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Are Financial Services Over-Regulated?

As the Equitable Life saga drags on, accounting scandals break over Enron and WorldCom and allegations of self-serving analysts reports swirl around Merrill Lynch and other US investment banks, this may seem an extraordinary question to ask. But this is the very time that one must beware of the 'dangerous dogs' reaction[1]*. It is easy to forget in the immediate aftermath of scandals that extra regulation may achieve little beyond satisfying the call for 'something to be done' and can cumulatively cost a lot, even perversely increase the chances of future disasters*[2]*. With the EU's Financial Services Action Plan, the DTI's consultation on Company Law, the Sandler review of savings and the FSA's review of polarisation, Listing Rules and simplified product selling, the opportunity for radical change, good or bad, is all to apparent. This article seeks to give an overview of the current position and assess the danger of an over-reaction.*

The principal economic justification for any Government regulation is an asymmetry of information. For financial services, it is argued that private investors in particular just do not have access to the information necessary to assess the risks that they are taking, and even if they have access, not the skill and time to do so. But does that mark out the purchase of financial products from the purchase of any other goods or service? Do consumers really assess the technical merits of complex purchases like cars and washing machines before purchasing them? As has been pointed it:

> 'Whilst travel agents are required to comply with various financial requirements, no one expects a regulator to ensure that the staff behind the counter have sufficient knowledge to advise on the holidays they sell. It is even harder to envisage a requirement to provide "best advice" on a holiday – "are you sure you can afford to go away this year?"; "wouldn't a British holiday provide a more economical means of meeting your needs?"
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> Instead, it is for the firm to decide what level of training is required – balancing the cost of training against the risk of incompetent staff driving consumers away. The customer is left to decide whether the product on offer is suitable and good value'[3].

Under the European Financial Services Action Plan[4], the UK will be accepting a raft of directives. These will entrench as European law, a minimum level (and in at least one

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[1] The unworkable Dangerous Dogs Act 1991 was passed in response to media coverage of one or two cases where fighting dogs had mauled children.

[2] A current example is the imposition of pension payment protection imposed after the Maxwell scandal which by giving existing pensioners full priority may leave remaining employees of schemes that have to close (usually because the company has become insolvent) with little or no pension.

[3] 'Why Regulate Financial Services?' C Ford and J Kay, *The Future for the Global Securities Market – Legal and Regulatory Aspects* ed F Oditah, Clarendon 1996 ('Ford and Kay'), p 150.

[4] COM (1999) 232 (May 1999)

case, a maximum level[5]) of financial services regulation in return for the opening up of a single European market in this area, supposedly by 2005. It is true that many of these directives are only imposing across the EU, regulations that are already in place in the UK, although some like the regulation of insurance intermediaries are new developments[6]. However, this begs the question, was the UK over-regulated in the first place? Before assessing whether the weight of current financial services regulation can be justified, it is necessary to consider the variety of risks faced and the regulatory tools that have been developed.

Risks and Regulation

The most fundamental risk is of a systemic banking collapse. Commercial banks inevitably carry large open positions with their fellow banks. They are also inherently vulnerable institutions because they 'borrow short and lend long'. A default by one or two can be perceived to threaten fellow banks and this can produce a 'run on the banks'. The most spectacular example of this was the US Crash of 1929, and the recent closure of Argentinean banks was a response to the same phenomenon. Some have argued that with global banks, this risk has spread far beyond any single domestic banking system, though retail banking remains remarkably country specific. Techniques for reducing this risk include:

a. a strong central bank as a lender of last resort to deal with liquidity crises;
b. prudential rules enforcing lending limits to maintain a capital base, some liquidity and spread risk;
c. prior approval of management and systems to test fitness and probity;
d. deposit guarantee schemes to discourage consumer panics; and
e. the structural separation of retail banking from other financial services.

In reducing systemic risk, the first four techniques inevitably offer a high level of protection for the funds of consumers transferred to these banks. However, banks are no longer the only, nor indeed the main, instruments of investment intermediation for consumers[7]. Others like building societies, insurance companies, pension funds and unit trusts all take in consumers' funds as principals. These do not usually have large open positions with each other and so they do not create major systemic risks. Nevertheless, the argument that consumers are not able to assess the riskiness of these institutions and that there should be a ‘level playing-field’ of protection, has led regulators to impose investment limitations, ie prudential rules, on these institutions as well. Mutual compensation schemes have also been created outside the banking area[8].

