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ENFORCEMENT OF CAPITAL MARKETS REGULATION: THE UNITED KINGDOM AND ITS INTERNATIONAL MARKETS

IAIN MACNEIL

INTRODUCTION

The cornerstone of the regulatory system for capital markets in the United Kingdom is the *Financial Services and Markets Act 2000* (UK) c 8 ('*FSMA 2000*'). The Act is envisaged as a framework for regulation and therefore its focus is on regulatory procedures such as rule-making and enforcement rather than substantive rules, which are to be found largely in the rulebook of the regulator, the Financial Services Authority ('FSA').[1] The regulatory objectives of the *FSMA 2000* are:

(a) Market confidence

The market confidence objective is maintaining confidence in the financial system. The financial system includes financial markets and exchanges, regulated activities and other activities connected with financial markets and exchanges. Market confidence does not imply a policy of preventing all failures but involves minimising the impact of failures and providing mechanisms to protect consumers of financial services (in the broad sense).[2]

(b) Public awareness

The public awareness objective is promoting public understanding of the financial system. This includes awareness of the benefits and risks associated with different kinds of investments and the provision of appropriate information and advice.

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[1] The rulebook is hereafter referred to as the '*FSA Handbook*', see FSA Website, <http://www.fsa.gov.uk>.

[2] See FSA, *Reasonable Expectations: Regulation in a Non-Zero Failure World* (2003). All FSA publications are available at <http://www.fsa.gov.uk>.

(c) The protection of consumers

The consumer protection objective is securing the appropriate degree of protection for consumers. In considering what is appropriate, the FSA must have regard to risk, expertise, the need for information and advice and the general principle that consumers should take responsibility for their decisions. 'Consumer' is defined broadly and includes: (1) past, present and potential customers of authorised persons; (2) companies and persons entering into transactions in a business capacity; and, (3) persons who derive rights from persons who are 'consumers'.[3]

(d) The reduction of financial crime

The reduction of financial crime objective is to reduce the extent to which it is possible for a business carried on (1) by a regulated person or (2) in contravention of the general prohibition against carrying on regulated activity without authorisation, to be used for a purpose in connection with financial crime. Financial crime includes any offence involving fraud or dishonesty; misconduct in, or misuse of information relating to, a financial market; or handling the proceeds of crime. The *FSMA 2000* itself establishes offences falling within the scope of this objective, such as making misleading statements and engaging in market manipulation.[4]

The *FSMA 2000* also refers to principles of good regulation to which the FSA must have regard in carrying out its duties.[5] They are:

(a) the need to use its resources in the most efficient and economic way;

(b) the responsibilities of those who manage the affairs of authorised persons;

(c) the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits,

[3] *FSMA 2000* (UK) s 138(7).
[4] *FSMA 2000* (UK) s 397.
[5] *FSMA 2000* (UK) ss 2(3), 73 in respect of the FSA's function as the competent authority for listing in the UK.

considered in general terms, which are expected to result from the imposition of that burden or restriction;

(d) the desirability of facilitating innovation in connection with regulated activities;

(e) the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom;

(f) the need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions;

(g) the desirability of facilitating competition between those who are subject to any form of regulation by the Authority.

The *FSMA 2000* should not, however, be viewed as a comprehensive system of regulation for capital markets, because it operates alongside other legal regimes which make an important contribution. From the perspective of listed entities, company law is of particular significance because it sets out the basic regulatory obligations applicable to all companies. For example, disclosure and statutory accounting obligations apply to most companies in one form or another. From the perspective of market participants (such as brokers, investment banks and fund managers), the *FSMA 2000* regulatory system operates in tandem with contractual and fiduciary obligations owed to customers in specific circumstances: these regulatory and private law obligations often appear quite similar but they are rarely coextensive. The Panel on Takeovers and Mergers is also a significant feature of the United Kingdom regulatory regime, reflecting the importance of takeovers as part of the corporate governance system in the UK. Viewed in its entirety, the regulatory system for capital markets in the United Kingdom is therefore much more than *FSMA 2000*:

it is in reality a combination of legal sources which operate in different ways and pursue different objectives.

The regulatory objectives of *FSMA 2000* do not provide a clear roadmap towards an enforcement strategy, but they do provide an initial indication that enforcement is unlikely to be a mechanistic response to every contravention. That initial impression is borne out by the manner in which enforcement policy and practice has developed within the *FSMA 2000* regulatory regime and associated legal regimes. As discussed below, several features of the United Kingdom's regulatory system result in formal enforcement action being quite rare. That outcome is capable of many different interpretations.[6] In order to set it in context, I begin by first looking at the development of *FSMA 2000* regulation and then the role of self-regulatory rules and market discipline in the United Kingdom model. I then move on to examine the link between models of responsibility and enforcement. I conclude by examining the modes of enforcement and sanctions that are available within the *FSMA 2000* system.

I RISK-BASED REGULATION AND ENFORCEMENT

A risk-based approach to regulation is now firmly embedded in the regulatory system established under *FSMA 2000*. That outcome is the result of a deliberate policy choice made by the FSA, as there is nothing in the statutory framework that explicitly or implicitly requires the FSA to adopt such an approach.[7] It does, however,

[6] For a discussion of the possible causes and implications of the low-level of formal enforcement action in the UK by comparison with the US, see John Coffee, 'Law and the Market: The Impact of Enforcement' (Paper delivered at the Dynamics of Capital Market Governance Forum, Australian National University, 14 March 2007).

[7] See Joanna Gray and Jenny Hamilton, *Implementing Financial Regulation: Theory and Practice* (2006) 28. The Treasury-commissioned Hampton Review, *Reducing Administrative Burdens: Effective Inspection and Enforcement*, March 2005, Recommendation 1, 115, available at <http://www.hm-treasury.gov.uk/budget/budget_05/other_documents/bud_bud05_hampton.cfm>, recommended that all regulatory activity should be on the basis of a clear, comprehensive risk assessment.

reflect a broader move in regulatory systems towards a risk-based approach.[8] The meaning of risk-based regulation within the *FSMA 2000* context is made clear by the following explanation given by the FSA Chairman:

> The theory of risk management at the FSA is very close to that of risk management in a financial firm, in that there are the same elements of setting aims (in our case attaining our statutory objectives rather than a financial objective), establishing our risk appetite, identifying risks to our statutory objectives, establishing an agreed measure of risk, monitoring those risks, and managing them through both those with direct responsibility and those who provide challenge. At a reasonably high level of generality, the process of risk management in the FSA and in a financial firm are the same. And at a very high level of abstraction, they are the same: a cycle of risk identification, measurement, mitigation, control and monitoring.[9]

As regards enforcement, risk-based regulation has two important implications. First, not all contraventions are necessarily the subject of enforcement action. Second, specific priority areas may be targeted for action because of the implications they carry in terms of risk to the FSA's statutory objectives.[10] The corollary, of course, is that there will be some contraventions that are ignored or fall below the regulatory radar because they occur in relatively low risk areas. Furthermore, there may well be instances in which an individual or firm is the subject of enforcement action when the relevant conduct is tolerated on the part of others. In that sense, there may be a sense of injustice on the part of an entity selected for enforcement action, where the purpose of that action is primarily to change the behaviour of others who are likely to have engaged in the same course of conduct. The net result is that risk-based regulation envisages from the outset that enforcement will not be an automatic response to a contravention. In the FSA's own words: 'The risk-based approach is as valid for

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[8] See, eg, Better Regulation Commission, *Risk, Responsibility and Regulation, Whose Risk Is It anyway?* <http://www.brc.gov.uk> at 21 February 2007; Bridget M Hutter, 'The Attractions of Risk-Based Regulation: Accounting for the Emergence of Risk Ideas in Regulation' (Discussion Paper No 33, Centre for Analysis of Risk and Regulation, London School of Economics, 2005), available at <http://www.lse.ac.uk/collections/CARR> at 21 February 2007.

[9] Sir Callum McCarthy, FSA Chairman, 'Risk Based Regulation: The FSA's Experience' (Speech delivered at the ASIC Summer School, Sydney, 13 February 2006).

[10] See FSA CEO John Tiner's Overview in the FSA, *FSA Business Plan 2006/2007* 14, for a re-statement of this approach to enforcement.

enforcement as for the FSA's other activities. One practical consequence of this is that the FSA cannot, and does not, attempt to pursue every rule breach.'[11] Statistics on enforcement tend to reinforce this view. There have been only 49 occasions[12] on which a financial penalty has been imposed on a firm since N2,[13] and in more than half of those cases the firm was designated as 'high risk' within the FSA's risk classification system for authorised firms.[14] However, any interpretation of the low incidence of enforcement action in the UK must take into account that enforcement action is only one of the regulatory tools available to the FSA to deal with contraventions. Alternatives, which are regarded by the FSA as contributing to compliance, include supervisory action, theme work and the policy consultation process. It follows that there can be no simple conclusions drawn between the low incidence of enforcement action and levels of compliance, because compliance is a function of several different factors and it is difficult to separate the causal effect of each.

