



**ACCA**

**financial  
services review**

**n**

A MAGAZINE FOR MEMBERS OF THE  
ACCA UK FINANCIAL SERVICES NETWORK  
MARCH 2008

# more principles- based regulation

The FSA's principles-based approach to regulation brings challenges and opportunities in equal measure

# more principles-based regulation

The FSA's principles-based approach to regulation brings challenges and opportunities in equal measure, as Paul Grainger explains.

■ **More Principles-Based Regulation was launched by the Financial Services Authority with great fanfare in April 2007. MPBR as it is often known signals a shift away from prescriptive rules towards an outcomes-based approach to regulation.**

The MPBR initiative is not new. My colleague, David Jackman, must take the credit for starting this particular ball rolling in October 2002, when as head of ethics and industry training at the FSA, he issued Discussion Paper 18 entitled 'An Ethical Framework for Financial Services'. In DP18, David set out a vision that suggested there might be a different approach to regulation based upon ethical values. He stated "In summary, reputation is the key to the business case for ethics, and reputation of the sector and the firms within it is important to all of us. We threaten no 'stick' as such, but we would emphasise a significant 'carrot'; good, ethical behaviour can also be a competitive advantage, and, in time, a way to lighter regulation."

The implication was clear: adoption of an ethics-based approach had the potential to deliver lighter touch regulation, whilst not diminishing the regulatory protection offered to customers.

Latterly, the FSA has also recognised that very prescriptive regulation did not prevent a whole series of regulatory reviews as a result

of inappropriate advice or mis-selling of packaged products. It was the customer who was disadvantaged, but in many instances the costs of the reviews were often perceived to be disproportionate for many firms. There was a sense that the FSA was so busy maintaining its vast rules framework that it was missing the real issues faced by customers. The FSA booklet *Principles-based Regulation – focusing on the outcomes that matter* states "Past experience suggests to us that prescriptive standards have been unable to prevent misconduct. The ever-expanding rulebooks of our predecessor

'adoption of an ethics-based approach had the potential to deliver lighter touch regulation, whilst not diminishing the regulatory protection offered to customers.'

bodies and our consolidated Handbook, designed to prevent misdemeanour, have not stopped further mis-selling, market misconduct or other detriment. Instead we believe that detailed rules have become an increasing burden on our own and the industry's resources."

The conclusion is clear – the system had to be changed. The question then arises as to what the new framework will look like.

## the FSA principles

There are 11 FSA Principles for Business. The principles have the status of rules and have been used by the FSA for a year or more to enforce compliance or to provide evidence in enforcement cases.

The 11 FSA Principles are:

1. **Integrity**  
A firm must conduct its business with integrity
2. **Skill, care and diligence**  
A firm must conduct its business with due skill, care and diligence
3. **Management and control**  
A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems
4. **Financial prudence**  
A firm must maintain adequate financial resources
5. **Market conduct**  
A firm must observe proper standards of market conduct
6. **Customers' interests**  
A firm must pay due regard to the interests of its customers and treat them fairly
7. **Communications with clients**  
A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading
8. **Conflicts of interest**  
A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client
9. **Customers: relationships of trust**  
A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment
10. **Clients' assets**  
A firm must arrange adequate protection for clients' assets when it is responsible for them
11. **Relations with regulators**  
A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm, for which the FSA would expect prompt notice.

---

These 11 statements of principle are generally used by the FSA to set the framework for principles-based regulation.

**what is principles-based regulation?**

The best definition of principles-based regulation comes from the FSA "Principles-based regulation means placing greater reliance on principles and outcome-focused, high level rules as a means to drive at the regulatory aims we want to achieve, and less reliance on prescriptive rules."

The FSA is at pains, however, to explain it does not mean an end to detailed rules. There are some aspects of regulation that will require detailed rules, such as in the setting of minimum financial resources requirements or some aspects of conduct of business. Additionally, there are certain aspects of regulation that must be adopted because of overriding obligations, such as those arising from European Union directives.

We do, however, have some experience of principles-based regulation in practice. Since 2004, we have experienced the roll-out of the FSA Treating Customers Fairly (TCF) initiative. This is a direct attempt by the FSA to invoke FSA Principle 6 as an overarching rule and to set a framework for behaviour by firms and their staff in the conduct of investment business.