The structural separation of retail banking was a particular feature of the US system (the

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[5] Draft Prospectus Directive COM (2002) 460 final (Aug 2002) as amended by the Council, 5 Nov 2002.
[6] Insurance Mediation Directive, 2002/92/EC.
[7] In 1998, sterling bank deposits of UK private individuals was less than £400 billion.
[8] The earliest scheme was probably the London Stock Exchange's own Mutual Compensation Fund and the first statutory one, the Policyholders Protection Act 1975.

‘Glass-Steagall Wall’) and was imposed by the Americans on Japan after the Second World War. It has only recently been dismantled in the US[9].

Where consumers are dealing with a financial services firm as their agent, regulators should be less concerned about the firm's solvency. But professional agents are expected to show loyalty and competence to their principals. The main risks posed by them are of misappropriation (including secret profits) and mis-selling. These risks are not confined to dealing with agents. Recent supposed mis-selling ‘scandals’, like personal pensions, endowment mortgages and split trusts, have mainly been with institutions acting as principals, selling their own products. In an effort to give equal protection in what is considered a complex market, regulators have extended normal agency duties to these principals and made them compulsory, at least when dealing with private investors. Techniques in this area have included:

a. prior approval of individuals and firms to test their fitness and probity;
b. client assets regulation, to keep such assets ‘ring-fenced’ in the event of insolvency;
c. information regulation, to give sufficient details on products, conflicts and remuneration bases;
d. advice regulation, to give ‘best advice’ based on ‘knowing your client’, ‘suitability of the product’, ‘risk warnings’ and ‘cooling-off periods’, together with ‘best execution’ for market products;
e. product regulation, banning sales to the public outright or only with prior approval (eg unit trusts) or having quality imprimaturs like being a ‘listed’ security or a ‘CAT marked’ product (eg ISAs and stakeholder pensions)[10]; and
f. the structural separation of conflicting interests like corporate finance, investing clients and running a proprietary book.

This last technique, structural separation, was a particular feature of the UK system before Big Bang. Merchant banks concentrated on corporate finance clients, stockbrokers on investing clients and jobbers on buying and selling and running proprietary books.

Classification of all these different regulatory techniques varies[11]. In general the former group of techniques (aimed originally at systemic risk) are considered prudential and the latter (imposing agency type duties), conduct of business. However, the terms ‘prudential rules’ and ‘conduct of business rules’ are often used for the more specific categories of capital/liquidity requirements and advice regulation respectively. Pre-vetting firms and individuals straddles the prudential/conduct of business divide[12].

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[9] The relevant provisions of the Banking Act of 1933 were repealed by the Gramm-Leach-Bliley Act of 1999.
[10] CAT stands for Charges, Access, Terms, for each of which standards are set.
[11] See *Financial Advice and Financial Products* McMeel and Virgo, OUP 2001, Chapter 1D.
[12] This has implications for implementation of the European passport, see below.

Regulators are also concerned with the integrity of the principal markets in which dealings take place. A form of micro-systemic risk can undermine a whole market where members carry large open positions with fellow members, normally as a principal (eg market-makers, locals etc), but sometimes as the effective guarantor of a major non-member client. Techniques for controlling this include:

a. prudential rules setting minimum capital and liquidity levels;
b. mutual insurance or an exchange counter-party to create a fire wall;
c. trading rules restricting settlement periods and margin calls where this is not possible (eg open derivative positions); and
d. insolvency rules that give markets a preferential position by allowing a defaulter's credits and debits with them to be set-off against each other.

The other concern is with the fairness of the dealings on such markets, particularly in securities. The value of any security should be its expected future cash flows discounted to their present value by the cost of money and the assumed risk factor[13]. So, foreknowledge of information that might affect those expectations or assumptions is valuable. Since a market price is established by the weight of investors buying or selling the security, foreknowledge of information about those dealings is also valuable. Exploitation of that foreknowledge has been discouraged by:

a. disclosure requirements on companies etc (Listing Rules);
b. disclosure requirements on market dealers (Transparency Rules);
c. structural separation of proprietary trading; and
d. criminal (and increasingly civil) liability for insider dealing and market manipulation.

A peculiar issue of fairness arises with equity shares. These securities only have residual rights on a winding up and until then dividends at the discretion of the board, but in return are usually given the right to vote for that board. Purchasers of sufficient shares to 'control' that board are usually prepared to pay a considerable premium over the normal market price. This can arise for a number of reasons - the power to install more effective management, to extract economies of scale, to reduce competition, or merely to indulge in megalomania. Two risks arise:

1. the existing management of the target may, from a desire for self-preservation, obstruct any take-over; and
2. some equity holders in the target may not be offered the premium and have to sell at a discount or be trapped as a powerless minority.