II PRINCIPLES-BASED REGULATION AND ENFORCEMENT

A *The Move towards More-Principles-Based Regulation*

The FSA is committed to developing principles-based regulation.[15] The rationale is that 'this can produce better outcomes for both consumers and financial services industry by encouraging a keen focus on how best to act in a particular situation rather than simply following a more mechanistic approach.'[16] The emphasis

[11] FSA, *Enforcement Process Review: Report and Recommendations* (2005) 7, available at <http://www.fsa.gov.uk/pubs/other/enf_process_review_report.pdf>.
[12] Out of a total of 59 enforcement actions against authorised firms since N2: see FSA, *Enforcement Process Review*, above n 11.
[13] The date on which *FSMA 2000* became effective: 1 December 2001.
[14] The FSA uses a system called ARROW (Advanced Risk Response Operating Framework) to categorise authorised firms according to their risk profile.
[15] See FSA, *FSA Simplification Plan* (2006) 3; FSA, *FSA Business Plan 2006/2007*, above n 10, 10.
[16] FSA, *FSA Simplification Plan*, above n 15, 3.

on outcomes in principle-based regulation rather than inputs or processes has been stressed by the FSA, and so too has the flexibility offered by principles-based regulation to firms in responding to regulation in terms of the structure and conduct of their business.[17]

Underlying this policy are two assumptions. The first is that principles-based regulation can be readily identified and differentiated from 'rule-based' regulation.[18] On its website, the FSA poses the following question: 'What does the FSA mean by "principles-based regulation" rather than "rules"?' It provides the following answer:

> Our approach is underpinned by the principle that it is neither possible nor desirable to write a rule to cover every specific situation or need for decision that a regulated firm might encounter. Instead, we focus on the Principles set out in the *FSMA*. These set out in more general terms the types of behaviour that we expect of firms and individuals (for example — 'A firm must conduct its business with due skill, care and diligence').[19]

At one level, the structure of the *FSA Handbook* makes the principle–rule distinction quite straight-forward. It comprises high-level principles and detailed rules, which are often linked directly with the principles and expressed as giving more precise content to the generality of the principle. Such an approach is also evident in other aspects of the United Kingdom regulatory regime, such as the 'true and fair' override for accounts and audit,[20] and the 'comply or explain' approach of the *Combined Code on Corporate Governance* ('*Combined Code*' or '*Code*'). However, it is difficult to judge from this feature alone how far the regulatory system is based on principles as opposed to rules. Nor does it help particularly to compare the volume of rules that sit

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[17] See, eg, Dan Waters, FSA Director Retail Policy, 'Implementing Principles Based Regulation' (Speech delivered at the ABI Conference, London, 7 December 2006), available at <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1207_dw.shtml> at 5 February 2007.

[18] The proposition that the meaning of principles-based regulation is subject to some uncertainty in the financial world is supported by anecdotal evidence: see, eg, 'FSA Regulation Move to Cost City £50m', *Financial Times* (London), 7 February 2007, 4 (reporting that 'Some finance professionals are likely to balk at the cost [of the move to principles-based regulation], especially given continued uncertainty in the City about the meaning of principles-based regulation and how it will work in practice').

[19] See FSA, *Facts and Figures* <http://www.fsa.gov.uk/Pages/About/Media/Facts/index.shtml> at 20 February 2007.

[20] See *Companies Act 1985* (UK) c 6, ss 226A, 235 respectively ('*Companies Act 1985*').

underneath principles, because that exercise does not in itself contribute to an understanding of the relationship between the principles and the rules. The critical features are (a) the extent to which the principles can, in isolation, form the basis for compliance and enforcement and (b) alternatively, the extent to which principles can override specific rules that flow from the principle. Thus, while it may be possible to identify regulatory systems that adopt some elements of a principles-based approach,[21] it is only when these two characteristics are present that a system can be regarded as being based on, rather than just influenced by, a principles-based approach. That is an issue I return to in Section B below.

The second assumption underlying the FSA policy is that principles-based regulation is superior as a regulatory technique to rule-based regulation. That is a common assertion[22] in the post-Enron and WorldCom environment, but not one that is always supported by evidence or reasoned argument.[23] The FSA's arguments in favour of the superiority assertion are that:[24]

- detailed prescriptive standards have not in the past prevented misconduct;
- the current volume and complexity of FSA standards acts as both a barrier to entry and a barrier to compliance;
- prescriptive rules divert attention towards compliance with the letter rather than the spirit of the standard;

[21] For a discussion of such systems see Christie L Ford, 'New Governance, Compliance and Principles-based Securities Regulation' (2007) *American Business Law Journal* (forthcoming), available at <http://ssrn.com/abstract=970130> at 21 May 2007.
[22] For example, FSA CEO John Tiner has said that: 'In short, the use of principles is a more grown-up approach to regulation than one that relies on rules': 'Principles Based Regulation: The EU Context' (Speech delivered at the APCIMS Annual Conference, Barcelona, 13 October 2006), available at <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1013_jt.shtml>.
[23] See Andrew Hill, *Lombard Column*, *Financial Times* (London), 7 February 2007, referring to the role of the superiority assertion in the regulatory debate in the United States: 'The FSA is right to pioneer the principles-based approach, although its American fans have exaggerated the UK's progress in their own self-interest'.
[24] The most complete version seems to be in Andrew Whittaker, FSA Director General Counsel, 'Professional and Financial Regulation — Conflict or Convergence?' (Speech delivered at the Fountain Court Chambers Conference, 31 January 2006), available at <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0131_aw.shtml>.

- many issues are not dealt with adequately by prescriptive standards, or can be dealt with in that way only at the cost of making the system overly complex;
- prescriptive standards are costly for FSA and consumer resources.

These arguments are certainly persuasive to some degree but they also reflect implicit judgments in respect of the causal influences that contribute to the success or failure of the regulatory system. There have been few attempts to subject the superiority assertion to widespread scrutiny or testing, but this process has occurred to some extent in the field of accounting standards, where the principles-versus-rules debate has a longer lineage.[25] In that context, recent versions of the superiority assertion have been premised on the basis that a rule-based system of accounting standards in the United States contributed to the collapse of Enron in a manner that would not have occurred had the (supposedly) more principles-based accounting standards in the UK applied.[26] However, it has been argued that it is simply wrong[27] to characterise accounting standards in the United States as more rule and less principle-based than those in the UK, and that a better explanation is that Enron was indicative of a failure to apply auditing principles in a manner which recognised the qualitative nature of accounting and instead applied rules in a mechanistic manner.[28] A variant on that argument is that the US Generally Accepted Accounting Principles do not lack a foundation of principles, but rather that auditors are unable or unwilling, because of the influence exerted over them by their clients, to interpret principles according to

[25] See Institute of Chartered Accountants of Scotland, *Principles Not Rules: A Question of Judgement* (2006), available at <http://www.icas.org.uk> at 23 February 2007.
[26] Waters, above n 17, 3, comments: 'We need not look too far to find the sort of regime that a defensive, legalistic approach will lead to. How many years would it take before we had our very own Enron experience?'
[27] See also William W Bratton, 'Enron, *Sarbanes-Oxley* and Accounting: Rules Versus Principles Versus Rents' (2003) 48 *Villanova Law Review* 1023.
[28] See David Kershaw, 'Evading Enron: Taking Principles Too Seriously in Accounting Regulation' (2005) 68 *Modern Law Review* 594.

their spirit or to override the application of rules on the basis of principles.[29] Thus, as regards support for the superiority claim, it seems clear that much rests on the perceived status of the UK as having prospered under a version of principles-based regulation combined with the absence of a major failure on the scale of Enron.[30]

Another issue to be clarified in this context is the relationship between principles-based regulation and 'light-touch' regulation. While the former relates to the structure and formulation of rules and can in principle be applied across the entire range of FSA regulation, light-touch regulation is more limited in its scope and relates to the substance of the obligations imposed rather than their formulation. The FSA has made clear that light-touch regulation is appropriate for the wholesale (or inter-professional) marketplace[31] and has not referred to this approach in the concept of retail markets.[32] Thus, it would be wrong to equate principles-based regulation with less onerous regulation in the sense that principles-based regulation represents an implementation choice and not a choice as regards the substance or intensity of regulation.[33] For example, few would doubt that the *Combined Code* is principles-based, but it represents an additional tier of regulation for listed companies, and

[29] See Bratton, above n 27, 1047–51.
[30] Recent comments by Federal Reserve Chairman Ben Bernanke do however make the case for a broad adoption of principles-based regulation in US based on its proven success in the US banking sector: see 'Bernanke calls for UK-style regulation', *Financial Times* (London), 15 May 2007.
[31] See Thomas Huertas, FSA Director Wholesale Firms Division, 'Regulating the Relationship: Banks, Firms and the FSA' (Speech delivered at the Joint AFB and ACT Conference, 8 February 2005), available at <http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2005/sp226.shtml> at 20 February 2007.
[32] But note the comment in the Treasury-commissioned Macrory Report, *Regulatory Justice: Making Sanctions Effective* (2006) 34, available at <http://www.cabinetoffice.gov.uk/REGULATION/news/2006/060522.asp> at 20 February 2007, concurring with the view of the Better Regulation Commission that the regulatory regime (across all sectors) 'remains light touch'. It is not entirely clear if that is intended as shorthand for regulation being appropriate and proportionate or whether it means, as in the FSA context, less intense regulation.
[33] The restructuring of the anti-money laundering requirements provides an example. The FSA replaced 57 pages of detailed rules with two pages of high-level principles, deleting rules with over £250 million of administrative costs. No claim was made, however, about the intensity of regulation, which has presumably remained the same following the changes, not least because of the obligations imposed externally by the EU.

regulates matters such as board structure and composition in a manner that had not occurred before its introduction.

