The Taming of The Shrew: An Analysis of the UK Regulators' Code and the Effectiveness of Financial Regulation

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Abstract: The new Regulators' Code ("the Code") in the UK, published by the Better Regulation Delivery Office in April 2014, marks a movement towards reducing regulatory burdens in a bid to better support economic growth. It claims to provide a new flexible and principled framework to ensure regulators devise and enforce regulations that best suit the needs of the business and financial markets. This paper analyses the framework by evaluating the feasibility of its application and the implications that may arise. The paper makes recommendations on alternatives to present regulation, stressing the great need to engender a culture of ethics within the financial services industry. Such a culture should be pervasive amongst individuals and embedded within internal governance structures of firms and entities.

Introduction

The sphere of regulation relating to constraining undesirable behavior[1] of individuals and corporations has always undergone constant evolution. With the unprecedented growth of financial markets, these changes have become more revolutionary than evolutionary, where regulation has become an instrumental tool in exerting institutional control over what is an extremely volatile industry. The inception of the Regulators' Code ("the Code") is one such revolution, perhaps more so than previous regulatory instruments. Rather than imposing greater controls, the Code significantly subverts the function of regulation. Through an analysis of the Code's substantive content, this paper identifies a gap of enforcement between conventional regulation and the entities that it seeks to regulate. Such a gap in embodying issues may result in lackadaisical enforcement. However, this paper seeks to reconcile the gap by engaging in a theoretical discussion on the role of culture and ethics as "extra-contractual or extra-legal gap fillers"[2]. The way forward in constraining socially undesirable activities may be through a form of self-regulation within individuals and corporations. However, this paper does not seek to provide a foolproof solution. Rather, it aspires to provide an alternative perspective to

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[1] Marion Fourcade and Kieran Healy, 'Moral views of market society' (2007) 33 *Annu. Rev. Sociol.* 285-311

[2] Lisa Bernstein, 'Opting out of the legal system: Extralegal contractual relations in the diamond industry.' (1992) *The Journal of Legal Studies* 115-157

the discussion about the role of culture and ethics in financial regulation and to set a basis for more rigorous consideration.

Regulators' Code

Under the stipulations of procedure in section 23 of the UK's Legislative and Regulatory Reform Act 2006, the Regulators' Code ("the Code") came into statutory force on 6 April 2014. The Code replaces the previous Regulators' Compliance Code that first came into force on 6 April 2008.

The Code was published by the Better Regulation Delivery Office, an independent unit in the Department for Business, Innovation and Skills. It forms a vital part in the execution of new government policy concerned with reducing the impact of regulation on business.[3] This policy is integral in fulfilling the Coalition Agreement ("the Agreement") as published in 2010. The Agreement asserts that 'red tape' would be cut for businesses and individuals and that there would be less reliance on rules and regulations.[4] As such, some regulations that perceivably restrict economic growth have been deemed ineffective and superfluous. The Code is thought to be a step forward towards greater flexibility and in turn, efficiency.

In his attached foreword, UK Minister of State for Business and Enterprise, Michael Fallon asserts the Code does not deviate from "core purposes" to regulate for "the protection of the vulnerable, the environment, social or other objectives".[5] Rather, the Code seeks to clarify provisions contained in the previous Regulators' Compliance Code so that "regulators and those they regulate will have a clear understanding of the services"[6] in order for regulated entities to have "greater confidence to invest and grow".[7] This is compatible with the increasing number of reviews conducted to gather the views of regulated entities on how enforcement of regulations may be improved. These series of reviews are called 'Focus on enforcement'. In addition a 'Red Tape Challenge'[8] was issued. This initiative sought the input of regulated entities (some of which are now no longer regulated) and the public on which regulations they thought could be removed or improved. The

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[3] Department for Business, Innovation and Skills and the Rt Hon Michael Fallon MP, 'Policy: reducing the impace of regulation on business' <https://www.gov.uk/government/policies/reducing-the-impact-of-regulation-on-business> accessed June 5, 2014

[4] HM Government, 'The Coalition: our programme for government' (*Coalition Agreement)* <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/78977/coalition_programme_for_government.pdf> last accessed June 24, 2014

[5] Regulators' Code 2014

[6] ibid.