Techniques for dealing with these include imposing:

[13] Based on the Capital Asset Pricing Model devised by William Sharpe, John Lintner and Jack Treynor, eg *Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk* (1964) 19 Journal of Finance 425. The attack of acute amnesia over this principle when valuing 'high-tech' stocks seems at last to have been cured.

a. the principle of ‘one share, one vote’;
b. shareholder votes for all potentially obstructive measures, like ‘poison pills’;
c. compulsory bids for all shares by anyone acquiring a controlling interest; and
d. a minimum bid price of the highest price paid for shares acquired before or during the offer period.

Are All These Regulations Justified?

Prudential Regulation

True systemic risk really only arises from the failure of significant deposit-takers and it could well be argued that prudential regulation should be confined to them[14]. The collapse of Barings was, for example, more of a risk to Far Eastern derivatives markets than to the UK banking sector. Such micro-systemic risk is surely for the markets concerned to regulate, not for a public body back in the UK. On the other hand, market set-offs on the insolvency of their members are a matter of public policy and with global markets, some degree of international co-ordination on insolvency policy is helpful. There is little evidence that structural separation on the American model contributed to the stability of the US banking system. The problem in European negotiations in the past has been that without European-wide prudential regulation being set for market operators and others, countries have not been prepared to open their markets to any but locally established firms.

As for extending prudential regulation to other non-market principals, life assurance (including pension schemes) may be something of a special case. To encourage the purchase of such long-term policies, confidence in the long-term solvency of those firms *might* need some external support. Solvency rules and possibly a limited guarantee may therefore be justified[15], and some sort of temporary guarantee may also be justified for compulsory insurance policies (eg car insurance) to protect consumers from unwittingly breaking the law - but beyond that?

The consumer lobby would argue, with some evidence on their side, that the intangible nature of financial products and services makes them peculiarly attractive for fraudsters. Physical inspection is not an option, and consumers seem far more prepared to write out large cheques (or rather give credit card details) for untested financial products than cars and houses. Also the electronic revolution has dramatically cut the costs of marketing fraudulent schemes and raised the cost of tracking down the culprits across jurisdictions.

[14] The chief advocate for structural separation and confining prudential regulation to ‘narrow banking’ is George J Bentson, eg *The Internationalisation of Capital Markets and the Regulatory Response* ed John Fingleton, Graham & Trotman 1992, Chapter 10.
[15] Although, strict application of solvency rules in falling equity markets can force insurers to sell into the falls, creating a vicious spiral towards the insolvency the rules were designed to prevent!

Therefore, some limited official imprimatur of authorisation and the concomitant pre-vetting may be justified for selling financial products and services (at least above a certain level of risk) that would be considered an unacceptable restriction on competition in other fields. On the other hand, consumer losses to real fraudsters must be small compared to their losses investing in high-tech companies on the advice of, and/or through authorised firms. Regulation did not, and never has been able to, stop such irrational bubbles and their fall-out.

Conduct of Business Regulation

The compulsory application of agency-type duties not just to agents but also to principals (a sort of 'synthetic agency') seems hard to justify. UK policy in this area is in a state of flux. Even the limited requirement of 'best execution' for transactions in marketable securities has become impossible to define, let known impose, in the new world where principals run, and agents are linked up to, a variety of different competing dealing platforms. How much more unrealistic is it to impose a duty of 'best advice' about financial products on a salesman tied to the limited product range of his principal and working on commission? As Ford and Kay have said 'the requirement to offer "best advice" really holds out a false prospectus'[16]. You do not go into Dixons and expect the salesman to tell you there are better products and/or prices at John Lewis. You either shop around yourself or pay an agent to do it for you. Indeed, the SIB's own polarisation policy on financial products recognised this problem.

No doubt that in persuading people to abandon their Occupational Pension Schemes ('OPS') for Personal Pension Plans ('PPP'), many salesmen did make deliberate or negligent misstatements that entitled investors to damages in our civil courts[17]. But retrospective surveys set up to work out who, with hindsight, might in fact have lost out and should on that basis alone be compensated are very dangerous. Indeed, now that OPSs are closing down, often with insufficient funding for future pensioners, they do not seem quite the 'risk-free' option they were assumed to be just a couple of years ago. The FSA has understandably resisted repeating the exercise for endowment mortgages. Even if encouraged by high commissions, it was not obviously unreasonable to advise someone to take out an endowment mortgage against the background of Governments allowing high inflation and stockmarkets rising to compensate in the late 1970s and early 1980s. The world looks very different since inflation was brought under control in the 1990s and share prices have fallen since 2000.