B *The Implications of More Principles-Based Regulation for Enforcement*

As suggested earlier, there are (at least) two tests for identifying a principles-based regulatory system. The first is whether the principles can stand on their own for the purposes of compliance and enforcement.[34] The second, relevant in particular when there may be the possibility that compliance with detailed rules in a particular instance will result in a departure from a principle, is whether principles are capable of overriding rules.[35] In both instances it seems clear that if the test is met the system can correctly be described as principles-based. These tests distinguish a true principles-based system of regulation from those in which principles may be present to some degree but do not meet the two tests.[36]

Closely linked with the issue of whether a particular principle has the capacity to be enforced independently, is the issue of predictability. This focuses on whether a principle has sufficient content to guide the regulated to compliant solutions and to provide a sufficiently clear basis for the regulator to be able to take enforcement

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[34] For this purpose the potential complication of distinguishing clearly between principles and rules is ignored. Even within a regulatory system such as *FSMA 2000*, which distinguishes explicitly between principles and rules, the matter may become confused. The FSA, when referring to enforcement, has sometimes described principles as rules: see, eg, Clive Briault, FSA Managing Director Retail Markets, 'Treating Customers Fairly and More Principles-Based Regulation' (Speech delivered at the FSA Summer School, Cambridge, 24 July 2006), available at <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0724_cb.shtml> at 5 February 2007: 'Finally, what does a more principles-based approach mean for enforcement? Three points are worth noting here. *First, our Principles are rules*. We can take enforcement action on the basis of them' (emphasis added).

[35] This is the essence of the 'true and fair' override which applies both to directors in their preparation of accounts and auditors in the giving of an audit opinion: see David Flint, *A True and Fair View in Company Accounts* (1982), available at <http://www.icas.org.uk> at 20 February 2007.

[36] See, eg, Ford, above n 21, for a much broader definition of principles-based regulation. It is true (as Ford comments) that virtually all systems of securities regulation are based on principles to some degree. However, my contention is that the two enforcement tests distinguish what may be regarded as the embedding of principles within the system from the inevitable inclusion of some (usually weak) form of principles within a regulatory system.

action. The issue of predictability is important in both the formal sense of compliance with the *European Convention on Human Rights*[37] and also in terms of the perceived validity of the enforcement process within the regulated community.[38] Its practical relevance can now be seen in the frequent reference within FSA rules and guidance to the high-level principle from which they are derived. While such a strategy cannot cope with every possibility, it does provide a means whereby the purpose and objective of the principle becomes clearer, with the result that firms are better able to determine their own implementation of a principle in a given situation.

It is clear from the structure of *FSMA 2000* and the *FSA Handbook* that FSA principles are capable of being enforced independently. This was apparent even before the recent initiative to move to more principles-based regulation. For example, in 2002 the Court of Appeal upheld a decision of the Disciplinary Appeals Tribunal of the Securities and Futures Authority to apply SFA[39] Principles directly to an individual.[40] More recent examples of the independent enforcement of principles are the penalty of £13.9m imposed on Citigroup[41] for breach of FSA Principles 2[42] and 3[43] in connection with a failure to control the firm's bond trading, and the penalty of

[37] *Convention for the Protection of Human Rights and Fundamental Freedoms*, opened for signature 4 November 1950, CETS No 005 (entered into force 3 September 1953) ('*Convention for Protection of Human Rights*'), incorporated into the law in the United Kingdom by the *Human Rights Act 1998* (UK) c 42 ('*Human Rights Act 1998*').
[38] The latter point in particular has not been lost on the FSA, which has frequently referred to the need for its principles to satisfy the requirement of predictability: see, eg, Whittaker, above n 24.
[39] The Securities and Futures Authority had regulated investment firms prior to the creation of the FSA.
[40] *R (ex parte Fleurose) v Securities & Futures Authority* [2002] IRLR 297. In that case, the individual was found to be in breach of Principles 1 and 3 and suspended from acting as a 'registered person' for two years.
[41] See 'FSA Fines Citigroup £13.9 million (Euro 20.9 mn) for Eurobond Trades' (Press Release, 28 June 2005), available at <http://www.fsa.gov.uk/pages/Library/Communication/PR/2005/072.shtml> at 26 February 2007.
[42] *FSA Handbook* PRIN 2.1.1R: 'A firm must conduct its business with due skill, care and diligence.'
[43] *FSA Handbook* PRIN 2.1.1R: 'A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.'

£6.3m imposed on Deutsche Bank[44] for breach of Principles 5[45] and 2 in connection with book-building and price stabilisation exercises. The significance of these cases is that enforcement action was not possible under the market abuse regime because the relevant conduct fell outside the scope of the regime in each instance: it was only through independent enforcement of principles that the FSA was able to take action. A similar approach to the independent enforcement of principles can be found in the retail financial sector.[46]

The most important implication of the independent enforceability of FSA principles is that firms and individuals cannot rely on compliance with detailed rules as an adequate compliance strategy. In that sense firms and individuals bear the risks associated with the application of principles to new developments or unforeseen circumstances,[47] with the proviso that the principle provides a sufficient degree of predictability regarding the range of appropriate responses. How extensive that risk will become as principles-based regulation expands depends to a considerable extent on (a) the reaction of the courts[48] to the challenges that are likely to be made in instances in which principles are argued not to have the required degree of predictability, and (b) the extent to which the FSA 'fleshes out' principles through rules and guidance. Rather ominously, the FSA, in observing that enforcement of principles may require a different approach to the enforcement of rules, has pointed to

[44] See 'FSA Fines Deutsche Bank £6.3 million and Mr David Maslen £350,000 for Market Conduct' (Press Release, 11 April 2006), available at <http://www.fsa.gov.uk/pages/Library/Communication/PR/2006/036.shtml> at 26 February 2006.
[45] *FSA Handbook* PRIN 2.1.1R: 'A firm must observe proper standards of market conduct.'
[46] See the enforcement action taken against the Nationwide Building Society <http://www.fsa.gov.uk/pubs/final/nbs.pdf>; GE Capital Bank <http://www.fsa.gov.uk/pubs/final/gecb.pdf>; and Home and County Mortgages <http://www.fsa.gov.uk/pubs/final/hcml.pdf>.
[47] See, for a general discussion of this transfer of risk in regulatory systems, Louis Kaplow, 'Rules Versus Principles: An Economic Analysis' (1992) 42 *Duke Law Journal* 557, 559–60.
[48] The Financial Services and Markets Tribunal has a wide-ranging jurisdiction over many of the FSA's decisions, including those of a disciplinary nature. It is not an 'appeals' tribunal in the strict sense, as it determines matters de novo and is able to consider fresh evidence that was not available to the FSA. The Tribunal must determine what, if any, is the appropriate action for the FSA to take. Decisions of the Tribunal may, with permission, be appealed to the courts on a point of law.

the possibility that greater use may have to be made of expert evidence.[49] If that is indeed the case, it suggests that principles-based enforcement may result in tension and confusion, with the *ex ante* benefits of principles-based regulation being offset to some extent *ex post* by a more complex and costly system of enforcement.

III THE ROLE OF SELF-REGULATION AND MARKET DISCIPLINE

At one level the regulatory regime for capital markets can be viewed as comprising regulatory (or public law) principles and rules that are enforced primarily by public authorities. That view, however, ignores two important influences on the regulatory regime. The first is the body of private law rules that govern transactions in the capital markets and the organisational structure of entities that engage in those transactions. Private law is relevant because the regulatory system is (largely) premised on the basis that the role of regulation is to address market failure, which occurs when the market mechanisms, which include private law, fail to provide adequate solutions. An example of this linkage can be seen in the FSA's current work on contract certainty in London's wholesale international insurance market. While the FSA is concerned that the absence of adequate disclosure of brokers' commissions may be harmful to London's international competitiveness, it has made clear that it will only intervene via regulation if appropriate contractual solutions cannot be reached within the marketplace.[50] The second influence is that of self-regulation, which, despite a deliberate policy shift towards statutory-based regulation in the UK since the mid-1980s, remains an important element of the regulatory regime. Indeed, such has been the success of the most prominent example of self-regulation, the

[49] Waters, above n 17, 3.
[50] John Tiner, FSA CEO, 'Principles-Based Regulation and What It Means for Insurers' (Speech delivered at the Insurance Sector Conference, 20 March 2006), available at <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0320_jt.shtml> at 20 February 2007.

