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Rules for the Regulators

Regulating Financial Services after Brexit

Barnabas Reynolds

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Sheila Lawlor

I

When the UK voters decided to leave the EU in 2016, there was one paramount aim: for the people of this country to have the right to determine the laws under which they are governed. Their decision was reaffirmed at the general election of 2019. It was put into effect by the Prime Minister, Boris Johnson, a month later. Given the chaotic political circumstances inherited from his predecessor and the attempts by many on both sides of the Channel to obfuscate and obstruct the execution of a democratic decision, this was a remarkable feat. It was of the same magnitude and marked by the same turbulence as the passing of the 1832 Reform Act, and showed the same popular involvement and Tory division as in the 1846 Repeal of the Corn Laws, driven through by a Conservative Prime Minister with Whig support. What we saw in the autumn of 2019, as crowds demonstrated and held vigils in Parliament Square, were not merely the attempts to obstruct Brexit, but Britain's parliamentary democracy itself under threat, as MPs seized executive power to obstruct the execution of the referendum mandate. Indeed, now as in the 1830s and 1840s, few involved in those tumultuous debates in and out of parliament could envisage how things would end. But end they did. By December 2020, the UK had left the EU, its Single Market and its Customs Union, though with a legacy of inherited laws.

Now, two years later, the special legal status of that EU law retained under the 2018 EU Withdrawal Act is to be ended and the process for removing it simplified under a Brexit Freedoms Bill, to be introduced in the current parliamentary session. Johnson's government intends also to accelerate a programme of wider regulatory reform so as to maximise the benefits of Brexit and to remove from domestic as well as inherited EU regulation the rules that inhibit growth. It aims for 'new competitive advantages', to collaborate on better rules, reduce compliance costs and ensure regulation is 'outcomes-focused'. The idea is to help businesses, both new entrants and established firms, to protect small and medium sized business from 'the most burdensome obligations' and for the regulation to be 'proportionate to the real or likely harms' and not 'precautionary and risk averse' except where justified.*

Though tackling regulation may not be so politically charged a cause as leaving the EU, it is potentially as significant constitutionally and economically. For across many areas of national life the UK bureaucratic state has developed as a ruling intermediary between people on the one hand, and parliament and government on the other. It operates a system of rules as a shadow power in itself, in which unelected and unaccountable officials to whom powers are delegated draw up the arrangements for how different parts of our society should conduct themselves, backed by their own rulebooks at one or more remove(s) from the laws of the land. The powers entrusted by government are exercised in different ways, either by independent agencies or quangos or officials in the civil service, who are neither subject to scrutiny by, nor accountable to, the public or parliament, but work under their own opaque internal systems of governance. Not only do they make the rules, but they enforce them, acting as judge, jury and executioner. There may in some circumstances be recourse to a judicial review, but in practice such an option is beyond the means of most people or small businesses.

II

It is remarkable that this country, renowned for its freedoms and proven system of parliamentary government, democratic accountability and historic protection of liberties under law, should have seen the growth of this dominant arm of the state over the past 70 years. The origins were mixed but reflect political and organisational theories over the 20th century about institutional and state systems, which came to permeate Britain's governing arrangements. They include political theories of bureaucracy, centralisation, collectivism, and managerialism. What they appear to have in common across the political spectrum - liberal, left and conservative schemes - is a belief in the efficacy of rationalisation as a tool of governance to promote effective and efficient rule for different political systems.

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* *The Benefits of Brexit: How the UK is taking advantage of leaving the EU*, HM Government, January, 2022, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1054643/benefits-of-brexit.pdf

For Max Weber, the German political economist and liberal, a philosopher, sociologist and historian, a structured bureaucratic system organised to perform certain tasks on hierarchical and demarcated lines would be the basis for common rules applied to all citizens fairly, impersonally, equally and effectively. By contrast, for Soviet Russia, the bureaucratic collectivism supported by Stalin gave to an elite the control of the state and its economy (and as a result divided other revolutionary leaders from Stalin). In this country, where the theoretical attractions of a more benign bureaucracy left their mark on the leftist intelligentsia even before the central organisation of state in the 1940s took off, a different layer of rationalisation was introduced in the later 20th century. To the bigger state of the 1970s and 1980s and its rising costs came the use of corporate management theories and managerial system, designed to rein in public spending and streamline structures: officials were increasingly to determine centrally through bureaucratic criteria how activities are conducted in many areas or life.

Thus now in schools, hospitals, the police, businesses, the most highly qualified specialists in a given subject, professional people, are as good as told how to do their job, with checklists and guidance, their success measured by opaque internally set bureaucratic criteria. Teachers in schools, doctors in hospitals, the police are all affected. To take one example, officials decide to which patients the most talented (and renowned) consultant physicians in the world should give priority, the time they should give for a hospital appointment, the treatments which may or may not be prescribed. Highly qualified professionals with specialist knowledge of their subject are obliged to follow centrally set official criteria, often reinforced by box-ticking exercises, judged on that basis. Their intermediate rule supersedes the normal mechanisms of accountability of doctor to patient, teacher to pupils and parents, police to local people in upholding the law. Instead is a culture of guidelines, checklists, targets and guidance, ruled over by themselves.

Nor is the private sector spared. In business, highly talented and successful entrepreneurs must follow the rulebooks of unqualified officials, and in financial services, as we read in this analysis, the picture that emerges is that the regulation of the financial services has much in common with that applied to other areas of national life, publicly and privately provided.

III

Whereas the bureaucratic organisation of the state in this country may have been inspired by intellectual trends and political developments internationally, it was adopted voluntarily. By contrast, the EU's legal framework, incorporated into UK law in 2018, but now to be subject to a simplified removal process, was imposed on the UK as a member of the EU. That system owes much to the French centrally controlled *dirigiste* economic model, used traditionally by France to promote the aims of the French State, political, economic and military, and finance its activities. In this model, favoured industries are protected from competition under law, and sometimes also generously subsidised from the public coffers; and rivals are kept out of the fray, unable to break into the protected market. The model was deployed by France after World War 2 to lock a potentially resurgent German economy into cooperation with the French, under joint Franco-German control, in the initial European Coal and Steel Community under the Treaty of Paris in 1951. Then and subsequently, as its successor organisations, the EEC and then the EU, extended their reach to 28 member states, the project developed over time all the underpinnings of a state: its own money and central bank, as well as a parliament, an executive, a legal system and court to uphold its laws. How much of a hit the City has taken since the 1990s tsunami of EU and other regulation for financial services is open for debate. But there is no question of the significant prizes, now to be won, if we strike the right balance between freedom under law and security against systemic risk.

More intractable, perhaps, than unpicking the legacy of the EU's laws will be the problem of tackling the UK's own regulatory system. For the financial services sector, the regulators make the rules, adjudicate over those bound by them and, where the option exists, punish them. They have the power to exercise personal judgement without seeking the advice of those qualified in the area, and to impose sanctions for alleged breaches of (their) rules over and beyond routine inspection of the application of the law.

Meanwhile the task of unpicking the voluminous EU rulebook for the sector is now to be delegated to the UK's own regulators, the Prudential Authority (PRA) and the Financial Conduct Authority (FCA), to determine which EU regulations to remove and which to keep. But that is only one side of the story. For, as we learn from Barnabas Reynolds in this analysis, the PRA and the FCA will, under the powers delegated by the UK parliament, continue, as they do now, to be free to add layers of their own rules – rules made, operated and judged by them alone. As matters stand, therefore, the plans need strengthening in two main ways: first, by an independent review of the EU's regulatory legacy under Parliament through its committees, drawing on specialist legal and business knowledge; and, second, by cutting the powers of UK regulators to make their own rules and to impose and enforce their own sanctions for supposed breaches, without the checks and balances normally afforded by our law.

Without these checks the way will be open for an explosion of vague, bureaucratic and potentially arbitrary rule-making by the UK regulators themselves, over and above EU rules, the upshot most likely being that they will wield even more unaccountable power over the nooks and crannies of the UK's financial businesses.

The arrangements and potential problems are explored here by Reynolds, a regulatory lawyer who leads his City firm's global financial services and regulatory practice. He includes a series of proposals for reforming financial services regulation, with a new framework for checks and balances, giving a more significant role for the courts, and proposing a system of greater accountability by the regulators for their decisions and a basis for ending potentially arbitrary decisions or the use of favoured treatment for some over others.

Not only should the proposed changes make the system more transparent and accountable, but, by curtailing arbitrary decision-making, they should lead to a more predictable system for businesses and for the certainty the sector needs to build its businesses with confidence. In short, scaling back the powers of the UK regulators could be a vital tool in promoting Brexit freedoms, including a free economy under UK law.

Sheila Lawlor
Research Director, Politeia
30th June 2022

The Author

Barnabas Reynolds is an international financial services and regulatory lawyer. He is a London-based partner at Shearman & Sterling LLP, where he leads the global financial institutions practice and specialises in UK and EU law and financial regulation. He has been a member of the group of lawyers advising Members of Parliament on Brexit, and originated and developed the UK's proposed model for financial services trade with the EU after Brexit, in *A Template for Enhanced Equivalence: Creating a Lasting Relationship in Financial Services between the EU and the UK* (Politeia, 2017). He has set out proposals for the reform of UK financial services law after Brexit, in *Restoring UK Law: Freeing the UK's Global Financial Market*, and for the legal structures now used across many industry sectors in the City for no-deal Brexit purposes, in *The Art of the No Deal: How Best to Navigate Brexit for Financial Services* (Politeia, 2017).

Other publications proposing and developing the options for the financial sector industry after Brexit include *A Blueprint for Brexit: The Future of Global Financial Services and Markets in the UK* (Politeia, 2016); *Free Trade in UK-EU Financial Services: How Best to Structure a Brexit Free Trade Deal* (Politeia, 2018); EU-UK *Financial Services After Brexit – Enhanced Equivalence: A Win-Win Proposition* (New Direction-Politeia, 2018). He co-authored *Managing Euro Risk: Saving Investors from Systemic Risk (*Politeia, 2020). He co-edits Sweet & Maxwell's *Journal of International Banking Law and Regulation*.

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Introduction: Exploiting Brexit's Freedoms

The City of London has, with New York, been a magnet for the world's financial services markets. Many international businesses, encouraged by the proven qualities of the United Kingdom's legal system, have for many decades chosen to do business there. They have found UK rules to be clear, predictable, and calibrated to address matters of financial risk whilst not unnecessarily restricting the market. Yet in recent decades the UK's success as a financial centre has been threatened by European Union rules and EU legal techniques. Not only are these part of the legacy of inherited EU law now adopted into UK domestic law, but they also affect the UK's approach to regulation and supervision. Now, if the sector is to make the most of the freedoms of Brexit, the law and regulation must change.

Already the UK has made a start. The government has indicated that it proposes to remove much of the inherited EU regulation from the statute books, transferring the text to the rulebooks, which comprise rules made by our financial regulators, under their statutory powers.[1] At present those rulebooks seek to buttress the EU scheme and fill in the gaps. In future the rulebooks would govern almost all of the behaviour of financial firms and their senior personnel. The regulators would have the task of managing and adjusting these new rules under their existing statutory powers (which allow them to remove, amend and make new rules). Changes are also being made to various inherited EU rules such as those for insurers, in the so-called 'Solvency II' directive,[2] an EU measure which codifies EU insurance regulation. These first steps for moving away from the EU's code-based methods, and its inflexible, purportedly exhaustive legislative text are essential. The EU's approach to law and regulation is a controlling one, with statute-based regulations that go far further than purely addressing matters of financial risk. It seeks to provide for acceptable forms of business and profit-making, shoehorning the markets into

1 See the Queen's Speech of 10th May 2022. See, also, *Financial Services Future Regulatory Framework Review: Proposals for Reform* (CP548), HM Treasury, November 2021, paras 7.3 and 7.4.

2 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

defined structures and ways of operating. It often imposes value judgements as to which forms of business are to be encouraged and which are to be loaded with additional burdens and restrictions. The UK is right to allow a revision of this regime, but this should be subordinated to the complete removal of unnecessary or poor EU law for the sector and the substitution of the best legal methods.

Far more will be required if this country is to see the benefits that our system is capable of achieving. In particular, the UK has so far left to one side alterations that would release the most value, involving the restoration of our traditional legal method, the creation of carefully defined statutory parameters within which the UK's regulators must act, and allowing our courts (and Parliament) to verify that the regulators operate in accordance with those restrictions. To fulfil its potential, the UK must now make significant changes to ensure that the new regime promotes:

- *freedom under clear laws* - removing all unnecessary elements of the inherited EU blanket of law and regulation, including its methods of control;
- *predictability* – applying the UK's court-based approach and reasoning, to achieve legal certainty; and
- *ambition* – introducing measures to make certain that UK regulators constantly strive to ensure that their rules are no more than those necessary to achieve a valid regulatory purpose under the operation of the law.