The consumer lobby would argue that heavy advice obligations are necessary because of the unique complexity of financial products. But this is not convincing. The problem with financial products is not usually their complexity but their uncertainty[18]. As the

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[16] Ford and Kay p 150
[17] Other salesmen claimed that they offered no comparative advice on OPSs because the SIB's polarisation policy forbade discussion of products they were not able to sell! It is interesting to note that the security of OPSs compared to PPPs may not seem quite so obvious now as even two years ago.
[18] Much of that uncertainty arising from Government actions.

Bacon and Woodrow survey carried out for the FSA showed[19], UK funds' past performances show no close correlation to their future performances, which makes even regulation of information, let alone advice difficult. Is one just left with giving warnings about high-risk products and about the need to spread risk? But, would they have dissuaded day-traders and others speculating in dot.com companies? Indeed, day-trading only became available because of electronic execution-only broking which itself has demonstrated the demand for cheap and cheerful services. Duties 'to know your customer' and of 'suitability' require expensive time and documentation that are just not compatible with the cheap and cheerful, a point accepted in the recent Sandler Report and the FSA's review of selling simplified products[20].

Prior approval product regulation also seems illogical. When direct sales of unit trusts were the principal mode of access to the securities markets for small investors, it may have made sense. Now that small investors can and do purchase even the most risky securities directly and cheaply without advice through execution-only brokers, such regulation of one type of product seems outmoded. There may be more justification for product regulation of the CAT imprimatur variety. One thing that can cut into future performance of a fund is high commissions. Comparison of the costs of many funds is now available on the FSA web-site. Encouraging low cost products would be in line with other markets where, although there are niches for individualised high cost services, most of us rely on chain stores and supermarkets. We accept that we will not get personalised advice and the consumer lobby has to accept the same in financial services. In fact, Big Bang was about dismantling the Stock Exchange's consumer protections of single capacity and personal unlimited liability in return for lower dealing costs. However, if there is any demand for CAT type imprimaturs, is the Government the best judge of the appropriate tests?

Indeed, the Government must recognise that a large move to cheap 'tracking' type investments would have its problems. The managers of such low cost products will have neither the incentive nor resources to engage in any active corporate governance, so beloved of the current administration. Also if the market became dominated by tracker funds, investors could be at the mercy of the small number of active investors setting the prices that the rest are tracking. On the other hand, it must be said that such products exist already, but with thin margins to spend on marketing, the take-up is not encouraging.

Moves in the US to impose structural separations[21], or at least Chinese Walls, between corporate finance and investment analysis, even perhaps between client and proprietary trading are more logical and have been tried in the UK. It was little surprise that US securities houses have been found to favour those operations from which they made their profits, corporate finance and proprietary trading. The reluctance of institutions and

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[19] Consultation Paper 28, FSA October 1999.

[20] *Medium and Long-Term Retail Savings in the UK – A Review* R Sandler, HM Treasury, July 2002; Discussion Paper 19 *Options for regulating the sale of simplified investment products* FSA, Jan 2003.

[21] Led by Eliot Spitzer, the New York Attorney General.

other investing clients to pay for trading and analytical services is the principal cause of their poor treatment. However, I have little confidence that mere Chinese Walls can withstand anything but relatively minor conflicting financial interests[22]. I also see no sign of the institutions or the rest of the investing public being prepared to return to the expense of the pre-Big Bang system with its real rather than synthetic agency protections.

Market Regulation

The one element of the Stock Exchange's consumer protection that has survived are the Listing Rules, although they are now statutory, many deriving from the various EU Listing Directives[23]. In theory, this type of regulation could be left to competing markets to determine what investors require realistically to value listed securities. The EU justifies minimum harmonised requirements and mutual recognition of documents as opening up a single market for capital raising, but the benefits can be much exaggerated since only the very largest companies can easily launch Europe-wide offerings[24].