[7] ibid.

[8] Cabinet Office and HM Government, 'Red Tape Challenge' <http://www.redtapechallenge.cabinetoffice.gov.uk/home/index/> last accessed June 24, 2014

results of this challenge, as of 27 January 2014, produced a list of over 3000 regulations that are being scrapped or improved.[9] These reforms are said to provide over £850 million of annual savings to businesses and other regulated entities. To this, Prime Minister David Cameron proudly stated that this was "the first government in modern history to have reduced – rather than increased – domestic business regulation during our time in office".[10]

Indeed the political significance of the Code in the context of other related initiatives is undeniable. In view of the local elections held in May 2014, drastic 'improvements' in regulation and enforcement were politically beneficial. In addition to the significant change in the substantive content of regulation, the timing of such changes is also noteworthy. The Code came into statutory force just days after the Financial Conduct Authority (FCA) controversially announced its investigation into 30 million policies relating to "zombie funds" sold between the 1970s and 2000s. As the Code covers a significant number of regulators, its arrival throws regulators' weight of authority into question. The Code, supported by the Legislative and Regulatory Reform (Regulatory Functions) Order 2007, limits the reach of significant regulators like the FCA, the Prudential Regulation Authority (PRA), the Competition and Markets Authority (CMA) and even the HM Revenue & Customs (HMRC) body in relation to its anti-money laundering functions.

Content of the Code and its Implications

The Nature and Scope of Responsibility on Regulators

While the encompassing reach of the Code may be attributed to supporting legislation and statutory instruments, for example the Legislative and Regulatory Reform Act 2006 ("the Act"), the language employed in the Code furthers the extensive obligation imposed onto regulators. At first blush, the compact nature of the Code consisting of only 6 principles suggests a straightforward and simplistic amendment to the law. However, upon further reading, the vagueness of language reveals a more sophisticated method of exerting a larger degree of social control[11].

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[9] Cabinet Office and HM Government, 'Challenge Results' http://www.redtapechallenge.cabinetoffice.gov.uk/themehome/red-tape-challenge-results/ last accessed June 24, 2014

[10] Cabinet Office and HM Government, 'Prime Minister announces government exceeds its target to identify 3,000 regulations to be amended or scrapped' http://www.redtapechallenge.cabinetoffice.gov.uk/themehome/pm-speech-2/ last accessed June 24, 2014

[11] George C Christie, 'Vagueness and legal language.' (1963) 48 *Minn. L. Rev.* 885

The unequivocal obligation imposed by the Code is set out explicitly in its introductory note, where it states that:

> *Regulators whose functions are specified by order under section 24(2) of the Act **must** have regard to the Code when developing policies and operational procedures that guide their regulatory activities*[12]

This binding obligation places an onerous burden on regulators, particularly with the incorporation of Principle 1. Principle 1 states that:

> *1. Regulators should carry out their activities in a way that supports those they regulate to comply and grow*

The Code goes further to explain in detail how this may be done:

> *1.2 When designing and reviewing policies, operational procedures and practices, regulators should consider how they might support or enable economic growth for compliant businesses and other regulated entities, for example, by considering how they can best:*
>
> - *Understand and minimize negative economic impacts of their regulatory activities;*
> - *Minimizing the costs of compliance for those they regulate;*
> - *Improve confidence in compliance for those they regulate, by providing greater certainty; and*
> - *Encourage and promote compliance.*

Given the high modality of the Code, regulators are statutorily obligated to devise policies and conduct procedures that minimize negative economic impact and cost for regulated entities. This is a high and potentially subjective threshold that would curtail the means of intervention significantly. Regulators whose operational procedures and policies that are not perceivably 'minimal' may be subject to judicial review. This is encouraged by Fallon, who states explicitly that with the passing of the Code, regulated entities will be better able to "challenge" such policies and procedures should they feel that these principles are "not being fulfilled".[13]