Combined Code, that it has become one of the UK's most successful exports during the past decade. Self-regulation, and in particular its implementation in the *Combined Code*, means that the regulatory system and its enforcement has to find a means to accommodate the quite different culture of market discipline that is given effect by the *Code*. As discussed below, this gives rise to some potential difficulties. The *Combined Code*[51] does not form part of the UKLA[52] Listing Rules. This has the effect that the *Code* itself does not have the same legal status as the Listing Rules, which are made and can be enforced under statutory authority.[53] The Listing Rules[54] do, however, require that in the case of a company incorporated in the United Kingdom, the following additional items must be included in its annual report and accounts:

> (i) a statement of how it has applied the principles set out in s 1 of the *Combined Code*, providing explanation which enables its shareholders to evaluate how the principles have been applied;
>
> (ii) a statement as to whether or not it has complied throughout the accounting period with the *Code* provisions set out in s 1 of the *Combined Code*. A company that has not complied with the *Code* provisions, or complied with only some of the *Code* provisions or (in the case of provisions whose requirements are of a continuing nature) complied for only part of an accounting period, must specify the *Code* provisions with which it has not complied, and (where relevant) for what part of the period such non-compliance continued, and give reasons for any non-compliance.

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[51] For the current and previous version of the *Code*, see Listing Rules in the *FSA Handbook*, available at <http://www.fsa.gov.uk> at 15 April 2005.
[52] In its role as the designated 'competent authority', for the purpose of the EC Directives on listing, the FSA operates under the title of United Kingdom Listing Authority.
[53] See *FSMA 2000* pt VI.
[54] *FSA Handbook* LR 9.8.6R. Non-compliance results in a breach of the Listing Rules, which can be sanctioned by public censure, fine or suspension from listing under the *FSMA 2000*. There are no instances in which the FSA or Financial Reporting Council ('FRC') has taken action against a company for failing to make disclosures associated with the *Combined Code*.

The statement required by paragraph (i) is generally referred to as the 'appliance' statement, while the statement required by paragraph (ii) is termed the 'compliance' statement. It can be seen that the Listing Rules require not just disclosure that there has or has not been compliance, but a reasoned explanation of non-compliance in respect of each instance of non-compliance. This approach forms the basis of the 'comply or explain' principle, because without adequate explanation in the event of non-compliance, there can be no possibility of the market evaluating whether or not it is justified. The disclosure obligation provides a mechanism whereby outsiders such as investors and analysts can observe and monitor compliance with the *Combined Code*. This is not to say, however, that compliance is an objective matter on which all observers agree. There is, for example, considerable divergence between the percentage of companies who consider themselves to be fully compliant (47 per cent) with the *Code* and those whom Pensions Investment Research Consultants Ltd ('PIRC') regards as fully compliant (34 per cent).[55] Moreover, not all aspects of the *Code* are capable of independent verification.[56] This point carries implications for the operation of the 'comply or explain' principle. A company which believes that it complies with the *Code*, but in reality does not, will not provide a non-compliance statement, and therefore the market will not be called on to exercise judgment in relation to that issue, at least not immediately.[57] However, as it seems likely that the market will weed out covert non-compliance over time,[58] the main effect of differing

[55] See PIRC, *Corporate Governance Annual Review 2004* (2004) 9.
[56] PIRC comments that interpretation is often required as to whether there has been compliance as a result of drafting ambiguities (in the *Code*) or because there are different ways of understanding a particular issue: ibid.
[57] Assuming of course that the market cannot independently discover non-compliance as it occurs. It seems likely that the market will discover covert non-compliance over time, not least because reports from organisations such as the PIRC are prepared specifically to inform institutional investors.
[58] This is likely to occur as a result of monitoring by or on behalf of institutional investors: see, eg, the PIRC surveys.

views of compliance as between companies and outsiders is to delay, rather than to prevent, a finding of non-compliance.[59]

Non-compliance with the 'comply or explain' obligation contained in the *Code* should in principle trigger two responses. The first is that investors should demand that an adequate explanation be given. There is little evidence in the public domain that this does in fact occur.[60] However, there are two complicating factors. One is that there is some evidence to suggest that a company which is able to sustain relative outperformance in its share price will not be asked to provide a 'comply or explain' reason for its departure from the *Combined Code*.[61] A possible rationalisation of this outcome is that the board of such a company has demonstrated superior management skills and should therefore be permitted greater leeway in setting the organisational and operational framework.[62] Another is that investors may prefer to exert influence in private rather than public on the basis that public disagreements are likely to be damaging to reputation and the share price. The second response that might be triggered by contravention of the 'comply or explain' principle is enforcement action by the FSA or FRC.[63] To date, no such action has been initiated, indicating that attention has focused on the formal aspect of the 'explain' obligation in instances of non-compliance rather than on whether a proper explanation has been given. An additional complication in this field is that the FSA's focus on market

[59] This can also be evidenced in the PIRC, above n 55, where the compliance rate is increasing year-by-year.
[60] See Sridhar Arcot, Valentina Bruno and Antoine Grimaud, *Corporate Governance in the UK: Is the Comply-or-Explain Approach Working?* (2005) London School of Economics <http://fmg.lse.ac.uk/upload_file/496_1st%20Dec%20paper.pdf> at 26 February 2007, finding that one in five explanations for non-compliance is not a good explanation.
[61] See Iain MacNeil and Xiao Li, 'Comply or Explain: Market Discipline and Non-Compliance with the *Combined Code*' (2006) 14 *Corporate Governance: An International Review* 486.
[62] Of course, such an outcome raises the possibility of escalation of risk when the board is permitted such leeway on the basis of share price performance, which turns out to have been based on a false premise. Enron provides a cautionary tale in this regard.
[63] See below Part V Section A for the role of the FRC.

detriment as the driver of enforcement action suggests that it would be reluctant to act if institutional investors were satisfied with a given explanation.[64]

Rather perversely, it appears to be the case that pure self-regulation on the part of investors may work more effectively than the hybrid form of self-regulation that is represented by the *Combined Code*.[65] Some evidence for this may be found in the operation of the self-regulatory rules developed by the ABI/NAPF in respect of share issues made by listed companies. The underlying objective of these rules is to add an additional layer of regulation to the statutory rules governing pre-emption rights that aim to protect the proportionate shareholding of investors when new share issues are made.[66] In contrast with the position under the *Combined Code*, there is evidence both of *ex ante* approval of new issues and *ex post* enforcement action in respect of contraventions. Perhaps it is the case that there are more direct private benefits associated with enforcement in this sphere (ie avoidance of dilution of a shareholding) than in relation to the *Combined Code*; but even so, it is somewhat surprising to find that the more formal enforcement structure under the *Combined Code* appears to be less active.

Another limitation of the 'comply or explain' obligation in the Listing Rules is that it applies only to companies incorporated in the UK.[67] This appears to link the *Code* more with company law, which applies in that manner, rather than with the

[64] See MacNeil and Li, above n 61, noting the link between share price performance and tolerance of non-compliance accompanied by inadequate explanation.
[65] The *Combined Code* can be regarded as a hybrid form of self-regulation because, although it developed outside the formal legal framework, it is closely linked with the listing rules and there is the potential for the FSA to enforce the 'comply or explain' disclosure obligation. An alternative description of the *Code*, favoured by the FRC, is 'market-led regulation', but that obscures rather than clarifies its legal status.
[66] See generally Iain MacNeil, 'Shareholders' Pre-Emptive Rights' (2002) *Journal of Business Law* 78.
[67] The reference to a company incorporated in the United Kingdom in *FSA Handbook* LR 9.8.6R makes clear that the *Combined Code* does not apply to overseas listed companies in the United Kingdom. In this respect, the United Kingdom differs from some other jurisdictions: see Iain MacNeil and Alex Lau, 'International Corporate Regulation: Listing Rules and Overseas Companies' (2001) 50 *International and Comparative Law Quarterly* 787, 806. However, to be included in the FTSE 100 index, foreign-listed companies will in future have to adhere to the *Combined Code*: see 'London Issues Guidelines for Foreign Listings'*, Financial Times* (London), 9 May 2007, 43.