The latest proposal from Brussels that it should now set maximum requirements has quite a weak justification[25]. There is no basis for believing that Brussels has any experience at setting the optimum level of regulation in this area[26], or indeed that there is one optimum level. It is ridiculous to believe that markets would expect the same information (often produced at considerable cost) from a small highly speculative company as it would from a core FTSE-100 investment. That is why second (and indeed third) tier markets have developed. Imposing one standard on all traded companies must mean either a lowering of standards on large companies or driving the costs up so much for smaller companies that they are forced towards private non-market based funding. The latest version of the Draft Directive makes some concessions to different types of issue and issuer, but it still tries to stop companies from choosing their jurisdiction for listing and individual markets from imposing higher entry standards[27]. In an area where a reputation for high standards is a competitive advantage, such a move to cap standards seems rather anti-competitive[28].

Transparency Rules clearly reduce the risk of fraud or mistaken pricing, but were until recently left to individual markets to decide. The main argument against them was from market-makers (in effect professional speculators). They claimed that they would not be able to offer liquidity for large institutional orders without some protective delay in

[22] As was the case with pre-Big Bang UK stockbrokers. In any case, they rather destroy the logic of conglomerate securities houses.
[23] Currently to be found in Financial Services and Markets Act 2000, Part VI; Consolidated Listing Directive 2001/34/EC; Public Offers Directive 1989/298/EEC.
[24] Intra-state offerings in the US are not subject to the SEC.
[25] Draft Prospectus Directive COM (2002) 460 final, issued 9th August 2002.
[26] The comitology arrangements involving a revamped FESCO are as yet untested.
[27] Draft Prospectus Directive, Art 17.
[28] For a discussion on optimum levels, see Professor Roberta Romano 107 Yale LJ 2359 (1998) cf Professor Merritt Fox 85 Va L Rev 1335 (1999).

announcing large deals to allow them to unwind large positions. With the fragmentation of dealings across competing platforms, the need for some external regulation to keep the overall market well informed has probably increased, including disclosure of significant short positions. Still a balance may still have to be struck to ensure that in second tier stocks, transparency does not undermine liquidity.

Arguments about the regulation of insider dealing and market manipulation have been rehearsed many times[29], though the Enron scandal has demonstrated that market manipulation is far worse than insider dealing. As the common law tradition has long recognised, lies are more damaging than silence[30]. It may be irritating that well placed insiders in Enron managed to sell much of their stock before the company crashed; but it was the misleading figures published by Enron and others that dented trust.

The arguments for legislating against persons taking advantage of an informational advantage in securities and derivatives markets are:

1. 'fairness' – insider dealing is an unacceptable abuse of confidence;
2. 'incentives' – it misallocates rewards to insiders for no useful effort;
3. 'confidence' – it deters use of a market through lack of confidence; and
4. 'liquidity' – it hits professional speculators like market-makers which raises the costs of dealing, particularly in any size.

There are, however, some arguments against legislating, at least in too draconian a manner:

1. 'efficiency' – insider dealing moves prices to reflect the prospects of issuers more accurately;
2. 'no loss' – investors who dealt with the insiders never lost anything they were entitled to;
3. 'liquidity' – fear of prosecution may deter necessary speculation; and
4. 'false expectations' – a level playing field in information is impossible.

Arguments about take-over regulation are still being rehearsed in Europe after the European Parliament's failure to approve the Draft 13th Company Law Directive in July 2001[31]. The UK's Take-over Code imposes all the regulations mentioned above except the 'one share, one vote' principle, and in practice that is imposed because of institutional investors' pressure. In the UK, such regulation seems the minimum necessary for a fair market for control of companies, although the US has not gone down quite the same route. There the view is generally taken that:

1. managers trying to preserve their jobs should be dealt with by the normal process of

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[29] eg *The Law and Finance of Corporate Insider Trading: Theory and Evidence* Arshadi and Eysell, Kluwer 1993.

[30] *Derry v Peek* (1889) 14 App Cas 337 and *Smith New Court Services Ltd v Scrimgeour Vickers (Asset Management) Ltd* [1996] 4 All ER 769 cf the principle of *caveat emptor*.

[31] For further details, see 'The Regulation of Takeovers' Alcock [2001] JIFM 163.

voting then off the board; and
2. bidding companies should be free to pay a premium just for control (50+%), albeit all existing shareholders who wish to accept such a partial offer should be treated pro rata[32].

Whatever the merits of the transatlantic positions, the UK specialist regulator system certainly scores on cost and certainty of implementation over the US court-bound system.