However, the cracks of imposing such limitations on the reach of regulators are already showing through. On 11 July 2014, the PRA and FCA

[12] Regulators' Code 2014
[13] Regulators' Code 2014

announced a review of 'Maxwellisation'[14] of former top directors at HBOS plc.[15] Crucially, Andrew Green QC, a senior barrister, was consulted as to whether prohibition proceedings should be brought against any of the former directors as part of the review. To Andrew Tyrie, the chair of the Select Committee for the Treasury, this was a "considerable step forward".[16] However, such measures may lead to an excessively tedious process of regulation that will inhibit the effectiveness and efficiency of regulators drastically. On a theoretical level, this throws the constitutional principle of a separation of powers into question. Power held by regulatory authorities may be increasingly conferred to the already progressively robust judiciary. More importantly, on a practical level, government authorities may be better placed to evaluate immediate needs and conditions given the specific knowledge and expertise that many of these regulators have.

Still, the ease in which regulated entities would now be able to circumvent and 'defend' themselves, most likely through the reliance on judicial review on such un-established terms of the Code, calls for concern. As it is, present governance arrangements within financial institutions give primacy to the financial interests of shareholders[17]. The limited scopes of power regulators are entitled to will only serve to create a larger incentive to reward behavior that may be "socially suboptimal".[18]

Indeed, it is not feasible and perhaps, impossible, for laws and regulations to fully encapsulate all realities and "potential future states of the world".[19] Even where it is possible, it would be extremely costly in reconciling between what legislation and regulation says and what its drafters intended and/or would have wanted it to say.[20] However, the onus should be on aforementioned drafters to minimize this incongruity where possible. As it is, legal rules are often over- or under-inclusive.[21] This is particularly jarring

[14] Maxwellisation is a procedure in British governing structures where individuals due to be criticized in official reports are sent details of the criticism beforehand and are permitted to respond to criticism prior to publication. See Philip Sales, 'Accountability of Government via Public Inquiries' (2004) 9 Jud. Rev. 173

[15] Bank of England, 'News Release – FCA and PRA publish detailed Terms of Reference for the HBOS Review' <http://www.bankofengland.co.uk/publications/Pages/news/2014/100.aspx> last accessed July 11, 2014

[16] Sam Fleming, 'UK regulators pledge to publsh HBOS review' <http://www.ft.com/cms/s/0/02e2bab6-0915-11e4-906e-00144feab7de.html#axzz37EMmrIcL> last accessed July 11, 2014

[17] Sofie Cools, 'The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers' (2005) 30 *Del. J. Corp. L.* 697

[18] Fourcade and Healy (n 1) 291

[19] Dan Awrey, 'Regulating Financial Innovation: A More Principles-Based Proposal' (2010) 5 *Brook. J. Corp. Fin. & Com. L.* 273

[20] ibid., 277

[21] ibid., 292

in the drafting of the Code. The pervasive use of intangibles such as “standards”, “approach” and “engage” that make up the legal vocabulary of the document results in an over-inclusive burden of compliance on regulators. This is further aggravated by the lack of a definition, or at least a reference as to what may be considered as ‘economic impact’. Simultaneously, the Code is under-inclusive to the extent that there is a lack of specificity in how these regulators may carry out the implementation of such “standards” and “approach”. These gaps may provide occasions for creative compliance and regulatory arbitrage by actors whose incentives are not aligned with regulatory goals. [22]

The Focus on the Communication of Information

Much of the Code is also spent attempting to reconcile the inherent asymmetry of information that pervades markets. Principles 2, 4, 5 and 6, as elucidated below, all deal with effective communication on the part of regulators.

> *2. Regulators should provide simple and straightforward ways to engage with those they regulate and hear their views*
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> *4. Regulators should share information about compliance and risk*
>
> *5. Regulators should ensure clear information, guidance and advice is available to help those they regulate meet their responsibilities to comply*
>
> *6. Regulators should ensure that their approach to their regulatory activities is transparent*

However, much of its focus is on the dichotomy of information between regulators and those who are regulated, which while important, overlooks the more pervasive issue of the lack of information faced by participants in modern markets. This is especially crucial for financial markets, where the nature, complexity and potential returns in such markets overwhelm the incentives for participants to distill and trade on new information[23].