Listing Rules, which apply as a result of the process of admission to listing. While that is an odd outcome for a governance *Code* that in its genesis and development aimed to place itself outside the formal structure of company law, it can be rationalised on the basis that to apply the *Code* to overseas listed companies would damage the UK's competitive position in attracting foreign listings. It is nevertheless ironic that a Code, which is trumpeted as a major achievement of the UK's regulatory system,[68] should not form part of the regulatory framework for international companies when many are attracted in the first instance by the quality of the regulatory regime.[69] The UK approach stands in sharp contrast to the extension, through s 404(a) of the *Sarbanes-Oxley Act of 2002*,[70] of the 'internal controls' requirements of federal securities law in the United States to foreign companies registered with the SEC. It also opens up the possibility, when the FRC's *Internal Control: Revised Guidance for Directors on the* Combined Code ('Turnbull Guidance')[71] is adopted as a framework for *Sarbanes-Oxley* compliance, of the 'comply or explain' principle being 'trumped' by the statutory-based compliance obligation imposed by *Sarbanes-Oxley*.[72]

It seems clear therefore that the role of self-regulation in capital markets in the UK complicates the overall pattern of enforcement. Market discipline is important in

[68] The CEO of the London Stock Exchange, Clara Furse, commented recently that 'London's principles-based regime, rather than a more prescriptive rules-based approach, continues to prove itself as a model that facilitates pro-competitive innovation in a tough but sensible regulatory environment. All the important independent corporate governance surveys confirm that the U.K. is number one for corporate governance standards': 'Comment: SOX Is Not to Blame — London Is Just Better as a Market', *Financial Times* (London), 17 September 2006, 19.

[69] But note that overseas companies with a primary listing on the Official List must disclose significant ways in which their corporate governance practices differ from those set out in the *Combined Code*: see *FSA Handbook* LR 9.8.7R. This obligation applies to relatively few companies, as most overseas companies have a secondary listing.

[70] Pub L No 107–204, 116 Stat 745 (2002) ('*Sarbanes-Oxley*').

[71] (2005), available at < http://www.frc.org.uk/corporate/internalcontrol.cfm>. The Turnbull Guidance provides guidance on compliance with the internal control provisions of the *Combined Code*.

[72] The SEC has identified the Turnbull Guidance as a suitable framework for *Sarbanes-Oxley* s 404(a) purposes: see FRC, *The Turnbull Guidance as an Evaluation Framework for the Purposes of Section 404(a) of the* Sarbanes-Oxley Act (2004), available at <http://www.frc.org.uk/corporate>.

any system, but the attempt in the UK to integrate it into the regulatory structure makes the regulatory and enforcement mix particularly difficult to read. On one reading, the absence of major failures in recent years and the relative success of the UK as a location for listing and capital markets transactions might suggest that the mix works well. On another reading, self-regulation might be seen as little more than the selective protection of mutual self-interest by institutional investors, with the contribution to regulation in the public interest being quite limited.

IV CORPORATE, COLLECTIVE OR INDIVIDUAL RESPONSIBILITY?

The United Kingdom regulatory system, viewed broadly so as to include company law, adopts three different models of responsibility for acts or omissions of a corporate entity.[73] In some instances it is the corporate entity itself that bears responsibility. This model forms the basis of many of the *FSMA 2000*-based obligations, which are expressed as binding on an authorised firm or a listed entity. It also operates in company law to make a company responsible for acts or omissions that it has authorised. In others instances, it is the board of directors as a collective entity that bears responsibility. The *Combined Code* reinforces that view, its first main principle being that: 'Every company should be headed by an effective board, which is collectively responsible for the success of the company'. That reference to collective responsibility is made with the framework of the concept of accountability adopted by the *Combined Code*, which focuses on the accountability of the board to the shareholders. In that sense, collective responsibility operates internally within the

[73] For a general discussion of models of responsibility, see Mark Bovens, *The Quest for Responsibility: Accountability and Citizenship in Complex Organisations* (1998). In addition to the three models identified here, Bovens proposes a fourth, termed 'hierarchical', in which responsibility is located by reference to position within a hierarchy. While the regulatory obligations imposed on senior managers in FSA authorised firms are related to position within the firm's hierarchy, it is argued below that the requirement for personal culpability results in the responsibility of senior managers being closer to the 'individual' rather than the 'hierarchical' model of responsibility.

company. It does not encompass regulatory or other obligations owed to persons outside the company. From the perspective of outsiders (regulators or contractual counterparties), the collective nature of board responsibility is a secondary matter because, from their perspective, the company generally bears responsibility for decisions and acts of the board. Finally, it is possible for individual responsibility to be allocated to directors and senior managers. This model is evident both in company law, which, particularly in respect of criminal sanctions, frequently refers to 'directors and officers', and in *FSMA 2000* regulatory rules, which are sometimes expressed as being applicable to individuals. It is also apparent in respect of the duties of directors, which apply at the level of the individual despite the collective nature of board decision-making.

The broad framework is therefore one in which, depending on the characterisation of a particular act or omission, enforcement might be targeted against the corporate entity, the board collectively, or individuals. Characterisation of the regulatory nature of particular acts or omissions is significant because they cannot always be allocated exclusively to a particular regime. For example, a single act may well involve a breach of the *Combined Code*, FSA regulatory rules, and a director's duty of care and skill. Moreover, a single lapse might even involve conduct that appeared to comply with one particular regulatory regime but to contravene another.[74] Thus, characterisation of the lapse will affect who takes enforcement against whom and on what basis.

Within the narrower framework of the *FSMA 2000* regulatory system, the focus of enforcement is simpler because the *FSMA 2000* regulatory system does not

[74] This possibility has been recognised as being quite real: see Gray and Hamilton, above n 7, 154–6, for the discussion of scenarios in which it might occur. The main source of conflict is that corporate law regards the duties of directors as owed to each individual company within a group, whereas the *FSMA 2000* regulatory rules for senior management — Senior Management Arrangements, Systems and Controls ('SYSC') — require senior managers to manage the group as a whole.

itself recognise the concept of the collective responsibility of the board. As the FSA has made clear, regulatory obligations fall either on the entity or on an individual.[75] However, that does not mean that the issue cannot be of relevance so far as FSA enforcement is concerned. The FSA recognises the importance of the collective responsibility principle established by the *Combined Code*, and its handbook gives 'due credit' for compliance with the *Code* when the issue of compliance with the FSA's own rules for senior management is being considered.[76] Nevertheless, precisely what 'due credit' means when different models of responsibility bite on the same circumstances remains to be seen. An additional complication is that the *FSA Handbook* recognises that 'controlled functions' may (so long as it is appropriate) be allocated to a 'committee of management', which could presumably comprise a sub-committee of the board or even the full board.[77] In that event, it would seem to follow that the board was indeed a 'bearer of regulatory obligations', although that outcome results from an internal decision within the firm rather than from regulatory obligations imposed externally by the FSA.

In recent years the *FSMA 2000* regulatory system has placed considerable emphasis on the individual responsibility (and liability) of senior management for compliance. The process has been described as forming part of a policy of 'individualisation'[78] of responsibility. It represents a refinement of the process of 'enrolment'[79] of key actors in the process of regulation in that it allocates individual

[75] FSA, 'Senior Management Arrangements, Systems and Controls' (Consultation Paper 35, 1999) [3.12]: 'However, under the financial services and markets legislation, the board itself cannot be the bearer of regulatory obligations. Regulatory obligations fall either upon the firm itself (whose organ the board is) or upon individual Approved Persons (including individual members of the board). There is therefore no question of the board as such becoming collectively exposed to disciplinary liability.'
[76] *FSA Handbook* SYSC 3.3.1G.
[77] *FSA Handbook* SYSC 2.1.6G.
[78] See Gray and Hamilton, above n 7, 118.
[79] See Julia Black, *Mapping the Contours of Contemporary Financial Services Regulation* (CARR Discussion Paper No 17, 2003), available at <http://www.lse.ac.uk/collections/CARR> at 21 February 2007.

responsibility within an enterprise for specific regulatory functions. Underlying the process is the rationale that directors and senior management must be held to account for their stewardship and cannot be permitted to hide behind the façade of a corporate entity, thereby transferring the cost of their failings to shareholders and third parties. The technique has been employed not just in financial regulation but also in the broader context of corporate and insolvency law. Examples are the identification in the *Combined Code* of the specific role of non-executive directors and members of board committees (opening up the possibility of liability for specific failures), and the possibility of directors being disqualified if, following the insolvency of a company, they are found to be unfit to be a director.[80] As is the case with the adoption of risk-based regulation, there is no specific legislative requirement that the FSA should follow the 'individualisation' approach, nor is there any legislative indication of the substance of senior management responsibility. The basis of the regulatory approach to this issue is the rather opaque 'principle of good regulation'[81] that the FSA should have regard to 'the responsibilities of those who manage the affairs of authorised persons'.