Summary

It can be seen from this discussion that most of the regulatory measures devised to date can be justified at least in certain limited circumstances. There arises a temptation to extend them to any comparable circumstances because:

1. suppliers may be offering all or many of the different products and services and may plead for a 'level playing field'; and
2. consumers will be safer and less confused if there is a generally applicable regulatory scheme.

This temptation, to which the UK and European authorities have been prone, must be resisted (and some cases reversed).

The Costs of Over-Regulating

Regulation is far from free. Over-regulation can be just as damaging as under-regulation, for a number of reasons:

1. *Direct Costs.* The 3,000 or so employees of the FSA have to be paid for by the financial services industry although for the size of the UK's industry, this looks quite modest[33]. However, the FSA already admits that small credit unions and independent financial advisers would be driven out of the market if the direct costs of regulating them were not cross-subsidised[34]. To those direct costs must be added the cost of compliance departments in all the firms. Financial services regulation has created a whole new and very well paid profession of compliance officers since the mid-80s[35], and have standards really been raised?

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[32] *Moran v Household International Inc* 500 A.2d 1346 (Del 1985); *Unitrin v American General Corp* 651 A.2d 1361 (Del 1995); Securities Exchange Act of 1934 ss 13(d)(e) and 14 (d)(e), these sections sometimes referred to as the 'Williams Act'

[33] FSA Annual Report 2001/2, Appendix 10 shows Australian and Canadian regulators employing over 2,000 per country and the US a staggering 32,000 – no economy of scale there!

[34] Consultation Paper 77, FSA December 2000, p 52; FSA Annual Report 2001/2, p 47. For overall competition effects, see para 5.

[35] Some of the compliance costs would no doubt be incurred anyway as part of any internal control, but it

2. *Diversion of Resources.* The wider the net of prudential and conduct of business regulation is cast, the more resource has to be diverted just to deal with day-to-day enquiries. As at 31st March 2002, the FSA regulated over 150,000 individuals, 9,000 financial services firms, 2,000 collective investment schemes 1,500 UK listed companies plus 8 exchanges and 3 clearing houses[36]. To that must now be added 700 credit unions and by 2004, innumerable mortgage and general insurance advisers. After merely keeping contact with all of these, how many man-hours will the FSA have for tracking down real fraudsters, within or without the regulated perimeter? These are the more obvious immediate costs of regulation, but it can also have less obvious long-term consequences.

3. *Economic Moral Hazard.* Close prudential supervision and generous compensation schemes can lead investors rationally to ignore any default risk and seek the highest apparent return, particularly from credit institutions. This in turn encourages reckless behaviour by those institutions in an effort to offer the highest return. The most obvious example of this in recent years was the Savings and Loans debacle in the US, although there may have been an element of it in the Equitable Life saga. Equitable Life had a consistently high 'with profits' declaration and investors no doubt believed that the regulator was ensuring that sensible levels of reserves were being maintained. Fear of this moral hazard has driven the FSA and its Chairman in particular, repeatedly to state that 'a zero failure regime is neither achievable in practice nor desirable in principle'[37].

4. *Infantilisation.* This is an extension of the moral hazard argument, where the very existence of an elaborate regulatory system leads investors to act irrationally. 'Treat people like children and they will behave like them'[38]. Investors begin not just to ignore the default risk of suppliers, but general market risk. How many endowment mortgagors were positively told that the endowment was *guaranteed* to meet the debt at the end of the period? Most probably assumed it without asking how that could possibly be the case. The panoply of regulation encourages people not to think at all. In particular, they forget that higher returns should involve higher risks. That could be particularly disastrous at this time as people seek the annual double-digit returns on investments they have come to expect just as such returns have become a thing of the past.

5. *Internal Corruption.* This is a variant of infantilisation, not on the part of investors, but on the part of the suppliers of financial services. Complex rule-based systems of regulation tend to inspire amoral behaviour. Suppliers no longer ask if a transaction is 'fair' or 'right', just 'is it within the rules?' A glaring example of this was Enron's and Arthur Anderson's attitude to off-balance sheet vehicles. Detailed US

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is remarkable how few specialist compliance officers existed before 1986.

[36] FSA Annual Report 2001/2, Appendix 11.

[37] eg speeches by H Davies on 13th June 2000 and 19th July 2001 and FSA Annual Report 2000/01, p 8.

[38] A favourite saying of my contract and tort lecturer at Cambridge, Tony Weir.

accounting rules did not specifically ban such treatment of debt, even if overall it made a mockery of presenting any 'true and fair view'. Over-regulation also inspires non-economic 'rent-seeking', where existing suppliers expend much intellectual effort seeking to persuade the regulator to a course of action that gives them a regulatory advantage. For a current example, look no further than the positions of various parties over the polarisation debate in the UK. This, however, is part of the next problem.