This is not to say that the transmission of information between regulated entities and participants completely unregulated. For example, the Dodd-

[22] Doreen McBarnet ‘After Enron will ‘whiter than white collar crime’ still wash?’ (2006) 46, No. 6 *British Journal of Criminology* 1091-1109

[23] Robert P. Bartlett III ‘Inefficiencies in the information thicket: A case study of derivative disclosures during the financial crisis.’ (2010) 36 *J. Corp. L.* 1

Frank Act enacted in the US mandates disclosure in an effort to level the playing field with regards to access of information.[24] Given the internationalization of financial markets, such legislation will have and has had an effect on UK companies, whether or not their securities are listed on a US stock exchange. However, such impacts arise not out of legal obligation but because of the great reliance these companies have on the US market as a financing tool. This makes regulation on the part of regulators exceedingly difficult. Regulators find themselves wedged within a conflict of jurisdiction. Regulators, while having their authority curtailed within the UK jurisdiction, are faced with businesses and other "regulated" entities whose internal governance structures are in tandem with that of the US jurisdiction.

The UK equivalents, the Financial Services and Markets Act 2000[25] ("the 2000 Act") and its supporting Financial Services Act 2012[26], are considerably less robust. Legislation on the provision and bars relating to information are less specific and relate primarily to general actors as opposed to specific agents or sectors of financial markets. For example, the Dodd-Frank Act specifically provides for disclosures by credit rating agencies in relation to credit ratings by authorizing SEC rules requiring filings containing information on the assumptions prevalent in credit rating methodology and data to ascertain the credit rating. In contrast, the 2000 Act grants power to call for information to any "competent authority", where such authority may be:

> *Section 89H (2)*
>
> *(a) an issuer in respect of whom transparency rules have effect;*
> *(b) a voteholder;*
> *(c) an auditor of –*
> *(i) an issuer to whom this section applies, or*
> *(ii) a voteholder:*
> *(d) a person who controls a voteholder;*
> *(e) a person controlled by a voteholder;*
> *(f) a director or other similar officer of an issuer to whom this section applies;*
> *(g) a director or other similar officer of a voteholder or, where the affairs of a voteholder are managed by its members, a member of the voteholder.*[27]

[24] Peter King and Heath Tarbert, 'The Dodd-Frank Act: the UK perspective' FINANCIAL TIMES (London) <http://uk.practicallaw.com/5-503-1541?service=finance#> last accessed July 5, 2014
[25] Financial Services and Markets Act 2000
[26] Financial Services Act 2012
[27] Financial Services and Markets Act 2000 section 89H

The juxtaposition in the substantive and conversely procedural material of regulation naturally attributes to the fact that two separate jurisdictions would have different discourse and drafting methods. However, given the convergence of global economic and financial markets towards the US model, it would be expected that corresponding regulation should follow. Yet, rather than stressing the importance of regulators in the constantly changing markets, the Code suggests an inversed responsibility, forcing regulators to defer to the economic efficiency even where it may be clear that there are undesirable repercussions.

Inherent Limitations

It is largely acknowledged, both in public choice and in regulatory capture theory that the law may be shaped by compelling vested interests. These interests are typically economic and political, with little or no regard for greater social welfare.[28] The Code is evidence of this, where the social significance of the need for regulation has taken a backseat.

In itself, the law and other codified regulation is a crude instrument. The overly encompassing language of the Code demonstrates that the law may not be suited for and cannot regulate all activities, let alone the complex nature of financial services. However, at the same time, specificity in regulation may also be as ineffective. Many activities cannot be reduced to simple, straightforward rules.[29] John Boatright gives the example that a law against conflicts of interest would be impossible to draft given that such conflicts are only 'illegal' when they relate to the violation of fiduciary duty or constitute fraud.[30] The implementation of the Basel standards are also an example of how codified standards often fail to embody financial processes to a degree that would ensure the effectiveness of external regulation. The inflexible reliance on risk weightings embedded in the Basel II framework proved to provide numerous loopholes for financial institutions using structured finance techniques and internal risk models. While Basel III allowed for greater flexibility, banks are still able to rely on their own subjective models in assessing the quality of assets.[31] Even with the most extensive or most stringent of conventional regulation, opportunities for arbitrage are still prevalent and will continue to arise with the development of technology and financial markets.