The starting point for considering individual responsibility is Principle 3 of the Principles for Business: '*A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems*.'[82] The meaning of this principle is spelt out in greater detail in the rules and guidance which comprise the Senior Management Arrangements, Systems and Controls (the SYSC component of the FSA Handbook). It is also part of the purpose of SYSC to encourage firms to vest responsibility for effective and responsible organisation in specific directors and senior executives. That represents the first step in the move

[80] See, in respect of disqualification, the *Company Directors Disqualification Act 1986* (UK) c 46.
[81] See Introduction for these principles.
[82] *FSA Handbook* PRIN 3 (emphasis added). These are high-level principles that bind authorised firms.

towards individual responsibility because it requires the implementation of management systems that provide a basis for identification of individual responsibility. The second step is the link between SYSC and the mechanisms that are available for taking enforcement action against individuals. One of the innovations of *FSMA 2000* was to introduce an 'approved person' regime ('APER' in the *FSA Handbook*) under which persons performing 'controlled functions' require the approval of the FSA.[83] Persons to whom SYSC functions are allocated are automatically included within the APER because such functions are designated as 'controlled'. This has the effect that the sanctions[84] available for breach of APER are available in respect of persons performing or failing to perform SYSC functions. Moreover, it has been noted that close linkage in rule formulation between the SYSC and APER ensures that failings in relation to SYSC can be positively identified as contraventions of the approved persons regime, thereby opening up the possibility of action against an individual.[85] Furthermore, accessory liability, in circumstances in which an approved person is 'knowingly concerned' in a contravention for which a firm bears primary responsibility, represents another route for enforcement action against individuals.[86]

The possibility of enforcement against an individual under SYSC or APER does not, however, mean that it will occur as a matter of course, even if the contravention falls within areas prioritised by the risk-based approach to regulation as a specific statutory provision requires the FSA to consider whether it is appropriate to

[83] Approval is subject to the FSA being satisfied that the relevant person is 'fit and proper' to perform the relevant controlled function.
[84] *FSMA 2000*. The relevant sanctions include: withdrawal of 'approved person' status (s 63); a financial penalty (s 66); or a public statement of misconduct (s 66). A prohibition order (under s 56) preventing an individual from engaging in specified regulated activities is a broader sanction that is not limited to the approved persons regime and is regarded by the FSA as a more serious penalty than withdrawal of approval.
[85] Gray and Hamilton, above n 7, 75.
[86] See *FSMA 2000* s 66; see also the enforcement action against Deutsche Bank/David Maslen, above n 44.

take action against individuals.[87] This approach recognises that it may not always be appropriate to take action against individuals, and is reflected in statements made by the FSA stressing that personal culpability is an essential element of a decision to take enforcement action against an individual.[88] It is this feature that distinguishes the model of individual responsibility adopted by the FSA from a purely hierarchical model of responsibility — in which position within the hierarchy, without a requirement for personal culpability, is the basis on which responsibility is allocated.[89] The low level of enforcement action against individuals under SYSC or APER tends to bear out the impression that this statutory consideration limits enforcement action.[90] On the other hand, recent enforcement action under APER against a senior manager knowingly concerned in a breach of Principle 5[91] by Deutsche Bank[92] indicates that independent enforcement of principles applies as much to individuals as to firms.[93] In that sense, individuals also bear responsibility for interpreting and implementing principles.

Another potentially significant source of individual liability in the context of listing and share issues is the accessory liability of 'a person discharging managerial responsibilities'[94] for contraventions of the listing rules,[95] the disclosure rules[96] or the

[87] *FSMA 2000* s 66(2)(b).
[88] FSA, 'The Regulation of Approved Persons' (Consultation Paper 26, 1999) [115].
[89] See Bovens, above n 73, ch 6, arguing that this feature of the hierarchical model violates one of the basic requirements of accountability (viz blameworthiness), resulting in such systems being fundamentally flawed.
[90] Gray and Hamilton, above n 7, conclude from a survey of action taken against individuals under the approved persons regime that 'as with the use of the prohibition order power, the use of this sanction has been confined to instances where the misconduct in question is flavoured with a lack of integrity'.
[91] *FSA Handbook* PRIN 2.1.1R.
[92] See above n 44.
[93] See FSA, *Final Notice to David John Maslen* (2006) <http://www.fsa.gov.uk/pubs/final/maslen.pdf> at 26 February 2007.
[94] See *FSMA 2000* s 91, as amended by *The Prospectus Regulations 2005* (SI 2005/1433) (UK). Prior to the 2005 amendment, it was only directors who could be punished for such contraventions.
[95] Applicable to the Official List, a term still used in the UK to identify the segment of traded securities that are subject to the 'super-equivalent' regime, under which the UK has gone beyond the requirements imposed by the relevant EC Directives.

rules relating to prospectuses. However, the very low incidence of (public) enforcement action based on this section (and its predecessor under the *Financial Services Act 1986* (UK) c 60 (repealed)) suggests that there is a reluctance to pursue the senior management of listed companies on this issue. A possible rationalisation of this approach is that such action would most often be against individuals who were not already within the FSA regulatory net, and who are not therefore as familiar with the regulatory techniques and culture of the FSA as those individuals who do fall within the FSA regulatory net as a result of being senior managers of *FSMA 2000*-regulated entities.[97]

Further support for individual responsibility is provided by the prohibition on authorised firms taking out insurance to indemnify individuals against the cost of paying a penalty imposed by the FSA.[98] This follows the approach in company law that provides that a company may not provide an indemnity to a director in respect of a fine imposed in criminal proceedings or a penalty payable to a regulator as a result of contravention of a regulatory requirement.[99] While the *FSMA 2000* prohibition is wider in its scope as it applies to any person, it is of most relevance to directors and senior managers, who are the most likely target for FSA enforcement action. The overall trend in *FSMA 2000* regulation is therefore towards individual responsibility. That trend is not immediately obvious from the relatively low incidence of enforcement action against individuals but, as indicated at the outset, the incidence of enforcement action is a particularly difficult variable to interpret. It is quite likely that

[96] These are rules applicable to securities admitted to trading on all regulated markets (even if they are not on the Official List): examples are the London International Financial Futures Exchange, the Professional Securities Market, and the Virt-x Exchange Ltd. The Alternative Investment Market, which has recently attracted many listings of overseas companies, made a policy choice in 2004 not to be a regulated market so as to leave itself the freedom to set its own disclosure rules.
[97] Gray and Hamilton, above n 7, 179.
[98] See *FSA Handbook* GEN 6.1, ENF 13.1.3G.
[99] See *Companies Act 1985* ss 309A, 309B.

the deterrent effect of limited high-profile enforcement against individuals is considerable, especially when combined with the possibility of independent enforcement of principles.

V THE RESPECTIVE ROLES OF PUBLIC AND PRIVATE ENFORCEMENT

The respective roles of public and private enforcement are an important characteristic of the enforcement regime for capital markets. Public enforcement tends to focus on punishment and deterrence whereas private enforcement tends to focus on restitution and compensation: but that need not always be the case and (as noted in Part VI below) the public system of enforcement in the UK now makes provision for the FSA to pursue restitution and compensation on behalf of consumers of financial services.

A *Public Enforcement*

Public enforcement of contraventions of *FSMA 2000* and the *FSA Handbook* is generally undertaken by the FSA, through its internal disciplinary procedure for contraventions that are not criminal offences, and through the courts for contraventions that are criminal offences. The Department of Trade and Industry ('DTI') and the Director of Public Prosecutions are also authorised to bring prosecutions for offences created by *FSMA 2000*, but have not to date exercised their powers. However, the FSA has no role in the public enforcement of offences under the Companies Acts. Such offences[100] are prosecuted either by the registrar of

[100] *Companies Act 1985* sch 24 sets out the extensive list of offences under that Act, the mode of prosecution, and the punishment. Most prosecutions in England and Wales occur in magistrates courts and result in relatively small penalties.

companies (Companies House) or the DTI.[101] Prosecution of such offences tends to attract much less media attention than the few higher-profile cases pursued by the FSA, and, while it is generally assumed that such prosecutions typically involve smaller companies rather those which are publicly listed, there is no reliable data on which to base that conclusion. Moreover, given the manner in which the company law disclosure and governance provisions mesh with those of the listing rules,[102] it would be wrong to dismiss as insignificant the regulatory role played by enforcement of the company law offences simply because they often appear rather technical and sometimes arbitrary (for example, offences in respect of time limits for the lodging of documents).

In the United Kingdom (and the European Union), the close linkage of the corporate and capital markets regulatory regimes is particularly evident in relation to the financial disclosure regime for companies. The *Companies Act 1985* (UK) c 6 sets out the basic disclosure regime for all companies.[103] That approach reflects the historic linkage of limited liability with disclosure obligations. The *FSMA 2000* and the listing rules build upon that foundation to create a more advanced and onerous disclosure regime for listed companies. The resulting disclosure regime for public listed companies therefore differs from that in parts of the United States, where corporate law does not extend disclosure obligations beyond publicly listed companies. The fact that the entire disclosure regime does not fall within the regulatory jurisdiction of the FSA is reflected in the arrangements for monitoring the

[101] See *Enforcement Strategy Policy Document* (2006) Companies House <http://www.companieshouse.gov.uk/about/policyDocuments/enforcementStrategy.pdf> at 9 February 2007. Companies House has responsibility for prosecuting the offences of failing to file annual reports and annual returns (*Companies Act 1985* s 242). Other offences are prosecuted by the Department of Trade and Industry. In Scotland, all prosecution decisions are made by the procurators fiscal.
[102] In contrast, for example, with the position in some parts of the United States, where disclosure rules apply only to public listed companies.
[103] Dispensations from some requirements are given to small- and medium-sized companies.

accounts of listed issuers and compliance with the *Combined Code*. Those matters are the responsibility of the Financial Reporting Review Panel ('FRRP'), a subsidiary body of the Financial Reporting Council,[104] which is an independent private sector body funded by the accountancy profession, the DTI, and City institutions.[105] The FRRP reviews Reports produced by issuers of listed securities for compliance with the accounting requirements of the listing rules.[106] It cooperates with the FSA in carrying out this function and adopts a risk-based approach to the selection of Reports for scrutiny.[107] Three outcomes are possible following identification of deficiencies in accounts. The first and most common is that the FRRP agrees a correction to accounts with the relevant issuer. The second is that the FRRP can make an application to the court to require an issuer to revise defective accounts.[108] The third is that the FRRP can refer the matter to the FSA, which can impose the following penalties for breach of the listing regime: public censure; a financial penalty to be paid by the issuer and/or possibly also its senior management;[109] discontinue or suspend listing.