6. *Restricted Competition.* We have already noted that dealing with regulations and regulators is expensive, but it is often secretly loved by established players because it raises high entry barriers to new suppliers and products which customers might want, like cheap execution-only dealing services and no-frills funds[39]. Howard Flight MP noted when the FSMA was going through Parliament that 'The large players welcome regulation. It raises the threshold of entry enormously. The innate tendency of regulation is towards consolidation and cartels'[40]. Low or no commission products can not be subject to stringent advice regulation, and yet it is the competition of these cheap products that has started to drive the costs in the whole industry. Lack of such domestic competition can also give rise to the final problem.

7. *Lack of International Competitiveness.* Over-regulation can impair international competitiveness indirectly by encouraging an uncompetitive domestic market, but also directly by driving operations to less heavily regulated jurisdictions, ie regulatory arbitrage. The most famous example of this is the development of an offshore Eurodollar market in the 1970s to escape regulation (and taxation) in the US. Various European directives have been passed to try and stop this happening within the EEA, but even European-wide rules do not stop some 'supervisory arbitrage', ie the tendency to head for the lightest and/or cheapest enforcement regime. In any case, in this electronic age, it will impossible to outlaw non-EEA competition (Switzerland springs to mind) if consumers do not perceive the protection offered within the EEA as outweighing the costs it imposes[41].

This last issue raises the general problem of the EU and international regulation, ie regulation over an area where there is not, as yet, one centralised regulator.

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[39] For a study of the anti-competitive tendencies of regulation in the banking sector, see the Cruickshank Reports, *Competition and Regulation in Financial Services: Striking the Right Balance* HM Treasury July 1999, and *Competition in UK Banking: A Report to the Chancellor of the Exchequer* Stationery Office March 2000. Think how the major airlines would love to have forced their no frills competitors to sell their tickets only through authorised travel agents.

[40] Vol 343 HC, 27 January 2000, c 652. This is also supported by a survey of industry views that showed the FSA was viewed far more favourably by large organisations than small, Forum's Annual Report 1999, p 26.

[41] That wholesale professional markets are extremely cost-sensitive and apparently unconcerned about regulatory protection can be seen from the recent flight of the German Bund contract from LIFFE to Eurex and specialist insurance from Lloyd's of London to the Bermudan market.

The EU and International Regulation

When developing its European Passport for financial services, the EU made a simple distinction between prudential rules, which were the sole responsibility of a firm's home state, and conduct of business rules, which were left to the host state where the service was provided[42]. Any such conduct of business rules were, nevertheless, subject to the restraining principle of the 'general good'[43]. By setting minimum prudential rules for credit institutions, insurers and other providers of investment services, the EU was able to persuade all member states to accept that the authorisation of such firms in any one member state would authorise it to conduct such business throughout the EU (indeed the EEA).

In theory, any company contemplating offering its services in another host jurisdiction has three possible methods of doing so. It can:

1. set up (or take over) a separate local company as a subsidiary;
2. set up a local office/branch as part of the home based company; or
3. operate from the home based company ('cross-border' business).

In case 1, the host state regulator can treat the local subsidiary like any other local company, which in this case just happens to have a foreign controlling shareholder in the same line of business. In practice, the regulator may be concerned how independent such a business can be from its parent and will want to liase with the parent's regulator. That is the approach adopted by the European Directives[44].

The problem in case 2 is that to a customer in the host state, the branch of an overseas business looks like a domestic business with all the host country's regulatory safeguards; but for the hosts state's regulator, a branch is just part of the home state operation. He can force it to adopt host state conduct of business rules but prudential regulation has to be left to the home state. The European Passport adopts this approach, except curiously the Investment Services Directive treats client assets regulation as a prudential matter for the home state, even when the assets are likely to be held in, and subject to the law of the host state[45].