Furthermore, changes of direction, or role, will be needed by government, the Treasury and the firms themselves, with each playing their part in the new arrangements.

Chapter I explains the differences between the code-based approach to law operative in the EU and the common law system[3] of development of the law by judicial decision operative in the UK. Chapter II examines the problems of governance in the existing system of regulation in the financial markets and

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[3] Scots law, the other legal system in use in the UK, is in large part a civil law system but was never codified, and for these purposes is similar to the common law.

considers how the system can be made more predictable and consistent, partly by more involvement of courts and lawyers. Chapter III explains how the regulators can, under the oversight of Parliament, rewrite the inherited EU rules on common law-based lines. Chapter IV considers how the Treasury and firms can adapt in order to maximise the benefits of the new system. Finally, Chapter V sets out specific Recommendations for optimising our new system, by making immediate changes to our approach to governance and rulemaking.

I
Why Legal And Regulatory Change?
The EU and UK – Two Different Systems

One inherited but overlooked problem from EU membership is that the EU legal system now grafted onto our law and forming part of our statute book, by virtue of the European Union (Withdrawal) Act 2018, has far-reaching consequences. In particular, the EU code-based legal system imposed over the decades since we joined, together with the regulations and techniques that underpin that system, is not as effective as UK law or regulation in a number of ways. For the financial services sector, the EU's method can create legal uncertainty and misdirect efforts away from what should be the principal focus of financial regulation: tackling financial risk. There are also other differences between the EU and UK approach. This Chapter addresses some of these issues and considers the factors which make the UK's common law approach better in a number of important respects. Many of the differences arise from the methods used by the two respective approaches to the law. As will be explained, there are various adverse effects of the EU-inherited method, which is why the UK's traditional techniques should be restored to the UK system. For financial services in particular, this should include the application of the UK's method to financial regulation, a special form of law which currently follows the EU's approach almost in its entirety. In future, much of financial regulation will be contained in rules made by each of our (main) regulators, the Financial Conduct Authority (FCA) and the Prudential Regulatory Authority (PRA),[4] using their statutory powers. These rules, which apply directly to the industry and key personnel who work within it as though they were themselves statutory requirements, will need to be adjusted if the sector is to follow the common law method.

The UK has inherited a legacy of EU financial regulation, which is statutory in nature. As things stand, these rules form part of our statute book but will shortly become part of the already extensive rulebooks, managed separately (within separate files) by the two main UK regulators. There are also additional UK

[4] There are other, more minor (though nonetheless important), regulators: see fn 48 below.

regulator-made rules that cover matters not contained in the EU scheme, rules made by the regulators on matters delegated to them by Parliament or those not covered in their view with sufficient clarity by (what is now) inherited EU regulation.

As a result UK businesses must now contend both with rules arising from the UK side and with those deriving from the EU's code-based system, adjusted (where possible) to compensate for the shortcomings of that system. The transfer of EU-inherited legislation to the rulebooks, and its consequences, are discussed in Chapter III below, but it should be noted that there is another feature of how the UK regulators approach their task. They have come to place particular reliance on a small number of their own rules called 'Principles' (11 in the case of the FCA; 8 for the PRA[5]) to control activities, which are drafted at a very high level of generality. These are used to control conduct that arises in the market which the regulators do not like, but for which there is no specific (EU) regulation or more detailed (UK) regulator rule. The regulators generally supervise on the basis of the EU regulations and the rules they have made, and enforce directly against firms and individuals for breaches of those provisions. It has become the case that the Principles are widely used as a basis for direct enforcement, although this was not intended when they were originally made, before the EU scheme was rolled out (when they were characterised more as aids to the interpretation of the more specific rules[6]). The methods used by the UK's financial regulators have developed during our membership of the EU,

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[5] These are termed 'Principles' by the FCA, and 'Fundamental Rules' by the PRA, and will be referred to here as Principles.

[6] For instance, following its 1998/99 consultation on its approach to enforcement, the FSA stated: "[w]e would expect most cases to involve breaches of rules (whether or not including Principles). There may be some cases where it is appropriate to discipline on the basis of the Principles alone." (see FCA, *'Response to Consultation Paper 17: Financial services regulation: Enforcing the new regime'*, 5 July 1999). However, in its Enforcement Annual Performance Account 2006/07 (as quoted in *The Financial Services Authority: looking back, looking forward,* House of Commons Library, SN/BT/3787, 6 July 2007, page 16), the FSA noted that "[t]he vast majority of enforcement actions in the last financial year were based on Principles only or a combination of Principles and rules. From 40 disciplinary cases, 12 (30%) were based on Principles and almost all of the remaining cases were a combination of Principles and rules. This demonstrates the alignment of enforcement with the move towards more principles-based regulation. Our Principles have the status of rules and we will continue to take action on the basis of a breach of them. Concerns have been expressed about us relying on a breach of the Principles alone..."

particularly since the enactment of the Financial Services and Markets Act 2000, and this presents unique challenges for our legal system. Many of these challenges need to be addressed afresh, now that the regulators will operate free from the strictures of the EU scheme.

Legal method and its relevance

The problems of the EU's approach run deep. Its very method of rulemaking is ill suited to the UK financial markets, arising as it does from the techniques used for the French and German legal codifications of the nineteenth century. As mentioned below, these even then were thought to be of dubious value by the 19th century Prussian jurist, Friedrich Carl von Savigny. By contrast, the benefits for the markets of the UK's legal approach are proven and it is vital that they should be fully appreciated: they are based on pragmatism, freedom and evolution, benefitting from limited and clearly drafted legislative provisions accompanied by reasoned judicial precedents arising from decisions in individual cases. The UK's approach brings greater levels of legal certainty, using fewer, more focused, rules, applied in a manner that is largely apolitical.

In future UK financial regulators will be managing the UK regulatory regime without EU interference and subject to UK law. As matters now stand they will be in a position to make rapid changes in applying the rules, with a lesser day-to-day role for judicial precedent than elsewhere in our system, basing their overall approach on their own legal system for regulation, established by the Financial Services and Markets Act 2000. Policy for a safe but permissive regulatory regime as here proposed is designed to ensure that the regulators use an adjusted form of our common law method in issuing guidance and make adjustments to their rules to conform with the new approach post Brexit.

The reasons for the practical benefits of our technique are subtle yet pervasive. They were not adequately considered when, during the period of UK membership of the EU, some areas of EU legal code (which still apply) were superimposed upon our system. The distinction between the UK approach and that of the EU was assumed by many to be unimportant, numerous jurists being beguiled by continental beliefs that the common law's uncodified system was intrinsically inferior in that it entertained an arduous and inaccurate process of trial and error in the evolution of the law. They tended to regard the UK courts as engaged in the task of making up the law as they went along. Indeed, they would have looked on our financial regulators as being engaged in the same process. In fact, continental lawyers, and those taught in such methods, often see the UK's legal approach as being on an inexorable but slow journey towards the outcomes set out in their statutory codes, which they take to be more precisely conceived. The codifiers regard themselves as able to see beyond the day-to-day minutiae and to identify how the law should be. It is notable that a key German treatise on the history of European private law omitted entirely to include any study of English law.[7] Other academic disciplines have overlooked the distinction between the two methods. It is also the case in economics that differences of legal approach do not always feature in the economic analyses used to evaluate ways of achieving future growth.

The EU-inherited approach: its effect

This point is significant to an understanding of the benefits and opportunities that arise from Brexit. It is not just of philosophical relevance, since the practical damage caused by the legislative code-based method is far-reaching. These matters were pointed out to some of the nineteenth century codifiers by the great Prussian jurist, Friedrich Carl von Savigny, who expressed concern over the proposals for the original codification of German law, and warned that German law was not ready for such a step. '[The proposals] appeared to [Savigny] as the most pernicious expression of the twin fallacies,' one distinguished legal historian observed: "that the normal line of legal development was by way of deliberate enactment by political bodies, and that it was possible to frame in the light of natural reason a body of law which, by its freedom from national characteristics, would suit any race, period, or clime, and at the same time be so complete as to limit the task of the judge and jurist almost entirely to the mechanical application of its terms."[8]

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7 *A History of Private Law in Europe*, F Wieacker, trans Weir, Clarendon Press, 1996.

8 *Historical Introduction to the Theory of Law*, JW Jones, Clarendon Press, 1940, p. 50. See also fn 10 below.

However, such admonitions were in the end brushed aside and, in 1900, Germany adopted its code, the BGB (*Bürgerliches Gesetzbuch*), partly because of an admiration for the assumed clarity brought by earlier codifications in France, and despite these being seen by Savigny as uncertain in their grasp of principle and unsatisfactory in their detailed rules. The use of code as a method was also partly prompted by the desire for German unification. This method, which lends itself to top-down control, later proved attractive to China and Japan when they established their modern legal systems. Also, unsurprisingly, given the identities of the founding members, the technique was adopted by the European Economic Community and then the EU. For financial services, vast amounts of EU code were added from 1989 onwards, with a particular acceleration in the programme after the financial crisis of 2007-8. EU-inherited code remains a significant part of our UK regime post-Brexit.

Yet, despite being eventually unsuccessful and forgotten in practice, Savigny's concerns were well-founded. Nowhere are the shortcomings of the statutory code-based method more evident than the modern financial markets, for which it creates a dangerous and unfavourable environment. In broad terms the shortcomings can be summarised as follows:[9]

- The EU's legislative text is voluminous and lacks transparency and its system undermines entrepreneurship. Its techniques are inherently uncertain and have worrying implications for the management of debt.

  The sheer volume of statutory rules (1.7 million rules in the EU's regime for investment business, known as MiFID II, alone) and the extraordinary level of prescription the code-based approach has required, in relation to all aspects of business operation, dampens innovation and entrepreneurialism, misdirects intellectual energies away from the points of principal importance (arising from financial risk), and often leads to unintended consequences.

[9] For more detailed discussion, see my Restoring UK Law: Freeing the UK's Global Financial Markets, Politeia, 2021.

The system also operates on the fiction that the regulators are judges of fact not law. In reality, the inherent uncertainty in the application of rules, designed to cover every eventuality, to rapidly evolving circumstances leaves the regulators with vast discretion on matters of interpretation.[10]

EU law also embeds a fallacy, in that it treats the debt financing of the zone as federal when it in fact arises principally at member state level: this arises from efforts to prop up the half-built Eurozone.[11]

- EU law's purposive method of interpretation unnecessarily restricts the effective operation of the markets.

In the interpretation of the EU's provisions, the plain meaning of the words frequently gives way to strained and artificial efforts to find the intentions (the 'purpose') of the legislators who made those provisions. Such interpretative tools are often deployed to address fundamental flaws in the text which become apparent as the market evolves.

Given the lack of written sources for identifying most legislative purposes and a lack of case law in general on financial services matters, EU regulatory officials have the discretion to assert their own purposes, and their views as to the application of provisions tend to prevail. This leads to an undesirable reliance on the public sector in applying the law. For the UK, the practice of referring to Parliamentary debates only applies if a law is poorly drafted or

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10 EU regulators (and judges) operate at a much less sophisticated level than ours. Their very system is established on a myth, arising from the abovementioned code-based methods of France and Germany of the nineteenth century. Reflecting the thinking of future codifiers, Montesquieu said, in his *Spirit of the Laws* (1748), that the judges are merely "the mouth that pronounces the words of the law". In 1801 the principal drafter of the Code Napoleon said that the code is an expression of an "overriding desire to sacrifice all rights to political ends". However, many of those political ends are to be found in the interpretation of the code, with the regulators (and judges) making political choices in applying its provisions.

11 Managing Euro Risk: Saving Investors from Systemic Risk, B Reynolds, D Blake, B Lyddon, Politeia, 2020.

> unclear, and even then this approach has been called into question by some of England's most prominent judges.[12]

The EU approach is therefore at odds with the UK's more focused, pragmatic methods. Not only do businesses, when taking important decisions, for instance in deciding upon investment location, show a strong preference for the UK regime with its methods,[13] but the inherently safer basis of this country's practical, targeted approach for the markets, is central to such decisions.

The UK approach

The common law approach sometimes requires the interpretation of statutes and regulations, but these will be drafted with a far more limited scope, and greater focus and clarity, than civil law codes. Otherwise it derives solutions from previous decisions and the principles to be extracted from them. This gives it great flexibility in facing new situations, which can be dealt with by the use of careful reasoning linking a present decision to what is already there, but also where appropriate by edging forward in the same or in a new direction.