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[28] George J Stigler, 'The theory of economic regulation' (1971) *The Bell journal of economics and management science* 3-21
[29] John R. Boatright, *Ethics in Finance* (Vol. 1, John Wiley & Sons, 2013)
[30] ibid., 8
[31] Brooke Masters, Patrick Jenkins and Miles Johnson, 'Fears Rise Over Banks' Capital Tinkering', FINANCIAL TIMES (London) http://www.ft.com/cms/s/0/fb64c08a-0b93-11e1-9a61-00144feabdc0.html#axzz37KOSFanF last accessed June 15, 2014

Regulation can thus, only be effective when regulated entities not only obey the letter of the rules but also adhere by the 'spirit' behind those rules.[32] Regulations like the Code can thus be said to be inherently contradictory, where the 'spirit' behind the drafting of the regulation is in conflict with the 'spirit' of regulation in itself. Paul Volcker, former chairman of the Federal Reserve and the Economic Recovery Advisory Board, in proposing the "Volcker Rule" opines that this is largely because regulation typically attempts to merely dictate how market participants act. Rather, it is of greater importance that the way in which people think when they act is influenced.[33] Yet, the established approach to regulation overlooks such a formation of cultural norms and neglects to situate market participants' decisions within a larger framework of personal ethics. Hence, there is a need to develop a culture of ethics as a means of conditioning and self-regulating behavior.

Recommendations

Ethics and Finance Theory

Incorporating the notions of culture and ethics into the realm of financial regulation is often met with much skepticism. Intangible concepts like culture and ethics is often seen to be at odds with the empirical and heuristic associations that are typically made with the economy, business and financial markets.

However, Robert Ellickson provides a distilled framework for understanding these abstract concepts in the context of self-regulation in financial markets.[34] The framework makes a distinction between first, second and third-party behavioral constraints.[35] First party constraints are imposed by the actor him/herself. This would be what is typically understood as "personal ethics".[36] Second party constraints are imposed in the context of a "contract" where there is an arrangement for reward and punishment when a promise is made between parties.[37] Third party constraints are imposed and enforced by external actors, such as organisations or governments, or social

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[32] Boatright (n 30) 50
[33] Richard Clarida, Jordi Gali, and Mark Gertler, *Monetary Policy Rules and Macroeconomic Stability: Evidence and Some Theory* (No. W6442, National Bureau of Economic Research, 1998)
[34] Robert C. Ellickson, *Order without law: How neighbors settle disputes* (Harvard University Press, 2009)
[35] ibid., 126-27
[36] ibid., 126
[37] ibid.

conventions and norms.[38] Culture can thus be said to be a part of what would be construed as a 'third party constraint'.

In the context of self-regulation as an alternative to conventional financial regulation, an understanding of 'first party constraints' and 'third party constraints' would be most applicable. Through the cultivation of a sense of ethics within and around the individual on an implicit level, substantive norms that current regulation strives to communicate will be better conveyed and adhered to by actors.

What then are these ethical norms? Thomas Jones identifies this in the context of decision-making by individuals in organisations.[39] He explains that the moral dilemma faced when attempting to balance "economic desirability" and "social welfare" may be understood through a six-pronged approach:

1) the magnitude of the potential consequences;
2) the probability that consequences will occur;
3) the concentration of such consequences;
4) temporal immediacy;
5) social consensus and
6) proximity.