B *Private Enforcement*

[104] The objectives of the FRC are to promote: high quality corporate reporting; high quality auditing; high quality actuarial practice; high standards of corporate governance (it is responsible for publishing and maintaining the *Combined Code*); the integrity, competence and transparency of the accountancy and actuarial professions; and its own effectiveness as a unified independent regulator.
[105] See Stella Fearnley and Tony Hines, 'The Regulatory Framework for Financial Reporting and Auditing in the United Kingdom: The Present Position and Impending Changes' (2003) 38 *International Journal of Accounting* 215.
[106] Its authority to do this is provided by *The Supervision of Accounts and Reports (Prescribed Body) Order 2005* (SI 2005/715) (UK), which designates the FRRP as the prescribed body for the purposes of the functions mentioned in s 14(2) of the *Companies (Audit, Investigations and Community Enterprise) Act 2004* (UK) c 27. There is no statutory basis for the FRC's role in developing and monitoring compliance with the *Combined Code*.
[107] See *Memorandum of Understanding between the Financial Reporting Review Panel and the Financial Services Authority* (2005) <http://www.frc.org.uk/images/uploaded/documents/300305%20-%20FSA-FRRP%20Memorandum%20of%20Understanding%20_Final_1.pdf> at 23 February 2007; *Financial Reporting Review Panel Operating Procedures* <http://www.frc.org.uk/frrp/how/procedures.cfm> at 23 February 2007.
[108] *Companies Act 1985* s 245B; *Companies (Defective Accounts) (Authorised Persons) Order 2005* (SI 2005/699) (UK). The FRRP is also empowered to compel the production of documents and the giving of information.
[109] See Part IV above.

Private enforcement is not a major feature of the system of capital markets regulation in the UK. This stands in sharp contrast to the US, where private enforcement, particularly in the form of class actions, represents a major part of enforcement activity.[110] While express provision is made by *FSMA 2000*[111] to permit an action in damages for losses suffered as a result of a contravention of *FSMA 2000* or rules made under it, the provision has proven in practice to be something of a dead letter. There are three main reasons for this. First, the right to bring an action in damages has been limited in most circumstances to 'private persons',[112] thereby excluding institutional investors and market professionals who might be more inclined to take up the action. Second, the provisions that are capable of private enforcement are limited. *FSMA 2000*[113] expressly excludes private enforcement of the Listing Rules and financial resources rules and authorises the FSA to exclude other provisions in its rulebook. The FSA has exercised this power to exclude the possibility of independent enforcement of principles through private litigation.[114] Finally, there are difficult issues of causation that arise in linking a contravention with loss and these are likely to act as a deterrent to bringing an action.[115]

Private enforcement does, however, remain at the fore in legal regimes adjacent to *FSMA 2000*. Auditor and advisory liability in negligence are probably the two most prominent examples.[116] Enforcement in these cases tends to focus on duties arising in corporate finance or restructuring transactions, in which it may be possible

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[110] See Coffee, 'Law and the Market', above n 6.
[111] Section 150.
[112] As a result of *FSMA 2000* s 150(2); *FSMA 2000 (Right of Action) Regulations 2001* (SI 2001/2256) art 3.
[113] Section 150.
[114] See *FSA Handbook* PRIN 3.4.4R.
[115] For a discussion of the problems of private enforcement under *FSMA 2000's* predecessor statute see Iain MacNeil, 'FSA 1986: Does s 62 Provide an Effective Remedy for Breaches of Conduct of Business Rules?' (1994) 15 *Company Lawyer* 172.
[116] See, eg, Philip Smith, *Negligence Claims Could Reach New Height with Litigation Funding Trend* (15 February 2007) Accountancy Age <http://www.accountancyage.com/best-practice/analysis/2183554/negligence-claims-reach-heights> at 20 February 2007.

to establish breach of a duty of care owed to a client. It has proven much more difficult to extend that form of liability to a wider group, such as investors who buy shares in the market on the strength of incorrect accounts that have been negligently audited.[117] The *Companies Act 2006* (UK) c 46 will provide further protection for auditors by permitting companies to enter into limitation of liability agreements with them.[118] Company law in the UK currently prohibits such arrangements.[119]

VI SETTLEMENT AND SANCTIONS

Viewed in the broad context of regulatory enforcement in the UK,[120] the FSA has a relatively sophisticated set of sanctions available to it. However, the risk-based approach to regulation (above) is one factor which results in resort to formal sanctions being quite rare. Another factor is the emphasis placed by the FSA on the settlement of enforcement proceedings.[121] The rationale for settlement is that it 'results in consumers obtaining compensation earlier than would otherwise be the case, the saving of FSA and industry resources, in messages getting out to the market sooner and assists in a public perception of timely and effective action'.[122]

Another issue that has an impact on sanctions and settlement is the procedural fairness of the FSA disciplinary procedure. This issue proved contentious during parliamentary debate on the FSMA Bill in the late 1990s and has continued to drive changes in FSA practice up to the present day.

Each of these issues is now considered in more detail.

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[117] The line of case law stemming from the House of Lords decision in *Caparo Industries plc v Dickman* [1990] 2 AC 605 has generally taken a restrictive view of the persons to whom auditors owe a duty of care.
[118] See ss 532–8.
[119] See *Companies Act 1985* s 310.
[120] For a comparison of the FSA with other regulatory agencies see the Macrory Report, above n 32.
[121] Since October 2003, around 80 per cent of disciplinary cases that resulted in a financial penalty have been concluded by settlement: FSA, *Enforcement Process Review*, above n 11, 50.
[122] Ibid.

A *Sanctions: The Statutory Options*

The range of sanctions available to the FSA is as follows:

(i) Public censure. This sanction is intended to cause a change in the behaviour of its recipient and act as a deterrent to others through the potential damage to reputation that may follow from publication of a contravention.

(ii) Unlimited financial penalties. There are a number of provisions in *FSMA 2000* that permit the FSA to impose an unlimited financial penalty for contravention.[123] While no limits are set for the penalty, the FSA is required to publish guidance as to its practice in setting penalties.[124] The FSA holds the distinction of having imposed both the single largest[125] financial penalty of any United Kingdom regulator and of imposing the largest average penalty.[126]

(iii) Variation or cancellation of permission to engage in regulated activity. This option effectively allows the FSA to vary or withdraw an authorised person or firm's licence to engage in regulated financial activity.[127] The power can be exercised if there is a failure to meet the threshold

[123] See s 66 (approved persons); s 91 (listing rules); s 118 (market abuse); s 206 (authorised persons).
[124] See, eg, *FSA Handbook* ENF 13.
[125] The £17m penalty imposed on Shell for market abuse: see FSA, *Final Notice to the 'Shell' Transport and Trading Company plc* (2004) <http://www.fsa.gov.uk/pubs/final/shell_24aug04.pdf> at 20 February 2007.
[126] See the Macrory Report, above n 32, 21, showing that the FSA's average financial penalty for 2004–5 was £75 000 compared to £6885 for the Health and Safety Executive, the second-ranked regulator by average penalty imposed. This outcome can be rationalised by reference to the argument advanced by Coffee that the smaller the risk of detection the larger a fine must be to act as a deterrent: John Coffee '"No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment' (1981) *79 Michigan Law Review* 386.
[127] *FSMA 2000* s 45.

conditions[128] for authorisation, or if it is desirable to exercise that power in order to protect the interests of consumers or potential consumers.

(iv) Prohibition orders. The FSA can prohibit an individual (ie a human person) from performing any regulated activity if it considers that he is not a fit and proper person to carry on that function. The effect of such an order is to exclude an individual from either specific activities or all regulated activity. In view of the potential to deprive a person of his or her livelihood, the FSA has made clear that it will only consider making a prohibition order in the most serious cases of lack of fitness and propriety.[129] However, when an individual is not an approved person, a prohibition order may be the only effective sanction.[130] In the case of an approved person, a financial penalty is more likely in less serious cases.