For many people this approach arises from an understanding of the benefit of the free market, in contrast to the continental European wish (particularly French, although to a lesser degree German) to control the market for national benefit. It is certainly true that the EU led the charge in applying a far more controlling approach to financial regulation after the 2007-8 financial crisis, erroneously blaming that crisis on the (allegedly Anglo-Saxon) markets themselves. The failure had in fact been that of the central banks, including the EU's European Central Bank, in not adequately identifying and managing

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12 E.g. Lord Hoffmann in *The Intolerable Wrestle with Words and Meanings* (1997) 114 South African L Journal 656; Lord Millett, *Construing Statutes* (1999) 20 Statute L Rev 107; and observations of Lord Hoffmann in *Robinson v Secretary of State for Northern Ireland* [2002] UKHL 32 [40], [2002] NI 390.

13 E.g. Cross, Identifying the Virtues of the Common Law (2007) 15 Supreme Court Economic Review 21; Graff, Law and Finance: Common Law and Civil Law Countries Compared: An Empirical Critique (2008) 75 Economica, New Series 60; Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, The Economic Consequences of Legal Origins (2008) 46 Journal of Economic Literature 285; and Mahoney, The Common Law and Economic Growth: Hayek Might Be Right (2001) 30 Journal of Legal Studies 503.

systemic risk, as the law already required them to do – i.e. risk that arises from the financial system itself and which cannot therefore be managed by individual firms in assessing the risk of their counterparties based on information placed in the public domain as a result of regulatory requirements.[14] However, the variance in approach also arises from the differences in method.

Now that the UK has already indicated it proposes to remove the special status for inherited EU law, so that the post-Brexit legal framework reflects the UK's traditional legal hierarchy,[15] a reconsideration of all aspects of inherited EU law is needed. This includes the techniques of EU law and also of course the substance of the regulations as well. Many of the inherited EU rules may have had or still have merit at a high level, not least since the UK played a hand in writing them. However, vast numbers of gains can be made, by amending or removing unnecessary rules and, most importantly, by making changes in technique. The overall effects will become apparent when the results are seen in the aggregate.

The first stage in such review will be an analysis of how the two systems of law and regulation operate in practice. The aim is to pinpoint how future UK arrangements, underpinned by the common law and its thinking, can work more efficiently with greater success, enabling the financial sector to make the most of its freedom in leaving behind the EU's methods of governance, law making and regulation. For this the role of the regulators and inherited characteristics of regulation will need adjustment.

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14 *Ibid*, *passim*, especially footnotes 182 and 449, and the surrounding text.

15 In the Queen's Speech, 10 May 2022, the government announced the proposed introduction of the so-called Brexit Freedoms Bill. See, also, Press release, *Prime Minister pledges Brexit Freedoms Bill to cut EU red tape*, 31 January 2022; the government's response to the report by the Taskforce on Innovation, Growth and Regulatory Reform (letter from Lord Frost, former Brexit Minister, to Sir Iain Duncan Smith, 16 September 2021); and the statement by Lord Frost, *Brexit Opportunities: Review of Retained EU Law*, 9 December 2021.

II
A Law Unto Itself?
Countering The Problems in the UK's Regulatory Regime

A. The Current Regulatory Regime – the Problems

In order for the new regime to operate efficiently, it is necessary to ensure that the regulators work within governance arrangements which make use of our common law method. As things stand, our system of governance for the regulators is unsatisfactory. We have an inherited problem arising from the code-based ways of regulating. We also have a second, home-made, problem to contend with, which is just as significant, arising from the regulators' use of an additional layer of their own (vague) rules, contained and published in their rulebooks, known as 'Principles', already referred to above. The UK's financial regulators have, particularly since the 2010s, increasingly come to rely on these imprecise rules in exercising top-down control over financial firms. The detrimental effects of this approach are apparent even under the existing regime. The Principles can include commonly held popular sentiments for which an objective measure does not exist, e.g. 'treating customers fairly' and 'high standards of market conduct'. These Principles are neither replicated in the inherited EU legislation, nor in harmony with the aims of UK regulation outlined above. The US regulators, who operate within a comparable common law-based regime, are far less guided by an approach of this sort. This Chapter explains how the result in the UK is to exaggerate the notion that the firms' relationship with the regulators is what matters most, more so than the wording of the actual regulatory rules. This phenomenon reduces legal certainty and market efficiency. The problem is particularly acute in the UK, because of the implications in practice of inherited EU law and the lack of a sophisticated scheme of governance and accountability for the regulators. The situation would be magnified if left unaddressed when, as planned, our regulators control the vast bulk of the financial services regime through their new, enhanced rulebook.

In considering this issue, this Chapter considers how, if the UK is to have a legal and regulatory regime that is predictable for financial firms, it will need to adopt an approach reflecting UK law that tends to prohibit enforcement except where the rule deployed is predictable in meaning under law and the market participant has failed to adjust to the required standard. Achieving this will require legal checks and balances. The vast numbers (in the thousands) of individuals working as UK regulators without necessarily having any related business or legal qualification cannot be expected to have themselves the ability to apply rules appropriately, with consistency and predictability, and at a desirable level of specificity of reasoning to achieve legal certainty. It has taken generations of UK lawyers to evolve our system into its current sophisticated state. Individual regulators, no matter how talented, cannot be left to reinvent a system in their own fashion or to employ an idiosyncratic system of subjective judgments that may vary greatly based upon a regulator's philosophy and disposition. Instead, Parliament should be specific in statute as to how the regulators, to whom it delegates its powers, must act. (See pages 39-44 below.) The courts must then be given a role in assessing whether these statutory requirements are being met, so that firms and individuals may challenge regulatory action in an independent forum under statutory rules of engagement. Maximum levels of predictability will be ensured by the courts' ability to consider such matters, using tried and tested techniques of legal reasoning, (See pages 23-29 below.)

A regulatory approach that creates uncertainty

As of now, the Principles used by our regulators lead to considerable uncertainty.[16] The meaning ascribed to them tends to be reactive to events, with the subjective judgements of the regulators being applied to pin blame on firms and senior personnel regardless of whether relevant rules or guidance existed when the event occurred, or if they did, whether they had been crafted so as to clarify the application of the Principles and prohibit the conduct in question. The Principles are also very much a vehicle for idiosyncratic judgements, and have been applied to follow the individual, discretionary rulings of whoever may be employed by the regulators from time to time. There is no binding 'precedent' which clarifies their application and restrains future decision-makers. Nor are the Principles used in the manner of normal common law

[16] For more discussion, see Chapter 4 of *Restoring UK Law,* fn 9 above.

principles, which is to inform the interpretation of specific rules. Instead, they have been applied as the basis for enforcement on a stand-alone basis. The result is that the industry is unable to determine in advance whether many specific actions are permitted or not, and the way in which the Principles are currently used makes it difficult to build a compliance programme.

For the regulators, the use of the Principles is highly attractive since it affords them a broad discretion to address conduct which by applying hindsight they now deem unacceptable. That, however, is a poor way to regulate. It has exacerbated an already deeply uncertain, yet over-rigid, EU-inherited regime. The upshot is that businesses may have no idea which business activities pass muster with the regulator, or whether what passes today will not tomorrow. The more recent emphasis on making regulations by reference to desired (and vague) outcomes,[17] leads to similarly vague results. This approach can be seen for example in proposals for a new Principle that firms should act to "deliver good outcomes" for consumers, which would be accompanied by various further high-level governing concepts.[18] This type of approach has little benefit as a legal operating technique since it is unclear what specific conduct is or is not permitted; it is particularly inappropriate where views can differ as to whether particular means to an end are justified, even if they are lawful. The approach also leaves open to debate whether a particular (vaguely defined) outcome has been sufficiently achieved.

It is vital that this issue of the UK regulators' own approach is addressed, in addition to the elimination of the EU approach.

Today's regulatory 'relationship' – one-sided, unchecked and bad for commerce

The approach of the UK regulators is a symptom of a wider governance problem which runs to the core of our regulatory regime. The poorly drafted, yet voluminous, body of EU-inherited rules and method, and the broad and

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[17] This approach was referred to in a recent paper by HM Government, *The benefits of Brexit: how the UK is taking advantage of leaving the EU*, January 2022 at, e.g. p. 21.

[18] A New Consumer Duty: Feedback to CP21/13 and further consultation, CP21/36, FCA, December 2021.

subjective powers of the UK’s regulators, have led to an extreme manifestation of the phenomenon of ‘regulatory relationship’, mentioned above. The upshot is that firms regard their personal relationship with the regulator as being their main focus. This raises questions of fairness and whether there is a level playing field. Even those who might believe they partially benefit from strong relationships with those officials who supervise them will be left wondering whether the relationships between other officials and their competitor firms (which those other officials supervise) are even better. The arrangements can also lead to firms designing products in line not with the law, but with what management assesses will be agreed with a regulator. All this can stifle innovation, undermine entrepreneurial activity under the law and lead to a shadow system. In particular, it is leading to:

- *Fewer ‘grown-up’ discussions*. Many firms feel unable to have ‘grown-up’ discussions with their regulator where they disagree with the view of an allocated line supervisor in the regulator’s office over the application of the regulator’s own rules. This is so even when firms may regard the line supervisor as exceeding their authority and imposing their own personal view on the firm, and even when the ruling concerned pays little regard to the proper regulatory task of addressing financial risk.

- *Regulators interfering in the commercial sphere*. Regulators have become embedded in commercial decision-making, particularly since the financial crisis of 2007-8. A high level of scrutiny is now placed over changes to business models, new products or product terminations and other commercial decisions. In many larger firms all board papers go to their regulator in advance of board meetings. In numerous instances, proposals made by a firm’s management to its board are considered with the regulators and adjusted following regulatory feedback before the board approves the proposals. Firms often adjust their thinking to what they believe the regulators might find satisfactory, on the basis of prior indications of the regulator’s expectations.

- *Lack of challenge over fines etc*. In enforcement matters, firms will be willing to accept proposed fines and settle early to maintain satisfactory relations with the regulators. The practical inability or unwillingness of firms to challenge the regulators in court, given the limited scope of judicial review under the current law, means that they feel compelled to acquiesce in regulators' 'findings' even when they profoundly disagree with them.

Further problems

The lack of a proper check on regulators has also had further detrimental effects:

- *Delays in operation.* The regime has allowed the regulators, particularly the FCA, to become progressively less responsive to official obligations, for example by failing to heed statutory deadlines. Their principal means of doing so is to avoid 'starting the clock' on statute-based procedures until they have entirely completed their review, deeming all applications to be 'draft' or 'incomplete' until the process is finished. (The other main financial regulator, the PRA does not engage in the evasion of statutory deadlines to such a degree.) This behaviour results in considerable uncertainty to firms when they wish to engage in statutory processes. Issue of a licence for a new market entrant does not take the prescribed 6 months, but more typically a year or more, because the regulators often deem applications to be incomplete and seek further details. Changes of control, whether due to M&A activity or internal reorganisations, are also subject to uncertainties because the regulators routinely ignore the relevant statutory deadlines laid down by Parliament. One remedy for this mischief of delay is relatively simple. Parliament's Treasury Select Committee or a joint committee or subcommittee of both Houses of Parliament is in a position to intervene by establishing an independent review[19] into the FCA's use of its resources in carrying out its functions. Such a review could result in public criticism of the regulators in

[19] Financial Services and Markets Act 2000, section 1S.

the resulting report, and in recommendations being made for reducing the delays.

- *Coextensive, personal liability of senior managers.* The UK's liability regime for senior managers, the 'Senior Managers and Certification Regime' (SMR), created by amendment to the Financial Services and Markets Act 2000, provides for a scheme of regulatory rules and accountability for senior executives and certain board members (termed 'senior managers'), including in respect of decisions taken on behalf of the firm as a whole, even sometimes when those decisions are taken by a committee. This scheme introduced a new regulatory framework to promote greater individual responsibility, including potentially for the actions of others whereby a senior manager may be deemed personally liable for rule breaches that take place within their area of responsibility, even if not personally implicated in the breach. That makes it easier for institutions and regulators to hold individuals to account. The SMR sits alongside the rules and regulations applicable to the firms themselves. Given that the Principles and other regulatory rules applicable to firms are often uncertain in their application, the result is that when a firm takes a view of what is within the rules and commercially desirable, but without obtaining a prior sign-off by the regulators, there may be direct exposure for senior personnel themselves. If there were subsequently to be an adverse finding against the firm by the regulators, the risk is that the individuals can be determined by the regulators to have been personally complicit and responsible for the breach, and hence failing to manage the firm properly. This is because there are also vague (and similar) Principles and other rules applicable to senior managers. The risk is hard to defend against given the vague nature of the relevant rules. Indeed, one might go so far as to say that, under the current scheme, the individuals involved in the decision are in danger of being seen to be automatically in breach when the firm is in breach. The regime is defensible if the rules are clear in their application. Yet, even when the UK's legal methods are restored to the making of rules under our system, absolute perfection will be hard to achieve in every instance, and the lack of sufficient differentiation between the standards applicable to firms and senior managers is problematic.