By distilling the ethical dimensions of such dilemmas, actors and decision makers are more likely to confront their decisions. Through a process of reframing elements of a moral problem, a technique often employed by theorists, actors and decisions makers are forced to engage in more thorough contemplation. Greater reflection is shown to impact cognitive processes greatly, which enhances ethical decision-making.[40] Cognitive processes can be split into two types: firstly, intuitive processes (decisions are made quickly and automatically) and secondly, controlled processes (decisions are slower and made with greater consideration).[41] Research suggests that moral judgments involving utilitarian and consequentialist theories take place predominantly within the second cognitive process.[42] Such an understanding

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[38] ibid., 127
[39] Thomas M. Jones, 'Ethical decision making by individuals in organizations: An issue-contingent model' (1991) 16 No. 2 *Academy of Management Review* 366-395
[40] Brian C. Gunia, Long Wang, Li Huang, Jiunwen Wang, and J. Keith Murnighan, 'Contemplation and Conversation: Subtle influences on Moral Decision Making' (2012) 55, No. 1 *Academy of Management Journal* 13-33;
[41] Shane Frederick 'Cognitive reflection and Decision Making' (2005) *Journal of Economic Perspectives* 25-42; Keith E. Stanovich, '*Who is Rational?: Studies of individual differences in reasoning*' (Psychology Press, 1999)
[42] Joshua D. Greene, Leigh E. Nystrom, Andrew D. Engell, John M. Darley, and Jonathan D. Cohen, 'The Neural Bases of Cognitive Conflict and Control in Moral Judgment' (2004) 44 No. 2 *Neuron* 389-400

towards decision-making is significant, particularly in the financial markets, where quick thinking and immediacy in decisions is valued and have become synonymous with efficiency.

Further to this, researchers found that actors and decision-makers engaged in a discussion were also more likely to make morally motivated decisions.[43] Amitai Etzioni suggests that conversation can be employed to highlight ethical dimensions of problems.[44] Applying economist Uri Gneezy's "deception game"[45], a study was conducted where a group of participants, amidst other groups, were asked to exchange an email with a stranger who faced the same moral decision with a different counterpart.[46] Despite this "truly minimal moral conversation"[47], it was found that discussion invoked the second strain of cognitive processes. By enhancing the role of ethical discussion in group decision-making processes, internal firm structures may prove to be a better arena for the cultivation of ethical and cultural norms. Of course, if such discussions were centered on self-interest, the effects would be converse. Thus, it is important that a culture of first party and third-party constraints are developed concurrently, given their symbiotic relationship. If this is achieved, self-regulation, in terms of formation and enforcement, within individuals and the structures of corporations holds greater promise than the external imposition of such norms through conventional regulation.

Conclusion

In light of the greater interconnectedness of markets, financial markets and the entities that operate within it have become increasingly unpredictable. Minor changes in markets can manifest into potential dangers that could have staggering effects on its entities. This inherent imbalance between cause and effect[48] results in the need for regulation to be "adaptable" to the changing financial and economic landscape and its corresponding changes in political motivations. As such, conventional regulation has become increasingly ineffectual as a legitimate means for constraining socially undesirable behavior. Hence, there is a great need to engender a culture of ethics within the financial services industry. Such a culture should be

[43] Gunia et al (n 40) 24
[44] Amitai Etzioni, *Moral Dimension: Toward a New Economics* (Simon and Schuster, 2010)
[45] Uri Gneezy, 'Deception: The Role of Consequences' (2005) *American Economic Review* 384-394
[46] Brian C. Gunia, Long Wang, Li Huang, Jiunwen Wang, and J. Keith Murnighan, 'How to Make People Choose Right Over Wrong' FORBES < http://www.forbes.com/2011/06/16/make-people-choose-right-over-wrong.html> last accessed July 6, 2014
[47] ibid.
[48] Judea Pearl, *Causality: models, reasoning and inference*, (Vol. 29, Cambridge: MIT Press, 2000)

pervasive amongst individuals and embedded within internal governance structures of firms and entities. This would encourage a greater propensity towards self-regulation. This form of regulation may be more effective, reaping greater benefits than conventional regulation in the long term. Yet, such reform is still contingent on political recognition and public support. The support of financial leaders is also crucial. Put succinctly, the parameters of reform have already been established. However, it is up to the actors and decision-makers to the take the step forward to commit to cultivating within themselves and amongst others a culture of ethics.

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