas such as directors' duties which may be directly linked to compliance with conduct rules. Nor would it be constrained by the EU regulatory framework since enforcement remains in the hands of the national authorities.

Another relevant factor for enforcement in the retail sector is the role of the Financial Ombudsman Service (FOS). Since the FOS adjudicates on the basis of the "fair and reasonable" standard, its frame of reference extends beyond the law and regulatory rules. Thus, its key role in promoting good standards of conduct in the retail financial sector would not be threatened by a move to subsume much of conduct regulation within general consumer law and fiduciary duty.

The EU dimension

The EU dimension poses something of a paradox for the argument advanced so far. On the one hand it is the source of the central provisions of consumer law that could function as a substitute for conduct regulation. On the other hand, EU policy has encouraged the development of distinct schemes of regulation for the financial sector at both EU and national level that overlap with consumer law. That approach is supported by the priority given by the UCPD to sectoral regulation (such as MiFID) over the UCPD and the exception that permits national measures in the financial sector to derogate from the maximum

[36] See n 16 above.
[37] Enterprise Act 2002, s213(5A).
[38] See H Bird et al, 'ASIC Enforcement Patterns. Centre for Corporate Law and Securities Regulation', 2003 (available at www.ssrn.com/abstract=530383) noting that ASIC was more likely to take enforcement action in relation to laws with an ethical foundation that address conduct that is widely condemned because it exploits and defrauds shareholders and creditors.

harmonisation approach of the UCPD. [39] That policy seems to have evolved mainly because national (financial) conduct regulation in some member States had developed earlier and more effectively than consumer protection at the EU level. At that stage it made sense to leave in place what seemed to work quite well. Were the issue to be revisited today on a *de novo* basis, it is unlikely that a market failure analysis would support the scale and scope of conduct regulation that has been adopted in MiFID because much of the work is already capable of being done by consumer law.

Nor is the policy of maximum harmonisation of conduct regulation through MiFID convincing. It is based on the premise that the development of cross-border business has been held back by the absence of uniform conduct regulation in the member States. Cross-border in this sense refers not to the much broader range of business carried on in another member State through a subsidiary or a branch, since those activities are already subject to the conduct rules of the host state and therefore consumers are familiar with the conduct regime and have access to national enforcement mechanisms. It refers instead to the much smaller segment of cross-border services provided by a firm in one state to a consumer in another. Yet no convincing case has been made as to why EU policy with respect to conduct regulation should be driven by a model of doing business that neither firms nor consumers find attractive and which excludes flexibility and diversity in national systems of regulation.[40]

CONDUCT REGULATION AND ETHICS

Reconfiguring conduct regulation so as to give fiduciary duty a more central role would open up the possibility of giving ethics a more central role. This would be true both for formal (FCA) regulation and self-regulation in the form of ethical codes.

The role of ethics in conduct regulation

The FCA Principles for Business and their antecedents are often characterised as a high-level code of ethics for financial services.[41] While they are framed by reference to ethical concepts such as integrity it is much less clear that they can function as ethical guidance in the current configuration of conduct regulation. The Principles were originally devised as part of a package of reforms to the FSA 1986 regime that were intended to address the criticism of

[39] See articles 3(4) and 3(9) respectively of Directive 2005/29/EC [2005] OJ L149/22. See also the article 4 derogation provision in the MiFID Implementing Directive, n 4 above.
[40] That issue was not addressed (nor was evidence provided that MiFID had caused any expansion in cross-border business) during the 2010 Commission review of MiFID: see the summary of the Public Hearing on the Review of MiFID (30/07/2010) at http://ec.europa.eu/finance/securities/isd/archives_en.htm. See also N Moloney, *How to Protect Investors* (CUP 2010) at 209-212 for an analysis of the risks associated with the policy of maximum harmonisation.
[41] See e.g. A Page and R Ferguson, *Investor Protection* (Weidenfeld and Nicolson, 1992) at 266.