In case 3, if a customer chooses to use an overseas firm, he presumably accepts the protection (or lack of it) provided by that overseas jurisdiction. But, what if the approach is from an overseas firm? At the very least, a host state may wish to regulate the advertising and other marketing techniques such an overseas firm can deploy on its

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[42] For the development of the European Passport see *The Financial Services and Markets Act 2000: A Guide to the New Law* Alcock, Jordans 2000, Chapter 2. Investment Services Directive, 1993/22/EEC, unlike the other directives, imposes a positive, albeit general, duty on the host state to draw up conduct of business rules for the provision of investment services, Art 11.
[43] *Sager v Dennemayer* [1991] 1 ECR 4229 at para 15.
[44] Cooperation between regulators is a theme of recent Directives, eg Post BCCI Directive 1995/19/EC and Insurance Groups Directive 1998/78/EC.
[45] Investment Services Directive, Art 10.

customers. In fact, the European Passport arrangements made no distinction between this and case 2, allowing host states to apply all their conduct of business rules.

So long as true cross-border business of this kind was confined to professionals, the failure to distinguish it from branch business did not matter as host states did not impose many conduct of business rules on inter-professional business. However, the World Wide Web has opened up the possibility of retailing financial services to ordinary investors across borders cheaply and this has highlighted two problems with the European Passport's approach:

1. Strictly speaking, the European system left conduct of business rules, not to the host state of the customer, but to the 'state in which the service is provided'[46], which for a number of financial services might not be clearly the home or host state and could even be a third state if the service is from a branch there[47].
2. With access to web pages from any EEA jurisdiction (indeed anywhere in the world) it was not practicable to comply with each jurisdiction's conduct of business rules, particularly those restricting advertising and marketing.

This has led, with the E-Commerce Directive[48] and the Draft Distance Selling of Financial Services Directive[49], towards home state regulation (or more accurately supplier state regulation, as it could be from a branch) of the conduct of cross-border business. To make this acceptable, minimum European requirements are being laid down (as happened earlier with prudential regulation), but there are still numerous exceptions that host states could use to obstruct such business[50].

These Directives and others that will follow as part of the Financial Services Action Plan are entrenching a considerable amount of regulation at a European level. Although Frits Bolkestein and most of his fellow European Commissioners seem to be conscious of the dangers of over-regulation, the co-determination procedures with the European Parliament do lead to a large amount of relatively unprincipled 'horse-trading'. I have already noted that two early proposals under the Action Plan, the Draft Insurance Intermediaries and Prospectus Directives have rather weak justifications. Not that the problem is confined to Europe. The responses to the recent scandals in the US are hardly a model of rationality[51]. Still, for all the extra-territorial tendencies of the US, it is Europe that impinges more on the UK. This does mean that in the end there may be quite a high regulatory price to pay for the supposed benefit of a single market in

[46] Ibid Art 11.2.
[47] The Commission tried to clarify the position, at least for banks, in *Freedom to Provide Services and the Interest of the General Good in the Second Banking Directive* [1997] OJ C209/6.
[48] 2001/31/EC.
[49] COM (1999) 385 final, almost agreed, see EU Press Release IP/02/707.
[50] For example, the E-Commerce Directive applies only to the co-ordinated field, and allows derogations for consumer (including investor) protection, Art 3, although they may be challenged by the Commission applying the concept of the 'general good'.
[51] Joint funded 'independent' analysts, for example. Who thinks that firms will be letting their best minds join that structure?

financial services.

Conclusion

There is no doubt that the current Chairman of the FSA is well versed in the arguments about the right level of financial services regulation[52]. As a regulator, you would expect to him to give the benefit of any doubt to regulation. As was said in the debates on the Financial Services and Markets Bill: '…fish swim, birds fly and regulators regulate'[53]. Nevertheless, Sir Howard Davies does seem to be very conscious of the dangerous dogs example, having commented on it himself[54]. Even if Sir Howard or any successor were less perceptive, the elaborate consultation processes laid down in the Financial Services and Markets Act 2000 allow the industry plenty of opportunity to lobby and persuade. However, as more and more of the developments in financial services regulation are going to be in response to European requirements, lobbying the FSA when it puts forward implementing proposals is going to be too late.

The very existence of a separate regulator, like the FSA, with duties to consult, consider and explain, rather than having a Government department responsible, provides some buffer from those pressures. The European institutions, particularly the European Parliament, will not be so immune and once regulations have been adopted, they can be very hard to remove. After all, it only took the American Congress 63 years to repeal the Glass-Steagall Wall, erected hurriedly in response to the 1929 crash and the slump that followed.

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[52] See for example, FSA SP 19: Davies *Why Regulate?* (November 1998)
[53] David Heathcoat-Amory MP, vol 351 HC, 5 June 2000, c 73.
[54] FSA SP 67; H Davies *A New Regulator for the New Millennium* (11 December 2000).