- *Lack of accountability of regulators to the industry.* There is no corresponding system of consequences for the regulators, either in costs or in respect of the position of individual regulators, which could provide discipline around decision-making.

Relationship dependency

The overall problem of a dependence on relationships with the regulators will remain unless it is addressed in a more structural manner. The costs are clear, and the problem is far-reaching. Significant resource, both within firms and the regulators, is currently diverted onto inefficient processes which do not harness the market or market discipline. That is why the issue is a structural one. The top-down approach relies on the individual skills and goodwill of regulators. A proper system, if well-constructed, should be able to operate without placing such a heavy reliance on the abilities and judgments of key officials amongst the regulators. Able, knowledgeable and experienced personnel are clearly vital to the top-notch system we desire. But the system cannot depend on their every thought for its success. At present, the climate of discretion and uncertainty, with an inevitable fluctuation in the preferences of individual regulators, dampens innovation and entrepreneurialism and causes delays. A well-constructed rules-based system needs to be clear, predictable and consistent with the law: it should rise above the opinion of particular individuals and be largely effective in and of itself.

Penalties under law, rulebooks under regulators

The penalties applicable to firms can arise under the criminal law or as a result of breaches of the regulators' own rulebooks. The processes and protections for the criminal law are well-developed and well understood. However, there is little comparable discipline or understanding around the use by the regulators of their statutory powers in enforcing against breaches of their own rules.

Instead of the present arrangements, what is needed is a system of regulatory rules under the law, carefully conceived in a manner that is more intuitive and predictable for the user, which are designed to manage financial risk. Chapter III describes how this can be achieved, but the new approach will only work if there is adequate governance. The rules must be applied by the regulators in a manner which is predictable and consistent. The rules currently described as Principles must be adjusted or applied in accordance with this technique. In order to ensure this occurs, it is necessary to introduce a statutory framework on these lines, which defines how the regulators must operate, and against which they can be judged in court.

B. Repairing a Broken Regulatory System

To counter the current problems arising from a lack of governance over the regulators, a number of straightforward steps should be taken to bring clarity to the rules, ensure firms can operate with confidence over what they are permitted to do, and enable senior management to form judgements in good faith under the rules without fear of reprisals.

Designing the test for appropriate regulation

It is important to identify at the outset how the common law methods apply when operating a modern regulatory regime. This involves two fundamental elements: predictability and consistency. Both will need to be provided for by statute.

- *Clear, predictable rules under Parliamentary oversight.* The existence of clear, predictable rules, made under a process overseen by Parliament by way of a select committee,[20] and applied predictably, is a necessary first requirement. For those areas which are capable of being set out in advance by way of rules (which is, for instance, true for most of the role of the FCA), the regulators

[20] See Chapter III.

should be required by statute to make clear and predictable rules, under Parliamentary oversight, and to supervise and enforce predictably in accordance with those rules under the law, as determined by judges. The key point here is that the rules should be applied in a manner foreseeable in advance; the common law approach to rulemaking is discussed in the next chapter (III).

- *Supervising the regulators' judgement-based decisions.* For those areas which principally involve the exercise of judgement, the main statutory requirement should be to ensure that decisions are consistent between firms which operate businesses of similar size and scope. Various areas of regulation require the exercise of significant judgement by the regulators, and cannot be set out entirely in rules. At present, this is the case, for instance, when determining aspects of the regulatory capital requirements for firms, whether key personnel are suitable for appointment by firms to vital positions, or the viability of specific types of systems and controls used by firms. Furthermore, it may well be that, in future, more areas should be left to supervisory judgment by the regulators than at present, so as to enable them to operate with fewer rules, intervening only where necessary. This is particularly the case for the PRA, whose role involves assessing such matters as whether systemic risk is arising or firms are taking undue risk. These matters cannot easily be encapsulated in a series of rules which are either satisfied or not.

A proper application of this technique means that the rules known as Principles will need to be adjusted by issuing guidance or otherwise dealt with appropriately according to how they are sought to be used. This may mean using the Principles only to interpret more specific rules, or issuing guidance or other materials which flesh out the meaning and application of the Principles and then for the regulators to act according to that material. So, instead of the vague requirement which now exists, for example, for treating customers fairly, the obligation might be to avoid the use of certain marketing techniques and contractual terms, and to summarise every product in plain English on one page of text in a manner which is clear to some industry-funded panel of consumer representatives.

Reforming the regime's approach to both parties - individuals and the regulators

A further set of statutory changes will also be needed, to ensure that individuals at firms and the regulators who transgress or misapply regulator rules, properly interpreted, carry the consequences appropriately.

- *Correcting the coextensive, personal liability of senior managers.* The UK's unique senior managers regime needs to be adjusted, since this exacerbates uncertainty by muddying the distinction between professional and firm responsibilities. The obligations of senior managers should be clarified so as to remove any notion of coextensive liability. Senior managers should be held to a clear standard which principally asks whether they acted in accordance with their reasonable and good faith assessment of the rules applicable to their firm as a matter of law, at a level of diligence appropriate to someone in their position. [21]

- *Consequences for individual regulators.* Consideration could also be given to applying a senior manager regime to the individual line regulators themselves, along similar lines to those described for firms' senior managers, whereby those responsible for decisions would be identified in advance, and if there are significant or serial breaches of the new system, as determined by the courts, those managers in charge of the matter would be replaced. Such a change would need to be made by statute.

Accountable regulators - the courts

The most important ingredient of all, however, is to ensure the accountability of our regulators. So that the statutory disciplines are observed, an independent

[21] See also *Restoring UK Law*, fn 9 above, pages 95-96.

third party should be charged with providing oversight. It is important that financial firms and senior managers have the ability to argue their case when they disagree with how a regulator is applying its own regulations and significant consequences arise for the firm or senior manager. Such a process will require the regulators, when challenged, to defend their reasoning and analysis before a third party, ensuring they operate in a way that is fair and predictable.

Parliament is ill-suited to such a task, since it requires a readiness to evaluate evidence and arguments relating to specific facts of a case as they arise. The courts generally perform this role. Without a facility for appeal to a higher authority, the regulators will remain judge in their own cause and it will be difficult to secure the positive effects of clearer and more predictable rules, or limited, discretionary interventions. The adjustment required relates to the way in which the regulators operate their rulebooks. Criminal law applicable to financial services is made by Parliament and already has its own court processes, with a higher burden of proof ('beyond reasonable doubt', rather than 'on the balance of probabilities'). For breaches of rules made by regulators, the position is much looser. The UK's regulators are of course already subject to judicial review. However, that generally looks to issues of due process and whether a regulator has misused its power, which shines little light on the merits of the particular case, and still less on whether the regulator was applying rules, predictably drafted, in a predictable way. The regulators' approach is (ordinarily) to come to a decision and then leave it to firms to challenge this. Currently for a successful challenge it must generally be established that various procedural requirements were not followed or that no reasonable regulator could have come to the decision in question,[22] but there is no assessment of the merits of the decision or its substantive appropriateness or fairness. Therefore, the right to judicial review, which does exist, is often perceived as a hollow basis for challenging a regulator's decision and the role of the courts, in practice, is at present minimal. As things stand, the law on judicial review is

[22] *Ibid*, Annex 6, section 3 as well as footnote 616 and the surrounding text.

inadequate to hold our regulators to account on matters of regulatory discipline and process.[23]

New mechanisms should therefore be adopted to allow the courts to exercise their vital supervisory role over how the regulators apply their own rulebooks. The law of judicial review (including in the US[24]) has not focused on delivering legal certainty, and so this idea needs to be introduced in statute by Parliament. It is vital that we expand the role of the courts, in a moderate and workable manner, so that they can ensure basic matters of clarity, predictability and consistency are verified in an independent forum without overburdening the regulatory or judicial systems. These concepts should be seen to be essential disciplines to which regulatory activity should conform. In practical terms, the courts should be involved in the following ways.

The role of the courts: a judicial gateway to enforcement.[25] Firms and individuals who are subject to sufficiently material[26] regulatory penalties (e.g. material fines), or day-to-day supervisory decisions which significantly affect their rights as a regulated party,[27] should be able to challenge the regulators' decision in court, within a strictly enforced and relatively short time limit.[28]

In the case of appeals against an enforcement decision, the court would review the decision on the merits, focusing in particular on whether and how the rule

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23 Judicial review is also considered an exceptional remedy, to be used as a last resort in cases where there is already an internal, or statutory, review mechanism.

24 See *Restoring UK Law*, fn 9 above, Annex 5.

25 *Ibid*, section 3.4, for more discussion, including other ways to enhance the role of the courts.

26 To be eligible for appeal, the case should meet certain clear, well-defined criteria, for example, the size of the proposed fine, the nature of the alleged breach and/or proposed regulatory sanction, the size of the firm or the status of the individual. The court would also have a residual discretion to refuse to entertain an appeal, for instance if it would be wasteful of costs or vexatious. The overall process would ensure that appropriate matters, including matters of general importance or widespread application, are subject to judicial oversight.

27 For instance, over levels of capital required for a firm, or the number of senior managers needing to be approved. Such decisions can be momentous in their importance, but at present do not go through any enforcement process.

28 E.g. a time limit of 3 months, as with judicial review, within which the firm must decide whether to initiate an appeal. This should ensure that enforcement action is not stymied by firms' tactical or dilatory behaviour.

which was invoked should have been applied to the facts of the case. This will include:

- examining the meaning of the rule and on that basis confirming or rejecting the action by reference to whether the conduct in question breached the rule, as properly interpreted;
- considering whether the enforcement penalty (such as a fine or the withdrawal or suspension of a licence or permission) or supervisory action is consistent with the regulator's objectives and with decisions in similar cases; and whether it is proportionate to other decisions (both in similar and dissimilar cases).

In the case of reviews of supervisory decisions, given the dynamic nature of the markets, and the limitations on the role a court can play in a supervisory context,[29] the focus would be solely on the second limb, relating to consistency and proportionality. In both instances, it should be possible for firms and individuals to bring cases that meet the materiality threshold for appeal to the court as soon as the regulator has made its decision. To prevent hardship or unfairness to firms, the effects of a decision could ordinarily be suspended once an appeal is commenced until the appeal is determined, except where this poses a risk to the financial system.[30] If both parties could agree that it is appropriate to go to court for the purposes of market certainty in a particular case, then the materiality thresholds would fall away.

This approach would mean that the court would consider the reasons given by the regulator, review the decision and expose the regulator's reasoning and decision-making process to greater scrutiny,[31] which in itself should make for

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29 See fn 44 below.

30 The appeal could take place after the issuance by the regulator of its so-called 'Final Notice' (the public and final statement of any enforcement decision). Alternatively, the appeal could take place once the proceedings reach the stage of the regulators issuing a Decision Notice (i.e. their reasoned decision), but before the Final Notice (when they have determined to follow through on their decision), on the basis it is already possible to appeal to the Upper Tribunal in certain specified instances at this stage. This step, which would not involve a fundamental change to the notice system, would slot easily into the existing framework.

31 As things stand, the regulators' Decision Notices and Final Notices tend to be poorly reasoned from a legal perspective, and are inadequate to amount to a precedent for the market's evaluation of future decision-making.

improved decision-making over time. At a fundamental level, the common law tradition requires that laws be made in such a way that they can practicably be complied with, and that like cases be treated alike. The courts are also best placed to determine whether regulatory determinations are based on legal reasoning that is sufficiently robust to withstand scrutiny. Both the regulator and the firm or individual could present evidence and make arguments to the court.

If the enforcement action was found by the court to be justified in principle, the court would also then review the sanction or supervisory decision, and confirm, reject or modify this by reference to the conduct in question, the size, means and circumstances of the regulated party, and the range of any previous fines imposed by the regulator on similar parties in similar circumstances.

Firms would then be able to help themselves by challenging a regulatory decision with which they are dissatisfied. They would also not feel compelled to settle a matter with their regulator in such circumstances, merely to curry favour. In order to ensure the regulated firm or individual does not suffer from challenging a regulator with whom it has an ongoing relationship, a statutory provision could be introduced which requires the regulator to treat all firms consistently and without disadvantage (or advantage) whether or not they appeal a decision. The proposed statutory arrangements would also prevent the regulators from following their current practices of giving discounts for early settlement and agreement with their viewpoint.