market practitioners that the regulators' rulebooks were legalistic, complex and impenetrable. However, while the technique of "bolting-on" a set of Principles may have given some high-level guidance as to the ethical objectives of conduct regulation, there remains a disconnection from the underlying rules. The disconnection arises from the "market failure" rationale for making rules whereas no such rationale (nor the related cost-benefit analysis) applies to the making of Principles. Thus, the ethical focus of the Principles is not clearly linked with the content of the rules because market failure analysis does not have an explicit ethical focus; rather it is driven much more by efficiency considerations. Similarly, the focus on risk-based regulation moves the process of compliance away from an ethics-based approach because risk (or its absence) is superimposed on ethical judgement and may in some instances sanction unethical conduct. While considerable attention has been paid to creating a legal structure that supports principles-based regulation (e.g. principles can be enforced independently of any rule breach[42]), it cannot be said that the current configuration represents a coherent approach to ethical conduct. Nor would it seem feasible to attempt to integrate ethics into the current structure without fundamental changes in the approach to regulation.

The role of Corporate Codes of Ethics

Corporate codes of ethics are common in the financial sector and firms have a variety of enforcement techniques in place but the role that they play in promoting compliance within the regulatory framework is not clear. There are two main issues. One is that ethical codes framed at a high level of generality (referencing concepts such as integrity) are in competition with a compliance process that is calibrated in much greater detail as a result of conduct regulation. In that sense, regulation may be said to limit the space within which ethical codes may operate although a role for corporate codes in promoting higher standards cannot be ruled out. Another issue is that ethical codes focus on individual responsibility which requires a degree of personal autonomy that may only be present in the management structure and business process of many firms at the higher levels. Thus, ethical codes may simply not be very relevant at the lower levels where autonomy and judgement are more heavily constrained. Even so, ethical codes could play a more significant role especially if they were developed to a more granular level whereby they could be enforced under the

[42] See *R (ex parte British Bankers Association v FSA [2011] EWHC 999 (Admin)*, supporting the independent enforcement of the FSA Principles in the context of mis-selling of PPI insurance.

provision of the CPRs that encompasses failing to honour a firm and verifiable commitment made in a code of conduct within the concept of misleading action.[43]

The role of Industry Codes of Conduct

While FSMA 2000 is framed without an explicit role for self-regulation, industry codes of conduct that apply on a voluntary basis with no statutory foundation continue to exert considerable influence.[44] There are three main reasons why such codes and the concept of market discipline that they seek to implement continue to be relevant. One is that they may cover activities that fall outside the regulatory perimeter.[45] Another is that they can provide a global set of standards that are not limited by national jurisdiction in the same way as regulation.[46] And finally, codes may serve as part of the process of "professionalization" of distinct functions within the financial sector.[47]

A key question is whether such codes have a meaningful role to play in improving standards of market conduct. Implicit in that question is the issue of whether self-regulation can deliver better and more context-specific standards of acceptable market practice. While the evidence on that issue is difficult to interpret, the Bank of England's Fair and Effective Markets Review (FEMR) adopts a fundamentally positive stance on the potential role of self-regulation with the proviso that a number of design issues require to be addressed to improve the effectiveness of industry codes. In particular, mechanisms for ensuring compliance with codes are viewed as weak and might be strengthened by techniques such as comply or explain, contractual commitments to market counterparties and official regulatory endorsement.[48] While a stronger role for industry codes would fit quite well with a revised regulatory scheme in which conduct regulation was cut back to give a more prominent role to the general law, an important caveat identified in FEMR applies. It is that changes in market structure (such as the combination of principal and agent functions) and increasing