(v) Restitution orders. An innovation of *FSMA 2000* was the power given to the FSA to order restitution against any person in favour of the 'victims', when it is satisfied that profits have accrued or loss has been suffered as a result of a regulatory contravention.[131] While there have been few instances of the express exercise of this power, it has been a significant factor in enabling the FSA to negotiate large industry-wide settlements in the market for retail financial products.[132]

(vi) Criminal prosecutions. Although *FSMA 2000* marked a deliberate shift away from enforcement through the criminal courts in favour of

[128] These are the requirements that must be met by an applicant for authorisation under *FSMA 2000*.
[129] See *FSA Handbook* ENF 8.5.2G, for the factors to be taken into account in deciding whether to make an order against an approved person.
[130] See *FSA Handbook* ENF 8.6.1AG.
[131] See *FSMA 2000* s 384. This is additional to the option available to the FSA to apply to the court for a restitution order under s 382.
[132] See Joanna Gray, 'The Legislative Basis of Systemic Review and Compensation for the Mis-Selling of Retail Financial Services and Products' (2004) 25 *Statute Law Review* 196.

administrative sanctions, *The FSMA 2000* did create a number of criminal offences. The FSA is authorised to bring prosecutions in respect of offences, but this option has not featured prominently in FSA enforcement. A relevant factor is no doubt the higher evidential standard that is required in criminal prosecutions by comparison with FSA disciplinary hearings.[133]

(vii) Suspension of trading in shares. In the case of entities whose securities have been admitted to trading on a regulated market, the FSA is able to instruct the market operator to suspend trading in the securities if it suspects that an applicable provision has been breached.[134]

(viii) Initiation of and participation in bankruptcy or insolvency proceedings. This is possible in the case of authorised persons, their appointed representative, or persons carrying on regulated activity without the required authorisation. It provides a mechanism whereby the FSA can act to safeguard the interests of the customers of an authorised person by initiating and participating in the bankruptcy/insolvency process.

B *Settlements: Process and Incentives*

Settlements for the purpose of FSA enforcement are regulatory decisions taken by the FSA, the terms of which the firm or individual concerned accepts.[135] Unlike settlements in commercial out-of-court cases, they are made public through the publicity requirements attached to FSA decision-making.[136] A settlement is possible at any stage of the enforcement process. The main incentive for firms and

[133] See *FSA Handbook* ENF 15.5.1G and the Financial Services and Markets Tribunal decision in the case of Davidson and Tatham, holding that the FSA was not required to meet the criminal standard of proof (beyond reasonable doubt) in disciplinary hearings.
[134] *FSMA 2000* s 87L.
[135] FSA, *Enforcement Process Review*, above n 11, 50.
[136] See *FSA Handbook* DEC App 1.10.3G.

individuals to engage in the settlement process is that the FSA is likely to reduce a financial penalty to recognise the degree of cooperation. Under the old guidance, early settlement of a case was treated as an element of cooperation, which could form the basis for an unspecified discount. Under the new regime,[137] an explicit discount of up to 30 per cent is available for early settlement. The starting point for the calculation of the discount is the penalty, adjusted for cooperation, and, while that adjustment will remain unspecified, it will not exceed 20 per cent.[138] A variant of the FSA type of settlement just described is the form of settlement agreed between the FRRP and listed companies in respect of corrections to published accounts. As explained earlier, scrutiny of accounts is the responsibility of the FRRP and its powers to require corrections are contained in the company law rather than *FSMA 2000*. However, in common with the FSA approach, the FRRP normally agrees corrections with companies.

C *Procedural Complications*

Since its inception, the *FSMA 2000* disciplinary regime has raised issues of procedural fairness.[139] The FSMA Bill was amended during its passage through Parliament to reflect this concern and to shield the FSA and government from challenges based on the incompatibility of the disciplinary process with the *European Convention on Human Rights*.[140] In particular, legal aid was made available to individuals subject to disciplinary procedures, an appeal system was put in place, and the use of compelled evidence (which has been instrumental in providing evidence in

[137] See *FSA Handbook* ENF 13.7.
[138] FSA, *Enforcement Process Review*, above n 11, 56.
[139] For a summary of the process and procedural fairness issues, see Iain MacNeil, *An Introduction to the Law on Financial Investment* (2005) 83–5.
[140] *Convention for the Protection of Human Rights*, opened for signature 4 November 1950, CETS No 005 (entered into force 3 September 1953), implemented into UK law by the *Human Rights Act 1998*.

other regulatory fields) was prohibited. More recently, the FSA has proposed changes that give greater effect to the requirement[141] that there should be a separation between those who investigate contraventions and those who decide whether the conduct in question should be sanctioned.[142] While it does remain true, as the FSA contends,[143] that the administrative nature of the disciplinary process means that it is more flexible and less costly than formal court procedures, there is nevertheless a clear impression that the degree of difference has narrowed considerably by comparison with the expectations that surrounded the introduction of *FSMA 2000*. It had been anticipated, particularly in connection with market abuse — an area in which criminal sanctions had clearly failed to punish or deter contraventions — that a move to administrative sanctions would provide much greater flexibility to bring to book individuals and organisations who had escaped the regulatory net as a result of the evidential and procedural safeguards of the criminal law. While it is difficult to state conclusively that this has not occurred, because there are many causal influences (for example the market abuse regime has itself been subject to considerable change as a result of an EC directive), it does seem fair to conclude that the move to administrative sanctions cannot, as a result of the progressive adoption of procedural safeguards, be regarded as a major contributor to the ability to sanction contraventions in the capital markets.[144]

CONCLUSION

[141] *FSMA 2000* s 395.
[142] See, eg, FSA, Enforcement Process Review, above n 11, 5–10; FSA, 'Review of the Enforcement and Decision Making Manuals' (Consultation Paper 07/02, 2007).
[143] FSA, *Enforcement Process Review*, above n 11.
[144] There is mixed evidence on the incidence of market abuse since the implementation of *FSMA 2000*: see FSA, 'Measuring Market Cleanliness' (Occasional Paper 23, 2006); FSA, 'Updated Measurement of Market Cleanliness' (Occasional Paper 25 2007). The revised data presented in the 2007 Paper suggests that 'informed trading' ahead of takeover announcements increased following the implementation of the *FSMA 2000* but that such trading ahead of other significant announcements declined.

Formal enforcement action is a relatively rare occurrence in the regulatory system in the UK. It is limited primarily by the regulatory and enforcement policy adopted by the FSA. Risk-based regulation means that enforcement policy does not target or pursue all contraventions. The recent move to more principles-based regulation does not carry direct implications for the incidence or pattern of enforcement action, but it does carry implications for enforceability. In particular, it raises the possibility of challenges to independent enforcement of principles which lack an adequate degree of foreseeability. However, to the extent that enforcement based on principles rather than rules is already quite well established, the process is one of expansion rather than innovation and therefore the risks are correspondingly lower.

The reliance on self-regulation and market discipline in the United Kingdom regulatory system poses a potential challenge for enforcement. There is evidence to suggest that the 'explain' element of the 'comply or explain' obligation contained in the *Combined Code* is often ignored, casting doubt over the willingness of institutional investors to undertake the scrutiny envisaged by the *Code* and the willingness of the FSA to undertake enforcement of the disclosure obligation on which investor scrutiny relies. Evidence of more active enforcement of other self-regulatory rules by institutional investors suggests that collective action and 'free rider' issues may explain the more restrained approach to enforcement of the *Combined Code*.

The presence of three different models of responsibility within the regulatory system raises the possibility of acts or omissions being characterised in different ways to fit into the appropriate regime. The overall trend is towards clearer identification of individual roles and responsibilities, but it remains to be seen how effectively this will

contribute towards compliance. There are certainly grounds for believing that individual responsibility combined with independent enforcement of principles should cause senior management to reflect more carefully on their business models and personal conduct.

Enforcement of the *FSMA 2000* system of regulation relies primarily on public agencies. That is the result of the policy of prohibiting private litigation in most instances on the part of institutional investors and market professionals. However, important common law causes of action (such as auditor or adviser negligence) remain available and may lead to substantial claims. Moreover, the FSA has power to require restitution and compensation in appropriate cases, and the experience of the exercise of those powers in the retail financial markets suggests that it can be a powerful tool in persuading parties to enter into negotiated settlements.

There remains the problem of estimating the impact that either the level of enforcement or its mix (as between different techniques) has on compliance. While it is clear, for example, that the FSA devotes proportionately much less resource to enforcement than does its US counterpart, the SEC, it is not entirely clear what may safely be concluded from such an observation. It would be rash to conclude, for example, that the low-level of enforcement in the UK results in a lower level of compliance. This would imply that the other regulatory activities in which the FSA engages have a lower compliance value than enforcement action, yet there is no clear evidence of that being the case. Equally, it would be wrong to conclude that a higher level of enforcement activity in the US implies a lower level of compliance: it may simply be the result of a higher ratio of enforcement action to contraventions. Differences in the regulatory structure and enforcement patterns as between different

countries simply add to the wider problem of estimating the effect of enforcement on compliance in any single regulatory system.