A stronger alternative would be for all enforcement cases which are above the materiality threshold[32] to go to court automatically.[33] This approach would

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32 If the regulator were to decide that the case did not meet the threshold to bring the matter to court (although the threshold criteria would ideally be selected with a view to limiting any uncertainty) and the firm or individual disagreed, that party could itself bring the case to the court, which would decide upon the question of materiality and, if it is met, then allow an appeal to proceed.

33 A further solution would be possible here, although it would place additional weight on the court system. It might be desirable to involve the courts in settlements, to ensure they have been reached through appropriate reasoning and processes and are not used to extract unjustified fines. When firms settle with the regulator, the regulatory settlements above the materiality 'threshold' could be subject to review to test whether the rules invoked by the regulator and the sanction to be imposed were sufficiently predictable and applied in a

address any concern that, to avoid costs, publicity and/or the regulators' disfavour, some firms may prefer to 'put up with' poor regulatory practices rather than challenge a decision, thus undermining this new approach altogether or otherwise resulting in too few cases over the short term for setting precedents. But because the judges may be wary of becoming (or even being seen to become) a gateway to regulatory enforcement, or part of the decision-making process, in this manner, this approach might be considered as a future possibility.

Once the option of a court review is introduced, fresh judge-made law, arising from new statutory requirements for judicial oversight, would clarify the meanings of rules whose interpretation is unclear or contestable. Indeed, a key aim of the appeal process would be to build a body of case law precedent, illuminating the distinction between rules which are well-conceived and fairly applied, and those which are not, and bringing with it the certainty and predictability that arises from the judicial process. This would force the regulators to clarify the precise application of any loose drafting of rules and their otherwise vague Principles, for instance by defining what proper systems and controls should look like, or what senior managers are responsible for. In turn, the efficiency of appeals would grow with the body of precedent, providing clarity to the regulator and regulated alike and thereby over time limiting the occasions in which review would even be needed.

This process would also help improve the rule-making and supervisory processes, because the regulators would operate knowing they could be subject to judicial scrutiny, and the precedents thus set over time would in turn assist

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manner analogous and proportionate to other cases. This review could be triggered by the firm or the individual; or the judicial process could be triggered automatically when the materiality thresholds are satisfied. This would make for predictability (as described above), help to prevent that being undermined by opaque private settlements, promote fairer outcomes, and serve as a check on settlements where the regulated parties consider they have little choice but to accept an unfair or inappropriate settlement. In theory, this discipline should be unnecessary since firms can and should refuse to settle if they are dissatisfied with the regulators' reasoning, and go to court, in reliance upon the above procedures. However, absent a check on settlements, the main approach proposed here could nevertheless continue to mean, in practice, that firms settle despite considering that the regulators' reasoning to force them to do so, or the settlement amount, is unjustified. The point needs to be considered.

regulators in deciding how to enforce their rules. Over a period of time, there would be clearer, more predictable rules and outcomes. Similar cases would be treated alike and publicly recorded. The courts would therefore provide for efficiency in the system, since their decisions would result in increased predictability, giving firms greater certainty about what is and is not permitted and encouraging the simplification of the financial regulatory regime as a whole. The clarity brought to the regime would better enable firms and individuals to adjust their conduct in advance so that they can avoid any breach. That should lead to more effective compliance processes on the part of firms, and a more effective, less costly system overall. Although this set of changes would create a new role for the courts in a formal sense, the judiciary are already accustomed to making such judgments. The appeal process should not preclude a firm or individual bringing an action for judicial review in respect of the same enforcement action at the same time, to the extent this would have utility in addition to the new process.

Additional features of this approach would be as follows. The onus for bringing appeals would always be on the firm or individual (except in cases where the regulator agrees an appeal is appropriate). Incentives should be weighted towards a fair outcome through costs consequences. The system of benefits, rewards and discipline should mean that, where a regulator loses an appeal, the relevant regulatory organisation should be liable for the other party's legal costs. These payments should not fall (directly) on the industry, which already funds the regulators.[34] The costs could instead be covered by insurance (preferable) or an investment pot provided for out of a portion of the industry funding for the regulators,[35] fines,[36] or (as a backstop) from general government

34 See FCA, *Annual Report and Accounts 2020/21* (HC 372), page 68.

35 Part of the industry funding for the regulators could be used to invest or pay for insurance, with the assets or insurance policy available to make payouts to firms and individuals in the circumstances described.

36 This solution would be to redirect those fines levied by the financial regulators away from the Treasury (to which they are currently paid) to compensate industry members affected by inappropriate regulatory decisions, and also to fund the Financial Services Compensation Scheme (called for, and debated, by many in the industry, e.g. Sonia Rach, 'FCA hints at talks with govt on cash raised from fines', *FT Adviser*, (21 September 2021) https://www.ftadviser.com/regulation/2021/09/21/fca-hints-at-talks-with-govt-on-cash-raised-from-fines/ accessed 29 June 2022; Press release, Personal Investment Management

funding[37] (on the basis that a proper court system, which is already publicly funded, is more than paid for by the economic benefits arising from the City). Conversely, to discourage unnecessary or vexatious appeals, there would be adverse costs consequences against firms that lose. Efficiencies could be achieved by adopting a similar approach to the facts as is taken in judicial review cases, i.e. in most cases the facts would be (and should be capable of being) agreed or assumed, so that the resolution of any factual controversies and the extensive disclosure of documents would be the exception rather than the norm.

The courts: Facilitating disputes with the regulators - sensitive matters. The courts could also consider further enhancing the operations of the new system by using their existing powers in a manner sensitive to market needs. For greater accountability to arise, firms clearly need to be more willing to challenge regulators even on sensitive matters, and regulators should not be in a position to punish firms which challenge them by adjusting their approach to other rules affecting the firm. The role of the courts in bringing legal and regulatory certainty only works if the courts are fully used in practice, without firms feeling the need to hold back. However, firms remain reluctant to challenge the regulators in court (even in those limited instances in which a challenge is likely to be successful), particularly on significant matters which raise complex issues of judgement. Part of the problem is the extreme risks for firms and their clients in having their internal workings aired in open court for days, during which the conduct of senior staff is criticised in public. The facts are often complex in such a way that soundbite quotes of what is happening can destroy the trust and confidence essential to the firm’s day-to-day interactions with clients and counterparties. The objection is not in respect of valid challenge, properly analysed and presented. The concern is instead with unfounded criticisms, shown subsequently to be so, which in the meantime

& Financial Advice Association, FCA willingness to engage on FSCS is positive, but real progress sits with the Government, 11 March 2022).

37 Government monies may ultimately be needed to reduce the cost of regulation to the industry and to ensure the industry does not suffer the consequences of a series of misguided regulatory decisions.

threaten to destroy a firm's reputation or business in a market which depends almost entirely on trust.

The courts have the power to permit proceedings to be confidential.[38] Ways should be sought to encourage the courts to consider the use of this power where the consequences for financial firms and individuals of regulatory breaches are quasi-criminal and potentially career-ending in nature.

Not over-burdening the system. The idea is not to open a Pandora's box for litigation, but to set out a limited basis for court involvement. Not many new court cases would arise from these proposals, given that we will only be dealing with the more significant matters which are above the 'threshold'. Furthermore, given the scale of regulatory fines paid to the Treasury by international financial businesses which breach the rules from time to time, the government should have the wherewithal to fund whatever additional court resources may be required. These fines are frequently far higher than in other sectors, and often levied on international businesses which may have no connection with the U.K. Having an efficient and fairer system of justice increases the likelihood of attracting business willing to pay these fines when transgressions occur. Efficient regulation should ensure the system is safe, whilst penalising those who flout the rules. A well-funded court system will ensure proper differentiation is made between those in breach and those who are not, which is essential to the credibility and efficiency of the regime.

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[38] Section 4(2) of the Contempt of Court Act 1981 permits courts to order the postponement of reporting of proceedings or a part of proceedings "where it appears to be necessary for avoiding a substantial risk of prejudice to the administration of justice in those proceedings or in any other proceedings pending or imminent". See, generally, s. 11 of the Contempt of Court Act 1981. Specific provisions also prevent the naming of certain parties in proceedings (e.g. children, or complainants in criminal cases involving sexual offences). In exceptional cases, courts may allow a witness to give evidence anonymously. However, it is very rare for a court to withhold the identity of a witness from the parties to proceedings even if it makes an anonymity order. For the position in civil proceedings, see CPR 39.2(4) and *Kalma & Others v African Minerals Limited & Others* [2018] EWHC 120 (QB). For the position in criminal proceedings, see Part 3 of the Coroners and Justice Act 2009. The provisions relating to anonymity should not be confused with 'special measures' – the provisions that allow a witness to give evidence behind a screen or by video link in criminal proceedings in order to limit direct contact with a defendant. In such cases, the identity of the witness is known to all parties; the judge, jury and legal representatives are still able to see the witness.

There may nevertheless be concerns that this plan would depend on having more judges at a time when there are cuts, backlogs and delays elsewhere in the system. It is important that the normal system of state justice is used, because only this provides for the most credible protections.[39] Options for slimming down the calls on our court system would include the following.

- *Judges.* Consideration could be given to appointing a few additional judges with financial understanding, perhaps solicitors, as extra, maybe part-time, judges, provided of course that they meet the high standards of the judiciary for competence and independence. Other part-time judges could perhaps be recruited from senior barristers wishing to gain judicial experience in this area (a practice already followed in the appointment of Deputy High Court Judges).

- *Separate division.* A separate division of the courts, dedicated to such hearings, could hear these cases.

- *Tribunal.* Alternatively, jurisdiction over such appeals from the decision of the regulators could be given to the Upper Tribunal,[40] which is of equivalent status in the judicial hierarchy to the High Court[41] and from which appeals can be made to the Court of

[39] Regulator-driven dispute resolution can prove problematic. In the US, government regulators, such as the Securities and Exchange Commission (SEC) and industry-affiliated and funded self-regulatory organisations, conduct administrative hearings and arbitrations, often with their own administrative law judges presiding. Serious questions of independence, due process and appellate rights, and even legal expertise have been raised about this administrative tribunal system, with an important US appellate court recently questioning the constitutionality of the manner in which that authority has been delegated, the discretion given to the regulator on when to proceed in court versus administratively, and other constitutional questions.

[40] This is established under the Tribunals, Courts and Enforcements Act 2007.

[41] Which allows it to set precedent.

Appeal.[42] The Upper Tribunal provides for more flexibility and already reviews certain FCA decisions.

The desired outcome. The aim of these changes is legal certainty. This approach would not stop routine judgements by regulators, provided they faithfully reflect the law, and are within their specified remit. Nor would the right to judicial review change. But as a general principle, the regulators should not be left to operate entirely alone in their day-to-day task of operating the rules. They will benefit from the legal certainty of any case law precedent on how their rules are to be applied, prompted by a challenge to their decisions in court. They can issue their guidance, to clarify the application of a particular rule. Naturally, the proposed new discipline might be seen by the regulators as unwelcome, but the approach is necessary for the transparency of and confidence in the system and the effective operation of the market under law. The regulators should quickly be able to ensure that their own activities meet the new standards, which will in turn mean that the role of the courts would be reduced over time.

[42] Like the High Court, there is a right of appeal from the Upper Tribunal to the Court of Appeal, which has the power to consider cases afresh, albeit the Court of Appeal does not tend to overturn factual findings unless obviously wrong.

III
Under the New Regime – The Regulators and Their Rulebooks

The new system – regulator led

As matter stand, the task of producing this new system falls principally to our regulators, who will now have an enhanced role, enjoying wide powers over writing the rules for the system. Under the new (post-Brexit) regime, certain regulations will remain in statute[43] and statutory instrument made by Parliament. However, as mentioned above, the government's plan is to transfer most of the EU legacy of inherited statutory regulations to the UK regulators to be included in the regulators' rulebooks as rules.

This means that the vast bulk of regulations will be controlled and made by the regulators themselves, as regulator rules. That will leave a far smaller body of legislative text made by Parliament to be followed up by the regulators. The idea is to enable them to act quickly in response to market developments, ensuring their rules are directed at conduct they wish to prohibit, clearly and precisely addressing the circumstances of the market. They will enjoy wide-ranging powers with a remit that covers both firms and the senior individuals, the 'senior managers', within those firms. The regulators can manage their rulebooks and remove or amend the EU-inherited rules as they see fit, using their statutory powers.