[43] See regulation 5(3) of the CPRs. It is unlikely that a court would hold that any of the Codes of Ethics currently in place would meet the requirements of that provision that the commitment is not aspirational and causes or is likely to cause the consumer to take a transactional decision he would not have taken otherwise.
[44] See The Bank of England, Fair and Effective Markets Review, How fair and effective are the fixed income, foreign exchange and commodities markets? Consultation document (October 2014) at 5.4 (Standards of market practice) for an outline of the various codes.
[45] See the Non-Investment Products Code (for principals and broking firms in the wholesale markets), available at http://www.bankofengland.co.uk/markets/Documents/forex/fxjsc/nipscode.pdf. The Code covers activity such as spot and forward foreign exchange and wholesale deposits that are not within the FSMA 2000 regulatory perimeter. In the retail market, the Lending Code covers consumer credit and unsecured loans, both of which fall outside the FSMA 2000 regulatory perimeter although the FCA took over responsibility for the regulation of consumer credit from the OFT in 2014.
[46] E.g. the ACI Model Code (Global) applicable to all OTC product markets: see Bank of England (n 44 above) at 39.
[47] E.g. the CFA Code of Ethics and Standards of Professional Conduct (Global) and CISI Code of Conduct: see Bank of England (n 44 above) at 39. The Code currently being developed by the Banking Standards Council will be another example.
[48] See Bank of England (n44 above) at 37 and 41. See also n43 above regarding enforcement of commitments in codes of conduct under the CPRs (which extend to conduct in the wholesale market that has a direct effect on consumers).

concentration in some market segments may have the effect of encouraging misconduct and limiting the role that might otherwise be played by market discipline.[49] Viewed in that light, the potential role of self-regulation is not static and changes in line with market configuration.

Ethics – options for integration into conduct regulation

There are various ways to approach the integration of ethics into conduct regulation. One is to take an instrumental approach whereby ethical values would be more clearly articulated in the conduct regime using techniques such as a requirement to treat all counterparties fairly.[50] While such an expansion of regulation might seem attractive in the light of recent misconduct it carries the risk of limiting flexibility in contracting and advisory patterns in the wholesale markets as well as sidelining the potential role of market discipline. Another option is to view ethical codes (industry as well as corporate) as a form of functional simplification that translates complex regulatory rules into more intuitive guidance for the exercise of discretion (in a more context-specific manner than can be achieved by the FCA Principles for Business). That approach would however require some support from the regulator as well as a conscious move away from mechanistic compliance by firms. Finally, codes of ethics might simply be characterised as aspirational standards but for that to work requires that market discipline and perhaps also corporate social responsibility operate as effective mechanisms to constrain unethical conduct. For the time being those conditions do not yet seem to be widespread in financial markets. However, the development of the Banking Standards Code in the UK and the increasing internal focus on culture and ethics within firms holds out some prospect of progress in the medium-term.

COMPLEXITY

Conduct regulation has evolved in a manner whereby the complexity of the rules works against their basic objectives. Complexity can be said to represent the relative degree to which four key features are part of the rules: density, technicality, institutional differentiation and uncertainty.[51] Complexity in itself is no bad thing and is often the result

[49] Ibid at 5.2 (Competition and market discipline).

[50] See Awrey, D Blair, W and Kershaw, D "Between Law and Markets: Is there a role for culture and ethics in financial regulation?" (2013) 38:1 *Delaware Journal of Corporate Law* 191. MiFID II (Directive 2014/65/EU, [2014] L173/349) adopts a similar approach in article 30(1) by extending the obligation to act honestly, fairly and professionally to eligible counterparties (who may be excluded under the current MiFID regime) but does not support the new obligation with changes to board structure and directors' duties in the manner proposed by Awrey et al.

[51] This follows the approach in P Schuck, 'Legal Complexity: Some Causes, Consequences and Cures' 42(1) *Duke Law Journal* (1992) 1 at 3. In this scheme institutional differentiation refers to different decision structures for making, elaborating and enforcing rules.

of making appropriate provision for different cases. However, as the scale of complexity increases so does uncertainty (although paradoxically it may be the demand for more certainty that generates complexity) and the cost of compliance. The point at which complexity will begin to be counterproductive is difficult to determine[52] but an important consideration is the tendency towards "delegitimation", whereby complexity leads to non-compliance as a result of the uncertainty and increasing cost associated with compliance.[53]