The FSA has always made it clear that it considers a breach of any of its 11 principles to be a breach of a rule. It is therefore not surprising that in promoting its TCF initiative the FSA states that in fast-changing markets, principles are far more durable than detailed rules that may rapidly become out of date.

**outcomes focus**

In explaining the move to principles-based regulation, the FSA has also stressed its interest in shifting the emphasis away from an audit-based approach or detailed prescriptive rules and processes, towards



## more principles-based regulation (continued)

judging outcomes. This is not as simple as it sounds. In judging the outcome, it may well be necessary for a firm to have demonstrated compliance with some detailed and prescriptive rules. This is the case with certain aspects of compliance with the Markets in Financial Instruments Directive (MiFID), the Capital Requirements Directive (CRD) and the Insurance Mediation Directive (IMD), to name but three examples.

The focus on outcomes can best be illustrated by the FSA's relatively recent practice of citing breaches of a principle when bringing enforcement action against firms. In doing so the FSA describes the outcome expected and how it was not achieved or alternatively explains how what took place failed to meet the outcome expected under the principles. Firms are now being judged on the basis of demonstrated behaviour rather than an audit of a prescriptive process. This brings advantages and disadvantages.

#### certainty versus pragmatism

There are elements of prescription that must remain in the FSA rulebook, in relation to MiFID and the CRD amongst others. However, the FSA has made severe cuts in the details and length of its rules, especially in relation to Conduct of Business (COBS) and Training and Competence (TC). In other areas, for example the Senior Management Systems and Controls rules (SYSC), there is a re-emphasis on senior management accountability and more detail on what is expected.

For many firms the transition from the previous prescriptive regime is an uncomfortable experience. The relative certainties of the highly prescriptive rules that existed until 1 November 2007 have been replaced with much less prescription about how a firm should behave.

However, there is a corresponding opportunity for firms brave enough and sufficiently well prepared to take advantage of the lack of prescription to define the

customer experience and outcome, to measure and monitor it and to gather the evidence that the outcome is consistent with the FSA principles.

It is also an opportunity for firms to be innovative and to set competitive standards in terms of the conduct of their business. It remains to be seen how many firms take advantage of it.

#### senior management responsibility

One constraint appears to be the lack of awareness or preparedness of senior

*'Principles-based regulation means placing greater reliance on principles and outcome-focused, high level rules as a means to drive at the regulatory aims we want to achieve, and less reliance on prescriptive rules.'*

managers and compliance officers. Many are either unaware of the scale of change that has occurred or, where they are aware, have struggled to capitalise on the opportunities available.

The TCF initiative has illustrated this dilemma. Many firms have attempted to implement TCF on the basis of it being something they have 'done' rather than being a continuing process of improvement. Many firms have not grasped the nettle of defining what a good customer experience looks like, ensuring all staff know and understand it and defining measurements for qualitative and quantitative aspects. It goes without saying that should a firm get that far it then needs to monitor the outcomes as well.

This lack of apparent commitment to implementing TCF is often not born of an unwillingness to buy into the principle behind it, but from a lack of comfort and experience

in moving out beyond the relative certainties of the previously more prescriptive regime. Senior managers are often poorly equipped for the new principles-based regime and their main source of advice and guidance, the compliance officer, may also be stuck in a 'time warp', harking back to the certainties of an audit-based approach to regulation.

Where a firm, its compliance officer and its senior managers are properly prepared for the new regime, there is evidence that they can gain competitive advantage – and, potentially, a regulatory dividend – as a result.

#### the regulatory dividend

It is perhaps worth focusing for a moment on what the regulatory dividend might be. As David Jackman wrote back in 2002, the success of an ethics or principles-based approach to behaviour and regulation may well result in a lighter regulatory touch. We might expect this to equate to less frequent reporting to the FSA, less detailed reporting and fewer visits to firms.

However, with modern risk-based regulatory techniques, the FSA can target those firms that are deemed to pose the greatest regulatory risks, and devote less time and fewer resources to those that embrace the new regime. This is the so-called regulatory dividend.

It appears that there is no way back from the principles-based regime. It is here to stay and the FSA has reiterated this on numerous occasions. It must therefore be in every firm's interest to ensure the firm, its senior managers, its compliance officer and its external advisor embrace principles-based regulation as rapidly as possible, and take the opportunity to benefit from the regulatory dividend. ■

Paul Grainger – Managing Director,  
Institutional Division, Resources Compliance