Of course, our regulators will not only be the sole legislators for the market for many purposes, but they will also be the supervisors and enforcers for financial firms, albeit operating under a common law system. A full application of common law techniques is needed for their new, enhanced role as:

- *rulemaker* - i.e. legislator, controlling the wording of vast amounts of EU-inherited text,
- *supervisor* - of firms' and individuals' conduct, and

43 Indeed, they must do so, for reasons of constitutional propriety: see *Restoring UK Law*, fn 9 above, pages 66-7.

- *judge* - for the purposes of enforcement of provisions contained in the regulators' rulebooks.

This is a matter of considerable complexity and will require significant understanding to achieve, as regulators will be empowered (by statute) to make, interpret and apply their own rules across the breadth of the financial services market. They are also to act as a mini-court. If the system is to work the arrangements should reflect statutory drafting techniques as well as judicial decision-making, with the common law approach adopted. Moreover a balance needs to be struck between Parliament's laws, and the regulators' role in interpreting and applying their own rules with some degree of autonomy.

The caveats

Regulators will need to be restrained in the exercise of their authority if the new system is to succeed. The fast pace of the markets means that the regulators' day-to-day judgements are not easily questioned.[44] However, our system contains its own checks and balances, and those described in Chapter II, if respected in practice, should help the regulators adapt their roles as supervisor and judge. This Chapter considers the rulebooks and the steps that will be needed if the rules are to operate in accordance with the common law method. The regulators are in a uniquely powerful position for, unlike a legislature, they will have the power to intervene and make new rules quickly, if they find that their existing rules do not cover new circumstances, a remedy which the regulators in the EU and other code-based systems generally lack. If such a system is to work efficiently rather than lead to arbitrary rules, private deal-making, and unfairness, certain conditions must be met to bring the predictability and clarity lacking in both the EU system and in some aspects of UK regulation.

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[44] Parliament is only able to engage in occasional oversight. Moreover, the courts are not equipped to consider matters of complex judgement in a dynamically changing environment: see Lon L Fuller, *The Forms and Limits of Adjudication* (1978-9) 92 Harvard L Review 353 for a discussion of the limits of adjudication and the need for managerial direction in circumstances which he terms 'polycentric'—ones involving a dynamic set of inter-related and inter-dependent considerations, any of which could be put at the heart of the decision.

In making or reformulating the rules, the regulators will be operating in an entirely new manner, as legislators in their own right under authority delegated to them by Parliament, rather than under Parliament's day-to-day supervision. This means that if no further changes are made, the regulators could be free to introduce, impose and operate whatever rules they wished, without even the constraints of the EU system. Yet they will also be operating in a more complex and sophisticated market environment than before the onset of EU financial services regulation. As a result, without additional adjustment, not only will the vital changes needed not happen, but the regulators' new, enhanced, role will make matters even worse.

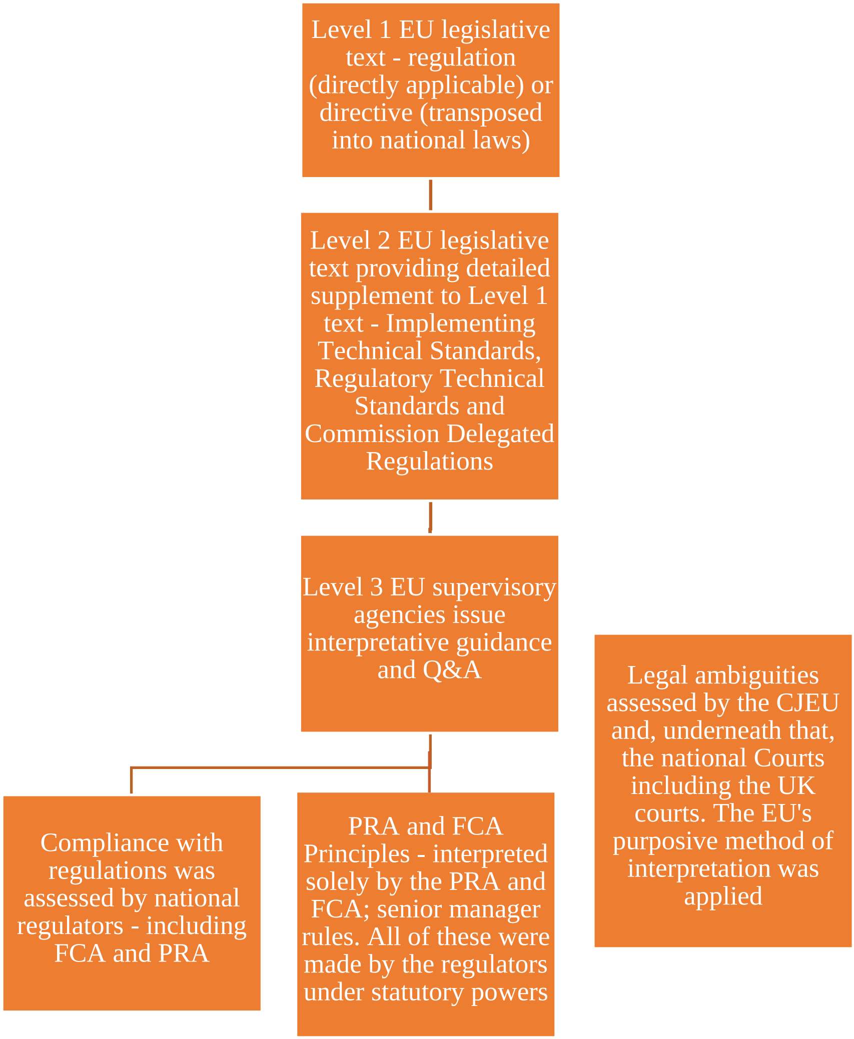
A change of course is therefore needed to current plans and certain steps must be taken. Parliament will have set out, in statute, the aims and approach for the regulators. Parliament also needs to set parameters for the regulators when they remove, amend and make rules under the new regime. Moreover, further steps are needed if the UK's regulatory regime is to achieve the optimum state on a consistent basis, and if there is to be a controlling impetus for the regulators to be ambitious in cutting the rulebooks down to size.

The changing roles of UK regulators post-Brexit

The fundamental differences in approach between the EU system and the UK's intended new system make the new legal task particularly difficult. Under the EU scheme, regulations were made at a statutory level, as so-called Level 1 or Level 2 text (with Level 1 made at a greater level of generality, developed in Level 2). There were exceptions where the regulators made the rules, for instance the Principles and other UK-only rules such as the senior managers rules (and senior manager Principles);[45] and where they exercised discretions to the extent still permitted by the EU's statutory scheme, for instance in determining the Basel Pillar 2 top-up regulatory capital requirements for banks. However, their actions were generally limited by the vast swathes of statute-based EU financial code. This diagram illustrates the position before the UK left the EU.

[45] These arose entirely from UK statutory provisions.

The UK Regulatory System – Before Brexit, within the EU



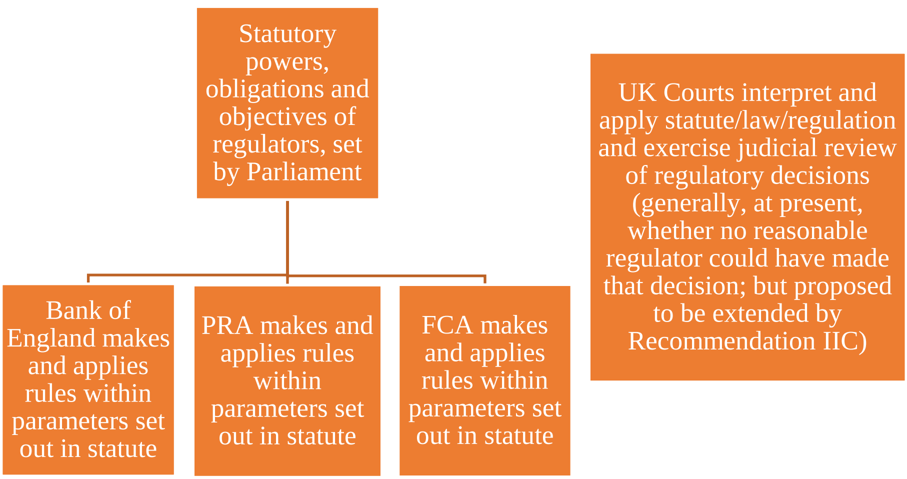
Under the previous system the PRA and FCA were not in charge of making the regulations. But they made (and published) separate rules, under their statutory powers,[46] where this did not conflict with EU regulation. As a result,

[46] Derived from the Financial Services and Markets Act 2000.

our regulators were for the most part left as judges of fact as to whether firms had breached EU legislative text, as interpreted by the EU bodies and, ultimately, the Court of Justice of the European Union (CJEU).

In future, once Parliament has passed a law implementing the government's proposal to move much of inherited EU regulation to the regulator rulebooks,[47] the regulators will be making almost all of the rules, operating with an unprecedented degree of authority, adopting (where relevant and to the extent desirable) versions of non-binding international standards which the UK has generally played a strong role in formulating. The UK regulators' new role is shown in the following diagram.

The UK Regulatory System after Brexit – Outside the EU, January 2020



The government's proposed structure and its dangers. Because of the importation of EU regulations into the UK statute book and their transfer to the rulebooks, alongside the UK regulators' own rules and principles, two systems will be running side-by-side, managed by the UK regulators. With the new freedoms to be enjoyed by UK regulators, the juxtaposition of regulatory

47 This is intended to be done by the so-called Brexit Freedoms Bill, announced in the Queen's Speech on 10 May 2022.

systems and techniques introduces additional uncertainty and complexity. Hitherto, despite the difficulties of the regulators' Principles described above, these operated within a much narrower sphere when the EU was making the rules, as regulations, at a legislative level. Therefore, now that the regulators are given the powers to make rules governing most aspects of the financial services regime and to exercise day-to-day judgement, there is an acute need for further adjustment to our constitutional arrangements for the regulators in order to impose some control.

The PRA and FCA[48] will make the rules within limits set by Parliament, subject to judicial intervention. It is also envisaged that the Bank of England will assume such a role in relation to central counterparties and other financial market infrastructure, such as systemic payment systems. Since the current regulators have not operated outside the EU's arrangements, there is little intrinsic understanding of how they now need to operate. Within the EU's legal system, the regulators do not have such wide-ranging rulemaking authority, nor do they need to make so many decisions. Given the numerous, often fine, distinctions between the EU and UK methods, detailed analysis is therefore needed by both the regulators and Parliament. Through its standing committees, Parliament can move to the more pragmatic, commercially friendly, common law approach in respect of the residue of regulation contained in statute and statutory instruments. However, the tussles involved in the making of Parliamentary text, with the checks and balances provided by the various competing viewpoints expressed in both Houses, will not arise to the same degree for the regulators. For them, there will be a limit to the role of Parliament or its committees, on account of the speed with which markets move, the volume of regulation and the rapidity with which it is often made.

Creating a new scheme – overcoming the difficulties and obstacles

The task of creating the new scheme is made even more difficult because the regulatory bodies, the FCA and PRA, are themselves relatively new (set up in

48 There will be other, more minor (though nonetheless important), regulators operating in financial services, such as the Payment Systems Regulator, which is an independent subsidiary of the FCA.

2013, replacing the Financial Services Authority), yet they will perform a function that is almost unrecognisable compared with the limited role allotted to their predecessors before the UK entered the EU. Not only has EU law and thinking changed our regulatory method, but so too has the very different range of businesses now under the UK umbrella, many from outside the UK, and insensitive to the UK's traditional system of law and its operation. The modern operating environment for the financial regulators arises from EU legislation which began to be applied, particularly from 1989 onwards, and from the more complex operations and activities of the sector and the global markets than those that existed in the last century. A proliferation of market participants, many based abroad, bring with them a need and expectation for more precisely nuanced regulatory methods. Yet, this does not require the EU's assumption to be adopted that a rule or code is needed for every transaction.

The markets prefer the nimbler, common law approach[49] involving regulatory rulemaking powers and supervisory discretions that can be restrained by firms' ability to challenge regulators' judgements in the courts. The new approach to rulemaking can draw on aspects of the traditional UK approach to banking regulation, involving (what was previously) stern discretionary oversight from the Governor of the Bank of England, in the way that more local UK businesses used to experience. It may also involve a greater use of industry codes of conduct, reflecting how the UK operated investment banking supervision through self-regulatory organisations under the law, as was the case under the 1986 regime before the system of statutory regulators was established in 2000. However, adjustments need to be made for today's environment. The UK has its own approach, so there is no template for how the rules should look, or even a high-level precedent. Instead, the UK's common law methods must be applied afresh to regulatory policy, to achieve the intended result.