Complexity is evident is several different ways. The first is with regard to the scope and application of the various conduct regimes. The FCA Handbook has four conduct of business sourcebooks, the most extensive of which is the COBS sourcebook covering designated investment business: the others are ICOBS (insurance); MCOB (mortgages and home finance); and BCOBS (banking).[54] While there are some common elements in the various sourcebooks, the fragmentation of regulation across products and services that are often sold together to consumers by a single provider does little to promote the development of clear and consistently applied standards of market practice. Moreover, the potential for exclusion of much of the regime in the case of eligible counterparties and professional clients, while justifiable in terms of proportionality, further limits the evolution of clear and consistent standards of market practice. While that might not be such a problem in a world of segmented markets, it is clear from incidents such as LIBOR that the wholesale and retail markets are connected and that consumers may well suffer as a result of different standards of market conduct in wholesale markets.[55]

The stability of the regime also poses problems for the development of clear and consistently applied standards of market practice. Leaving aside the complications that flow from the institutional structure of regulation (both at the EU and UK levels) the substance of conduct regulation has been subject to a degree of change that causes complexity and confusion and drives the compliance process towards a more mechanistic approach. While there is of course a valid argument to be made that any rulebook must keep pace with a changing world, constant change, especially by comparison with the relative stability of the general law, risks creating the impression that there is little that is fundamental, durable or ethically robust about conduct regulation.[56]

[52] There is little in the way of empirical evidence on this issue but for proposals on how to measure the scale and effects of legal complexity see J B Ruhl and D M Katz, 'Measuring, Monitoring and Managing Legal Uncertainty' available at www.srrn.com/abstract =2566535.
[53] Schuck, above n51 at 22.
[54] While CASS (Client Assets) and MAR (Market Conduct) are also included under the FCA category of "Business Standards" they differ from mainstream conduct regulation in that their focus is on rights in property (CASS) and market integrity (MAR) in the context of organised markets.
[55] Bank of England (n 44 above) at 5.2 and 5.4.
[56] Stability may also be characterised more broadly as a general condition for legality: see L Fuller, *The Morality of Law* (Yale University Press, 1964) at 79.

A third source of complexity is the interaction between the general law and conduct regulation. It has already been noted that regulation is developed without appropriate reference to the law but an additional complication is that FSMA 2000 does not indicate how regulatory rules are to interact with the general law. One approach to this issue is to regard regulatory rules as constituting a separate sphere that does not interact with the general law. On that view the public law of regulation and private law are parallel systems that do not interact. An alternative view is that the objectives of FSMA 2000 imply a power to alter private law rules. The Law Commission's 1995 Report on Fiduciary Duties and Regulatory Rules[57], focusing on the narrower issue of *conflicts* between fiduciary duty and regulatory rules, adopted a hybrid view that courts would already take account of reasonable regulatory rules when ascertaining the content of fiduciary duty. While that represented a pragmatic solution to the overlapping scope of the two regimes and subsequently attracted some judicial support[58] it did not fully address the broader issue that parallel regimes create confusion so long as their interaction is not made clear in the statutory framework. A more central role for the general law in conduct regulation would go some way towards removing that confusion by cutting back conduct regulation to a scheme that focuses more on the FCA's market integrity objective.

It may of course be countered that the overall scheme of conduct regulation adopts two classic strategies to cope with complexity: *contracting around* the rules (in the case of professional investors and eligible counterparties); and *simplification* of the rules through FOS adjudication according to the "fair and reasonable standard". While those strategies do admittedly mitigate the scale of complexity within sub-sets of the market they also contribute to the fragmentation of the system as a whole and in that sense promote complexity.

CONCLUSION

Conduct regulation has evolved in a manner that lacks coherence. There are three main problems. First, the process of making regulatory rules does not give proper consideration to the role of the general law and in particular the expansion in the scope of consumer protection in recent years. Second, despite much contemporary debate over ethics and culture in the financial sector, the role of ethics in the system of conduct regulation is unclear. Finally, the complexity of conduct regulation has reached a point that is counterproductive for the achievement of its objectives. While there may be different ways of approaching these problems, it seems unlikely that conduct regulation will work well until they are properly addressed. The proposal made here for fiduciary duty to take a more

[57] N 20 above.
[58] See further MacNeil (n 16 above) at 6.6 and 14.2.

central role in conduct regulation would represent one way of addressing all three problems. It is unlikely to be a panacea but would be better than what we currently have.

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