Creating an impetus. A mechanism is needed to ensure that the actions of the regulators are properly and perpetually focused on the desired new approach to

[49] The world's top international financial centres, New York (1st), London (2nd), Hong Kong (3rd) and Singapore, all operate on the basis of the common law method: see *The Global Financial Centres Index 31, Report*, March 2022, published by Y/Zen, for the relative standings of financial centres.

rulemaking. This must go further than the Treasury currently envisage.[50] Parliament should require the regulators to organise themselves and operate in the intended manner, through statutory provisions which provide for clarity in how the regulators are to act in reformulating and maintaining the rulebook. In particular, the regulators should be reformed, they should be expected to reorder inherited EU rules in line with UK methods and their statutory powers and obligations should be refocused.

Optimising the new regime - reorganising and refocusing the regulators. Changes should be made to the regulators and their approach, in a number of ways, as follows.

- *Regulating the new system.* The role, qualifications and mode of operation of the regulators must be reconsidered in order to enable them effectively to operate the new system. For this, they will need to be competent and equipped to apply the common law approach, operating the new regime in the most efficient manner possible, with the fewest of restrictions and rules. They will need to ensure their legal function is fully embedded throughout their organisations, so that they can operate with the desired legal method.

- *Reordering the inherited EU regime.* The regulators should act to clean up the existing regime. The regulators should undertake the task of reordering the inherited EU regime so that it conforms to the UK's methods, and then apply our methods in the future. This will involve the practical task of cutting inherited red tape when the inherited EU regulations are moved to the regulators' own rulebooks, addressing those rules which remain by reformulating drafting which is often poor, and keeping the rulebooks as simple as possible, focusing the rules on the management of financial risk.

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50 See fn 59 below and surrounding text.

Under the common law approach the following aims must be at the fore:

- Fewer rules with clearly drafted provisions will be needed for high regulatory standards, with less red tape. These must be easy to use and understand, illustrated by the use of practical examples and decisions, and kept up to date. Such rules must then be predictably applied (see Chapter II). The advantages of this method are significant:

    - it frees up the private sector; and

    - it allows for the use of traditional UK legal methods to produce easy to use and understand legal concepts. These are more 'intuitive', being developed over time at a practical, detailed level, in light of real-life experience. They are also principally based on remedying perceived wrongdoing, so are easier to grasp than those arising from the more abstract regime constructed by code-makers, which focuses on broad statements of rights, obligations, exceptions and so on.

- More reliance should be placed on market discipline, with greater use of rules requiring disclosure, coupled with a caveat emptor approach for the wholesale markets. This will allow the financial markets to operate more autonomously. Such an approach enables private sector experts in the wholesale markets to root out various bad practices themselves, by avoiding risky counterparties and clients.

- The rules surrounding protected classes – for example, retail customers – should be preserved and enhanced.

The object must be nothing short of removing unnecessary EU law, together with the unattractive techniques that it brings, in order to promote a more entrepreneurial economy.

- *Oversight of rulemaking.* As things stand, the Treasury Select Committee oversees the regulators.[51] In principle this committee, or a joint committee or sub-committee[52] of both Houses[53] could oversee the use of the new methods in shaping the rulebooks. However, for greater democratic accountability for the regulators in the exercise of their quasi-legislative, rulemaking function, consideration could be given to the adoption of a statutory regime, equivalent to the US Congressional Review Act (CRA),[54] that would allow Parliament to review and overrule new financial rules made by the regulators. In the US, Congress has a window of time lasting 60 legislative days (i.e., days that Congress is in session) to disapprove of any given rule by simple majority vote, failing which the rule will go into effect at the end of that period.[55]

Optimising the new regime - refocusing powers, duties and aims. The statutory powers, obligations and objectives of the regulators need careful reformulation to ensure they provide for the new approach to be followed by the regulators. The reasons for a prescriptive legislative approach are clear.

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51 On 23rd June 2022, the Treasury Select Committee announced the formation of a new sub-committee to scrutinise new regulatory proposals.

52 In principle, it would be possible to create such a sub-committee of the Treasury Select Committee, by amending Standing Order No 137A(1)(e) so that specified non-members could take part in certain proceedings: this is considered by the Treasury Select Committee in *The Future Framework for Regulation of Financial Services,* Fifth Report of Session 2021-22, HC 147, para 91.

53 For the transition to the new system, this could be a small joint Parliamentary committee of HM Treasury and the Department of Business, Energy and Industrial Strategy (BEIS), in coordination with other Parliamentary committees, including the European Scrutiny Committee, given its extensive knowledge of inherited EU law. On an everyday basis, such matters are currently overseen by the Treasury Select Committee (including through its new sub-committee, fn 51 above).

54 5 U.S. Code Chapter 8 – Congressional Review of Agency Rulemaking (enacted as Subtitle E of the Contract with America Advancement Act of 1996 (Pub. L. 104–121)).

55 See, generally, 5 U.S.C. 801 et seq. The CRA empowers Congress to review, by way of an expedited legislative process, new federal regulations issued by government agencies and, by passage of a joint resolution, to overrule a regulation. Once a rule is repealed, the CRA also prohibits the reissuing of the rule in substantially the same form or the issuing of a new rule that is substantially the same “unless the reissued or new rule is specifically authorised by a law enacted after the date of the joint resolution disapproving the original rule” (5 U.S. Code § 801(b)(2).

- *Significance of the change required.* Unless there are statutory provisions defining in some detail what the regulators are to be asked to do, and the standards against which they are be judged, it is apparent that the required efforts are unlikely to be made. It should be accepted that the task of formulating clear and predictable rules, but only when necessary, is complex and requires considerable thought. Identifying how the inherited-EU rules should have been couched under our own methodology is particularly tricky. This is far from a simple task, especially because we are emerging from a regulatory culture which is at odds with our own. Under our system, the regulators will be given wide-ranging discretion in a manner alien to the code-based civil law method of the EU. The necessary disciplines for producing the scheme we would want, and for maintaining it on that basis, are not to be found naturally embedded in our current regulatory thinking. A cultural change within the regulators will be difficult to engineer even partially without an external force holding them to account. Regulatory culture needs to be given clear prompts. This means it is vital to provide new statutory instructions for the operation of their regulatory powers, defining what is required.

- *Parliamentary oversight.* As a matter of constitutional principle, the regulators should operate under the oversight of Parliament, through its select committees, and the rule of law. The overall aim is to limit the regulators' powers to what is necessary for the task at hand, and for Parliament then to oversee the broad conduct of the regulators, as its delegates. The making of statutory restrictions will allow Parliament to reduce the scope for the regulators to make rules other than in accordance with our desired common law method, forcing the move from the old EU approach to the new common law one. In addition, by clearly defining the obligations and objectives of the regulators, the system will be guided as to how to operate. The new approach, as defined, can then more easily be overseen by Parliament.

It should nevertheless be understood that Parliament has not the resources or structure to set up a system to oversee the regulators on a routine level, its overall legislative role being informed by ad hoc specialist advice submitted to select committees, which meet periodically. Generally, Parliament's interventions are political and discrete. It moves quickly from one concern to another in respect of the government's political agenda as the largest party in the legislature. The Treasury Select Committee currently oversees the regulators, but it does not have the means to examine multiple specific instances of complaint by hearing argument from both sides in the manner of a court.

- *The role of the courts.* Legislative provisions must ensure that the private sector can challenge, in the courts, any overreach by the regulators of their powers. The regulators are only too capable of continuing with an EU-style approach, both in terms of resource and time, which is not the outcome desired at all. To prevent that from happening and to optimise the regulatory system, the basis on which power is delegated to the UK's regulators needs to be defined carefully and precisely, in the manner indicated above, so that the courts can be appealed to and play their role in ensuring Parliament's statutory instructions are observed.

Optimising the new regime - further checks and balances. There are other rulemaking disciplines that should also be imposed by statute. Such provisions would be useful for the courts, and would also provide a further benchmark for Parliamentary oversight, exercised through the Treasury Select Committee[56] or some other, new, Parliamentary committee.

First, a new statutory requirement should be introduced for the regulators, obliging them, when exercising their powers, to bear in mind the objective of facilitating the UK's competitiveness. In the recent Queen's Speech the government has said this would be done, by way of an amendment to the

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[56] This committee proposes to review new regulatory proposals through a newly-established sub-committee: see fn 51 above.

regulators' objectives to prioritise growth and international competitiveness.[57] This change would encourage the regulators to take a more liberal approach where possible and not to make rules unnecessarily. The new requirement will be couched as being secondary to those objectives, already prescribed for the regulators, which aim to ensure the safety and soundness of the financial system.

Secondly, cost benefit analyses and consultations are already required for regulatory rulemaking, but should also be made subject to clear judicial processes, along US lines, allowing for challenge as to whether appropriate procedures have been correctly followed. Statutory provisions could allow the courts to be appealed to by those wishing to challenge the application of those processes. The courts, when invoked, could be asked to determine whether a cost-benefit analysis was properly constructed; and whether consultation responses were properly considered. [58]

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[57] The amendment is envisaged to be contained in the forthcoming Financial Services and Markets Bill. See also the *Financial Services Future Regulatory Framework Review*, fn 1 above, paras 3.16 – 3.20.

[58] Further discussion of some of the issues covered in this Chapter is to be found in Chapter 4 of *Restoring UK Law*, fn 9 above.

IV
Reinforcing the New System – Changing Policy and Culture

Finally, in order for the system as a whole to be at its most efficient, there must be certain changes in practices. The government, particularly the Treasury, needs to adapt its approach, buttressing the new regime. In addition, firms themselves will need to make changes to how they operate, to gain the full benefits of the new system.

Tackling Treasury reluctance: tone from the top - greater ambition

The Treasury has started to engage on a review of the current inherited EU regime, before the rules are devolved to our regulators. The Hill Review of Prospectuses and the Wholesale Markets Review of MiFID II are being followed, including by steps taken to liberalise the treatment of insurers' risk margin arising from the inherited Solvency II regime. Various more minor changes have also been made. This is certainly a start. However, the Treasury has indicated that it does not envisage the regulators making rapid changes once the inherited EU provisions form part of their rulebooks,[59] despite the fact that the Treasury and our regulators were advised by the industry of concerns over many of the rules when the EU was consulting on those. Officials cite comments from leaders of many of the larger financial firms that significant changes are unnecessary, perhaps by reason of their sunk costs of complying with the existing regime. It is interesting that many of those same firms are engaged in discussions with legislators and regulators in various emerging markets over the optimisation of local regulatory regimes, during which the firms are encouraged to come up with ideas for adjustment to enable those markets to attract more of the firms' business.

Part of the reason for the sluggish approach and confused messages is perhaps the imprecise nature of the discussion. There is no precedent for exactly how the UK's new regime would apply, and therefore no reference point for businesses to consider. There is also a general wariness of official intentions as a result of what is perceived to have been a highly politicised overreaction to

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[59] E.g. Financial Services Future Regulatory Framework Review, fn 1 above, paras 18 and 19.

the 2007-8 financial crisis, which pinned the blame almost entirely on the financial industry. This has left many firms reluctant to express views on regulation to leading regulators, such as those of the UK. Furthermore, a false trade-off is sometimes raised, between more rules and greater legal certainty, as against fewer rules and less certainty. The industry would benefit of course from fewer rules but greater legal certainty, yet the asserted trade-off implies that such an outcome is thought to be unachievable by some of those operating the system. The common law method shows that simple principles and rules, properly used, can operate to provide clarity and predictability, even for complex areas such as consumer protection. This is achievable in the regulatory context, as demonstrated by the Consumer Credit Act 1974, which was a masterpiece of drafting, and indicates that the point is not limited to case law, but can be applied to statutory provisions or regulatory rulemaking.

As a further drag on change, it is sometimes said that, were the UK's regime to be different from that in the EU and elsewhere, this could prove problematic for cross-border business. This is despite the fact that the main changes required are largely ones of legal method, not regulatory policy, and the UK's desired system would operate with higher standards and fewer rules. There is no valid reason for such a problem to arise.

Although the government's role in regulation will be reduced under the new scheme, it will still play an important part in determining framework legislation, and in ensuring the system as a whole is ambitiously calibrated. The Treasury is proposing to give itself the power to drive the regulators in their design of the rulebooks.[60] This will pose further dangers to the proper adoption of the traditional UK methods. Changes are needed. The government should be more ambitious in declaring its commitment to change and reform. Firms should have the confidence to develop their businesses under the law, encouraging their own legal departments to design risk and operational procedures and seek legal

60 *Financial Services Future Regulatory Framework Review*, fn 1 above, paras 20-22. This is on some levels a surprising policy choice because the Treasury itself cites IMF evidence that governmental interference with regulatory standard-setting is likely to deliver less predictable and stable regulatory approaches over time: see para 5 of *Financial Services Future Regulatory Framework Review*, fn 1 above, para 5.

advice if necessary, and the courts should be helped to facilitate challenges to the regulatory regime.

The Government also needs to be more ambitious than it currently is in supporting the regulators in reforming inherited EU rules and shifting to the UK's new system. It should be recognised that this process will require a greater degree of control than currently envisaged.

Encouraging cultural change in financial firms – capturing the benefits of the UK system

The new approach will allow firms to operate more independently within a more predictable legal and regulatory system. To do so, they will need to operate confidently under the law and regulation, bringing to bear legal advice where necessary. If they remain in doubt as to what is required, they can engage constructively with the regulators on the basis of legal reasoning; if they wish to challenge the decisions of the regulator they can go to court. The regime will permit them to operate differently, saving expense and with greater levels of innovation and entrepreneurialism.

Particularly since the financial crisis of 2007-8, many firms have created huge departments for compliance and risk. The role of in-house legal has been reduced, both in a regulatory context and more generally. Interactions with the regulators are often handled by compliance officers who are not practising lawyers, using reasoning that is non-legal and based on the notion of a regulatory relationship. Government affairs personnel deal with interactions with the government and regulators on legal and regulatory reforms. Significant, expensive and mechanical compliance processes have been introduced which, instead of starting with what the law and regulation requires, are standardised and often ill-tailored to what the laws and regulations seek to prevent and what they entail. A precautionary approach prevails for firms' compliance efforts, in part because of uncertainties as to what the regulators might determine they want with the benefit of hindsight. The result is inefficient and wasteful, and means that financial firms are at a disadvantage in competing with those operating outside or at the margins of the regulatory arena. The regulatory perimeter ensures that those acting within it compete on a level playing field, but if the legal and regulatory techniques used within the arena are inferior to those used by those outside it, then firms are operating at an unnecessary disadvantage. This is particularly noticeable when financial firms compete with private equity funds and financial technology businesses. Such businesses take full advantage of the predictability of the common law.

In the US, the problem of maintaining strong relationships with the regulators is also seen as significant, manifesting itself to some degree in an over-emphasis on acceding to regulatory expectations, which can drive undesirable behaviour and outcomes. However, firms there are more willing to challenge their regulators and so the phenomenon is less marked. In the US firms are, at least in certain respects, able to be more legalistic in their methods, sometimes engaging in litigation with the regulators (particularly the Securities and Exchange Commission). As a result, to some extent, they are able to operate with greater clarity as to what is and is not permitted. This allows for more focused and thoughtful compliance efforts, even though the US system is not without its problems. In the UK, challenge to the regulators is rare, in part because of the difficulties for firms in questioning their regulators in open court when the court is not automatically or readily involved in regulatory processes (unlike the position in various contexts in the US); and in part because of the perception that because of the absence of sufficient third party (i.e., judicial) oversight, any disagreement with the regulators under our system, even when substantiated, would be unprotected and could have negative consequences for businesses.

Under the UK's new approach, firms will need to adjust their own internal cultures so as to be more law-based. There will also need to be a fresh approach by financial firms, capturing the benefits of the UK system.

The role of the legal department. Firms should give their legal departments a greater role in designing risk and compliance processes, in liaising with and if necessary challenging the regulators (and government), and in assisting with overall strategy. This will allow firms to benefit from the natural efficiencies and avoidance of unnecessary bureaucracy that the UK's common law method provides. This can be achieved in part by:

- a rebalancing of reporting lines, perhaps considering the placement of the compliance department under the overall charge of the General Counsel;
- embedding lawyers more in the design of compliance processes; and
- using the skills of lawyers in interacting with the regulators (and government).

Using lawyers to innovate under the law. The legal department and outside counsel should also be able to help innovate, under the law, by identifying possible new business models, services and products.

V
Recommendations

One of the central aims of the law and regulation in financial services is the prevention of systemic risk, a risk the market is unable to remove. It is for that reason that the new regime should be kept under constant review, to ensure that statutes, statutory instruments and regulator rules properly address this risk. It should be a matter of government policy that the Treasury and the Bank of England, drawing on its Financial Policy Committee, should track developments with a view to measures being taken to prevent systemic risk as a matter of vital national importance. Often, this objective is lost from sight.

Such an arrangement should not be confused with the freedom that individuals and businesses enjoy under UK law to pursue their goals in an entrepreneurial manner, with freedom to fail as well as succeed.

To promote a manageable, clear and simple system, the following steps should now be taken.

I. NEW APPROACH TO FINANCIAL SERVICES LAW

Primary and secondary legislation

1. Primary legislation and statutory instruments should be reviewed as a matter of policy. The remaining statutory and statutory instrument provisions should be reviewed and redrafted to reflect the common law approach.

Interpretative approach – removing the EU approach as well as EU law

2. The EU’s purposive approach to interpretation as operated under EU (and civil) law should be ended, by amending the Interpretation Act 1978 and the regulators’ rules.

Consequences for individuals

3. Adjustment should be made, by statute, to the UK Senior Managers Regime to ensure that senior managers are held to a fair standard, which asks whether they acted with a reasonable and good faith assessment of the rules applicable to their firm as a matter of law, at a level of diligence appropriate to someone in their position. They should not be subject to liability that is coextensive with that of the firm for which they work. Such a change would bring the sector and the country more into line with the legal approach used elsewhere, including the US.

4. Consideration should be given to applying a similar regime to individual line regulators, whereby those responsible for decisions are identified in advance and, if there are significant or serial failures in applying a predictable and consistent new system, the managers in charge would be replaced.

II. REGULATORY ACCOUNTABILITY

Statutory discipline for supervision and enforcement

5. The regulators should be required by statute to supervise and enforce predictably in accordance with their rules, ensuring their decisions are consistent between firms which operate businesses of a similar size and scope.

6. Formal decisions by the regulators should include published reasons, with sufficient analysis to operate as precedents, illuminating the application of the relevant regulator rules. There should also be a greater use of guidance offered by the regulators, with examples.

The role of the courts[61]

7. An appeal process should be available, for a short (defined) time period after the regulators have made supervisory or enforcement decisions in relation to their rules, and clear, well-defined thresholds have been reached, such as the size of the fine or the nature of the alleged breach and/or proposed regulatory sanction in question, and/or the size of the firm or status of the individual, as follows:

   a. The firm or individual would apply to court, which would review the merits of the enforcement decision, including in particular:

      i. the meaning of the rule being invoked and confirming or rejecting the action in principle based on whether the conduct in question breached the rule, as properly interpreted in light of available guidance and precedent;

      ii. whether the enforcement penalty (such as a fine or the withdrawal or suspension of a licence or permission) is consistent with the regulator's objectives and with decisions in similar cases; and whether it is proportionate to other decisions (both in similar and dissimilar cases); and

      iii. the sanction imposed, by reference to the size, means and circumstances of the regulated party, and consistency with sanctions previously imposed.

   b. The firm or individual could also apply to court for a review of a significant supervisory decision on the basis of consistency and proportionality (point a. ii. above).

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61 Further discussion of these and other linked matters, such as the undesirable role of the Financial Services Ombudsman, is to be found in Chapters 3 and 4 of *Restoring UK Law*, fn 9 above. (For the Ombudsman, see pages 75-6.)

c. The regulator's penalty would be suspended from taking effect until the above processes have run their course, except in instances where doing so would pose a risk to the financial system.

d. The costs of appeal proceedings in instances in which the regulated firm or individual is successful should not fall on them, but instead regulatory fines could be used or an investment pot or insurance policy (from seed corn monies or premia arising from a portion of firms' fees going to the regulators) could be created from which their costs would be paid.

Facilitating disputes with the regulators over the most sensitive matters

8. The courts should consider the use of their power to permit proceedings to be held in private (partially or totally) where the consequences of regulatory breaches, for financial firms and individuals, are quasi-criminal or potentially career-ending in nature. This is not to cover up, but to ensure that firms are willing to test a rule which is important for the workings of the system.

III. REGULATORS' RULEBOOKS

Requiring the new approach

9. The regulators, the PRA and FCA should be obliged by statute to reflect the changed direction in their rulebooks, making clear and predictable rules under Parliamentary oversight.[62] They will also need to be reformed so that they can properly operate the new system, involving changes to personnel, training and modus operandi. We want leaner, more efficient, more effective regulation, with more streamlined rules. For this, we should encourage experienced market personnel, including lawyers, into the regulatory profession to rewrite the rules. They should

62 These rulebooks are made and published by our regulators under statutory powers set out in the Financial Services and Markets Act 2000.

have experience of running the sector and applying the rules, and knowing what the problems are and how industry rapidly changes. They may be persons returning to work after maternity or retirement, or wishing to take on different responsibilities. Rules would be laid before Parliament, in the manner of the US Congressional Review Act, allowing for veto within 60 Parliamentary days.[63]

Ending EU regulation - quickly

10. Reforming our regulatory method requires the removal of unnecessary EU-inherited rules and re-writing those which remain, where appropriate, on common law lines.

    a. Working parties. The PRA and FCA should set up working parties to revise existing regulations, with a deadline of 11 months for first tranche cuts (to make a significant difference), to come into operation by October 2023, with a deadline of a further 11 months for the remainder. In each case there would be two phases, with initial proposed headings and sub-headings produced within 4 months of the commencement of the period, and full drafting within 10 months, for select committee review in each case. The task would require the regulators to draw on imaginative people, some of whom could be drawn from the private sector, including the legal professions.

    b. Parliamentary oversight. A select committee, such as the European Scrutiny Committee (given its expertise in EU law), should oversee the process, ensuring it is sufficiently ambitious. This committee can call on independent experts to inform its assessment of what is being done. Another option might be a sub-committee of the Commons and Lords, which would apply a high-level review on a spot check basis, dipping into proposed drafting to ensure the desired approach is followed.

[63] See fn 54 above.

11. Arrangements should also be put in place to make sure our common law methods are followed by our regulators when making new rules in the future, as follows:

    a. Cost benefit analyses and consultations. The existing statutory processes for the making of rules by the regulators, requiring cost benefit analysis and consultations to be conducted, should be made subject to clear judicial processes, allowing challenge by firms and individuals as to whether appropriate procedures have been correctly followed.

    b. Parliamentary oversight. The Treasury Select Committee, which oversees our financial regulators,[64] or a designated sub-committee of this committee, comprising members from the Commons and the Lords,[65] should oversee the approach taken to the writing of rules, for which the (sub-)committee can call upon independent experts to provide advice and challenge.

[64] This committee now proposes to review new regulatory proposals through a newly-formed sub-committee: see fn 51 above.

[65] See fn 52 above.

Conclusion: The Benefits of Change

The benefits of change away from the EU inherited regulatory approach to a model based on our traditional methods are clear. Economic analysis and practical experience have demonstrated the superiority of our pragmatic common law approach.[66] It would be regrettable to emerge from the EU's inferior scheme, only to leave the bulk of the inherited EU rules in place for the sake of avoiding the effort and commitment required to make the necessary adjustments.

With the further changes proposed here – statutory instructions to the regulators, validated by Parliament, and the involvement of the courts – financial firms would quickly reap the benefits of an efficient regulatory system. In combination, these changes would release firms from the idea that their relationship with the regulators is crucial to their operations and, in so doing, should allow the UK to leapfrog the US in the efficiency of our regulatory system (since the US's methods have allowed for elements of regulatory relationship to prevail). Legal discipline would mean that firms could in most instances proceed with their own good faith interpretations of the relevant rules, without having constantly to stop and seek the buy-in of inherently cautious regulators. With legal advice they could tackle the more difficult judgments on their own.

None of this prevents the regulators from making whatever rules are needed provided that these are lawful, clear, and not a matter of a retrospective, opaque or idiosyncratic ruling. It does however put them to the necessary trouble of carefully and thoughtfully conceiving those rules in advance and then operating in accordance with those rules.

None of these proposals involves techniques that are entirely new. They are based on elements already present in our existing legal arrangements and find parallels in the other major common law jurisdiction which hosts a global financial market – the United States. The clues to our future success lie in our tried and tested legal traditions, which are built around prudent regulation and

[66] See fn. 13 above.

remedies for losses suffered, and whose entire construction recognises individual and commercial liberty. Unless we now apply these methods, boldly and in full, we will miss out on the opportunities in front of us.

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